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Making Bankruptcy Work for Consumers: Suggested Amendments to the Federal Bankruptcy Act

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Making Bankruptcy Work for Consumers:  
Suggested Amendments to the Bankruptcy Act

By

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AND

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I. INTRODUCTION

On October 2, 1975, in one of the most spectacular commercial failures in modern memory, W. T. Grant, Inc. declared bankruptcy.³ Public comment was focused on the plight of the thousands of employees who would be out of jobs,⁴ the potential

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loss that the store’s financing banks would suffer, and the battery of lawyers and accountants who would work for years to lay the company’s financial affairs to rest. In all of the fuss, however, there was little attention focused on the most innocent group affected by the bankruptcy: the consumer creditors. For the thousands who had made lay-away purchases from Grant in the weeks preceding the bankruptcy, for those who held “Grant’s cash” or merchandise certificates and had not converted them into goods prior to the bankruptcy, and for the uncounted number who had warranty claims arising out of purchases made at the store, the bankruptcy meant the probable loss of any possibility of recovery against the merchant. While the employees will be paid some of their past due wages, while the government will receive payment on any unpaid tax liability, while the major banks will, undoubtedly, receive at least partial payment on their loans, Grant’s customers will most likely not receive one cent. Even though they had dealt with the store in good faith, answering advertisements and shopping with the confidence the store’s well-founded reputation was meant to induce, these consumers will be innocent victims without a remedy under the Bankruptcy Act.

The Grant problem is not atypical. Each day hundreds of businesses file either “straight” bankruptcy or “arrangements” and their customers are thereby victimized. Commonly, a failing business tries to accelerate sales in order to salvage itself. When it is unsuccessful, bankruptcy occurs, leaving purchasers to their remedies under the Bankruptcy Act. But the Bankruptcy Act deprives unsuspecting consumers of essential rights. This paper will analyze how that happens and what can be done to protect these innocent victims of the Bankruptcy Act.

7 11 U.S.C., §§ 1-112. (The Bankruptcy Act is found at 11 U.S.C. § 1, et. seq., but is commonly known by the section numbers of the Act itself rather than by United States Code numbers.) The Act contemplates both liquidations (or “straight bankruptcy”) and reorganizations (known as “chapter proceedings”).
A Definitions

An important point, by way of definition, must be made at the outset. The focus of this discussion is on consumers as creditors in bankruptcy proceedings. While there has been much comment elsewhere on the plight of individuals filing bankruptcy petitions as debtors, their problems are unrelated to those of consumer creditors. Status as a debtor in bankruptcy can arise either by a self-filed petition or a petition filed by the bankrupt's creditors. It is not necessary, however, to take any affirmative action to become a consumer creditor. That status arises because of the existence of a bankruptcy proceeding filed by a business with which the consumer has had commercial dealings. To the extent the consumer seeks to assert any claims against the bankrupt company on account of that commercial relationship, the consumer becomes a creditor in the bankruptcy. The Bankruptcy Act defines this status as, "anyone who owns a debt, demand or claim provable in bankruptcy . . ."  

The fact that no affirmative act is required to achieve the status of creditor in a bankruptcy proceeding is one of the primary causes of victimization of consumer creditors. Those who make purchases for their personal, family, or household use do not see themselves as creditors in that relationship. They are consumers in that they are people "who use goods or services for their own needs." Their intention in the transaction is neither profit-making nor risk-taking. They are not in the market as sellers, but rather solely to buy for their own use. Nothing in their situation seems analogous to the position of a financing bank or other lender. It is therefore not surprising that consumer creditors fail to recognize their status under the Act.

9 See Wickham, Bankruptcy or Not? Advice for Attorneys who Counsel Consumer Debtors, 41 Tenn. Law. Rev. 667 (1974); and Festersen Equitable Powers in Bankruptcy Rehabilitation, 5 Creighton L. Rev. 221 (1971).
Further, because such creditors are often unrecognized by business debtors or not listed in their bankruptcy petitions as required by law, they never get notice of the proceedings.

The problem of defining the consumer creditor is complicated by the many variations in which he/she might obtain that status. Those consumers who secure their purchases with deposits and reserve the remaining balance to be paid upon delivery of the promised good or service are creditors for the amount of the deposit if the seller files bankruptcy prior to completing performance required under the contract. Such a creditor may also have a claim for the benefit of the bargain under the contract or warranty claims arising from the contract. Those who purchase services on time are creditors to the extent that their payments exceed the pro-rata value of the services received under the contract. Those who purchase goods on time, however, are not creditors of the bankrupt debtor because they owe performance to the debtor, not vice versa. Finally, those who prepay entirely for services to be delivered at a later date, i.e. payment now for an airline trip next week, become creditors if the airline becomes bankrupt prior to carrying the passenger to his/her destination.

Examples of the creation of consumer creditors out of whole classes of unsuspecting individuals abound. In In re Land Auction Bureau and Auction Value Land of Boston, Inc. purchasers of parcels of "up-country" land on an installment basis were totally confused about their status as creditors of the company after Land Auction filed for Chapter XI arrangements on Feb-

14 11 U.S.C., § 25 (1970) requires the debtor to list all of his pre-bankruptcy creditors with the bankruptcy court.
15 See Schrag and Ratner, Caveat Emptor—Empty Coffer: The Bankruptcy Law Has Nothing to Offer, 72 COL. L. REV. 1147 (1972) [hereinafter cited as Schrag and Ratner]. While creditors who are unscheduled can not have their debts discharged (11 U.S.C., § 35), it is often true that a post-bankruptcy claim is worthless.
17 See, e.g. MASS. GEN. LAWS. c. 255D, § 1. Note that those purchasing goods on time must often receive the merchandise "up front", although title may not pass until the payments are complete under the contract. Nevertheless, warranty claims arising out of time-payment contracts may confer creditor status on a consumer.
18 Nos. 75-244-HL and 75-831-HL (D.Mass., petition filed February 3, 1975).
ruary 3, 1975. The company had promised delivery of good title to the land to those who chose to make purchases. It also offered a full refund of deposits to those who changed their mind about purchasing land within a specified time. Those who had made deposits under the refund option clause had far less conceptual difficulty with their status as creditors, in general, than those who had purchased land, fronted the money, and were merely awaiting deeds or mortgage discharges. Indeed, the number of attorneys who advised their clients that they had made purchases and were therefore not creditors was amazing.

Similarly, in *In re New England Spas, d/b/a Cosmopolitan Health Spas,* over 8,000 spa members were notified by the Attorney General of the Commonwealth of Massachusetts that the spas’ bankruptcy made them creditors for the balance of their prepaid, unperformed memberships at several spas located in Massachusetts. It is in the nature of the health spa business that consumers prepay for extended memberships. The spas use these funds immediately with the expectation that many consumers will “drop-out.” Thus the consumer provides much of the financing for the spa’s operations. In *New England Spas,* only the existence of a successor spa to honor memberships from the bankrupt one prevented widespread loss to the unsatisfied consumers. A large proportion of those responding to the Attorney General even vigorously denied that they were creditors.

Finally, one of the largest Chapter XII petitions ever filed in the First Circuit also illustrates this point. The investors in Colonial Realty Trust had purchased priority participations worth, in some cases, $10,000, which became nearly worthless upon the Trust’s insolvency. In addition, the Trust owned a

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19 See correspondence on file in the Consumer Protection Division, Department of the Attorney General, Commonwealth of Massachusetts.


23 See correspondence on file in the Consumer Protection Division, Department of the Attorney General, Commonwealth of Massachusetts.

24 *In Re Colonial Realty Investment Trust,* No. 74-1557-G, (D. Mass., Petition filed Nov. 1, 1974), and companion cases.
large number of residential apartments, the residents of which had claims for the return of security deposits at the time of the bankruptcy. We consider such purchasers as consumers who purchase items for personal, family, or household purposes. To date, neither group of "consumers" has recognized their status as creditors by filing proofs of claim in the court.

B. Size of the Problem

Accurate data as to the number of consumer creditors in bankruptcies filed in the past few years is impossible to obtain because the definition of who qualifies for the status is often difficult to apply in particular cases. One starting point, however, must be the number of commercial bankruptcies filed, including arrangements of all kinds. The National Commission on the Bankruptcy Laws of the United States reports that the number of business bankruptcies was 19,103 in 1971. All indications are that the number is increasing. When one considers that the number of consumer creditors may often be overwhelming in individual cases (i.e. 114,000 reported by Schrag in In Re FAS Int'l Corp., over 8,000 in New England Spas, d/b/a Cosmopolitan Health Spas, and as yet uncounted numbers in the Grant proceeding) the problem appears to be of enormous dimensions.

C. Previous Analyses of the Problem

The most complete statement of the problems encountered by consumer creditors in bankruptcy proceedings appears in Caveat Emptor, Empty Coffer: The Bankruptcy Law has Nothing to Offer. The solutions proposed for consumer creditors in that article, however, do not appear to us to go far enough. While their proposed procedural reforms regarding the place

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28 See note 20, supra.
29 See note 3, supra.
and time of bankruptcy hearings involving substantial numbers of consumer creditors would be helpful, and the recommended simplification of the bankruptcy forms (like so much other legal writing) is desirable, these suggestions will not eliminate the injustices that befall consumer creditors in bankruptcy. Professor Schrag has accurately identified the problem areas: the size of consumer creditor claims being too small to justify the individual expense of hiring an attorney; the inability of individuals to operate effectively within an overwhelming and callous system; the consumer creditors' position outside the "bankruptcy club"; and finally, the difficulty of proving constructive trusts or other theories which would give priority status to their claims. The solutions they proposed, however, would not materially affect the status of consumer creditors as victims in the bankruptcy process in our opinion.

An examination of the various solutions advanced by Professors Schrag and Ratner and others to improve the position of the consumer creditor in bankruptcy, as well as a review of proposals of various statutory alternatives which states might adopt constitutionally to protect their consumers leads one to the conclusion that reform of the Bankruptcy Act is the only acceptable method of achieving justice for consumer creditors in bankruptcy. Suggested amendments to the current proposals now being considered by Congress are presented below with a commentary. These amendments are designed to balance the bankruptcy process so that important commercial interests are disturbed as little as possible.

To the extent that any disruption of traditional modes of distributing the assets of insolvent businesses will cause concern to the financial community, these proposals will constitute a threat. But if they are viewed (as the authors intend) as a fair attempt to create a bankruptcy law which causes the least disruption to all segments of the economy affected by commercial insolvency, they will produce meaningful dialogue between consumer and financial interests in the resolution of a common problem.

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31 See text accompanying footnotes 122-130, infra.
II. SEEKING RELIEF UNDER CURRENT LAW

Before seeking federal statutory remedies to a particular problem, it is important that the proponents of such changes review other, less drastic methods of accomplishing the same goal. Attempts have been made to obtain a just result from the bankruptcy court for the innocent consumer through state statutory schemes as well as through the common law. Additionally, amendments to the Bankruptcy Act and various procedural devices have been utilized to this end. These efforts have not proved satisfactory.

A. Relief Under State Law

There are a number of sources of relief which state legislatures and courts have tried to adopt to provide consumers in bankruptcy with some measure of justice.

1) Section 2-502 of the Uniform Commercial Code

Perhaps the most notable source is Section 2-502 of the Uniform Commercial Code. This section of the Code is intended to provide some relief to buyers in the ordinary course who discover that the seller has become insolvent within ten days of tender of their payment. Professor Countryman has argued, however, that this section is unconstitutional because it operates only upon the debtor/seller's insolvency and appears, therefore,

32 Section 2-502 of the Uniform Commercial Code provides:
1) Subject to subsection (2) and even though the goods have not been shipped, a buyer who has paid a part or all of the price of goods in which he has a special property under the provisions of the immediately preceding section may on making and keeping good a tender of any unpaid portion of their price recover them from the seller if the seller becomes insolvent within ten days after receipt of the first installment on their price.
2) If the identification creating his special property has been made by the buyer he acquires the right to recover the goods only if they conform to the contract for sale.

33 Other sections of the Code concern additional protections available to the buyer in the ordinary course, i.e. taking security in other collateral (§ 9-204[1]) or in goods identified to the contract (§ 9-204[3]). We assume that the ordinary consumer neither takes such security nor does he perfect it and therefore these protections do him/her little good.
to conflict with Section 67 (c) (1) (A) of the Bankruptcy Act.\textsuperscript{33A} Furthermore, setting aside the issue of constitutionality, Section 2-502 benefits only those consumers who 1) purchase from sellers becoming insolvent within ten days after they have made their downpayment and 2) when the consumer has a "special property" in the goods which are the subject matter of the contract. Few consumers qualify for protection under this provision. With regard to the ten-day limitation, it has been pointed out that many retailers become insolvent long before they actually cease doing business.\textsuperscript{34} Under Section 2-501 of the Code, a special property arises only when the goods are specifically identified to the contract either by agreement, tagging, seller's identification of same in the warehouse or elsewhere, or by shipping. With the exception of certain "big-ticket" consumer items, it is rare that such identification actually takes place in the limitation period. For example, when purchasing a new automobile, the consumer can ordinarily expect delivery of the next conforming model produced in Detroit. Similarly, the refrigerator shown on the retail selling floor is not the one which will be delivered. Section 2-502 is thus little help to most consumers.

2) \textit{Constructive Trusts}

State law traditionally provides some remedy for those who have been dealt with unfairly in a commercial context by allowing the fiction of a trust to be established on the monies wrongly received or taken.\textsuperscript{35} However, even though a court may be willing


\textsuperscript{34} See Schrag & Ratner, supra note 15, at 1161-1162.

\textsuperscript{35} For Massachusetts cases establishing and defining the doctrine of constructive trust see U.S. v. Newbury MFG. Co., 36 F. Supp. 602 (D.C. Mass. 1941); Meskell v. Meskell, 355 Mass. 148 (1969) (refusal to perform an oral promise alone not sufficient fraud to establish trust); State Street Bank and Trust Co. v. Beale, 353 Mass. 103 (1967) (fraud in obtaining legal title to property sufficient to impose trust); Barry v. Couch, 332 Mass. 338 (1955) (use of information confidentially received at expense of one who provided it sufficient to impose trust for his benefit); and Ranicar v. Goodwin, 326 Mass. 710, (1951), (refusing to impose a trust upon a son's breach of his oral promise to his father).
to restore a defrauded consumer to his previous position, the requirement of "tracing" the funds in the estate of the "trustee" has been imposed traditionally as a limitation on this remedy. Because of these strict requirements on the creation or imposition of a constructive trust, and because some courts refuse to allow such trusts in the absence of a fiduciary relationship, this doctrine is often no help to consumers seeking the return of their deposits.

A doctrine of general applicability regarding the imposition of a trust relationship on property in the hands of the debtor, would be an effective tool for the benefit of consumer creditors in bankruptcy. The benefit to the class of consumer creditors on whose behalf such a trust might be established is that payment to them would occur prior to distribution of the debtor's assets through the court. The theory is that money held in trust is not the property of the debtor and not properly the subject of distribution along with his other assets. The beneficiary of such funds could claim them regardless of the existence of other priorities. However, because of the traditional limitations on trust doctrine through the common law, the authors have concluded that consumers must seek the expansion of this remedy legislatively.

3) Piercing the Corporate Veil

Another approach which might be used effectively in proper cases is to take direct action against any individual or company

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It is only where some of the assets can be shown to be a part of the trust estate or the product of the conversion of specific funds or property of the trust estate into another form that the trust estate can obtain an advantage over creditors generally. That advantage does not equal a right to priority preference, but rather a right to reclaim assets of the trust estate that can be traced and found. Id. at 25.


38 See the discussion of this problem in Schrag and Ratner, op. cit., at 1151-1157.

39 See 3 A Colliers, Bankruptcy Law, § 64.02 (14th Ed., 1970) and 4A Colliers § 70.25 for a discussion of this proposition.

40 See text accompanying notes 122-130, infra.
who may be charged with operating the debtor's business to the prejudice of the public.

The protection of the Bankruptcy Court does not extend to those who cause the debtor to become insolvent and who are not debtors themselves. Consumer protection statutes of general application or common law notions of fraud or misrepresentation might well be asserted against one who causes an insolvent company to receive deposits or enter into contracts which it knows or should know it cannot perform. The same theory might well be advanced against officers or directors of insolvent corporations by piercing the corporate veil to reach them in their individual capacities. Under either theory, however, recovery occurs outside the Bankruptcy Court proceedings. Nevertheless, it suggests an often forgotten remedy. The protection of the Bankruptcy Court is only conferred upon the debtor; other participating parties have preferred or protected status insulating them from liability merely because the debtor, against whom the consumer ordinarily might also have an action, is in bankruptcy.

4) Enjoining Future Conduct

Finally, the remedy of prohibition of future offending behavior is effective to limit the potential harm an insolvent company can continue to do to the public. The appropriate party to bring such an action is a state law enforcement official rather than a private party class representative. The purpose of such an action would

41 See, e.g. MASS. GEN. LAWS, c. 93A.
42 See Commonwealth v. Keene, Mass. Supreme Judicial Court No. 75-91 Civil (complaint filed March 28, 1975) for a case in which such conduct is alleged to be unlawful.
44 Prospective relief is available in the usual case only to those who can show actual harm will come to them. It is particularly difficult to establish this criterion in commercial law settings (as distinguished, perhaps, from civil rights class actions.) See e.g., Baldassari v. Public Finance Trust, Mass. Adv. Sh. (1975) 3188. Indeed, in such a case (where the relief is to protect as of yet unidentified and nonexistent members of the "class") it is arguable that there is no actual case or controversy to satisfy limits on justiciability.
be to require certain disclosures of an insolvent business, even one allowed to conduct its affairs during arrangements (either as debtor in possession or through a receiver \(^{45}\)) or while in liquidation during bankruptcy.\(^{46}\) Such disclosures would inform the unsuspecting public of the business' insolvency. In the alternative, the court could require it to maintain deposits received during the time of insolvency separately in trust for the benefit of the consumers until delivery of the goods or services is complete.\(^{47}\) While such an action will have no effect on monies already paid prior to the filing of the bankruptcy or chapter petition, it may effectively prevent consumer loss thereafter.\(^{48}\)

It should be noted that one problem with such an action, particularly during the pendency of an arrangement proceeding, is the exclusive, original jurisdiction vested in the Bankruptcy Court.\(^{49}\) Not only must the action be brought there, but in most cases, debtors apply for and receive stays from the institution or continuation of any other litigation against them in any other court.\(^{50}\) While such injunctions are clearly lawful, they often place the Bankruptcy Court in an untenable conflict. The Court's duty to preserve and enhance the bankrupt's estate may conflict with state law, particularly where the debtor's previous or proposed method of operation has been declared suspect by state enforcement agencies.\(^{51}\) In addition to the difficult problem of balancing these often conflicting responsibilities, the Bankruptcy Court is


\(^{47}\) See In Re Land Auction Bureau and Auction Value Land Co. of Boston, Inc. for a case where such orders were entered by the court for the protection of the consuming public.

\(^{48}\) Reading Co. v. Brown, 391 U.S. 471 (1968) holds that the negligence of the receiver during a C. XI proceeding confers priority status on those harmed over other creditors. Such a holding might well be read to provide relief for consumers dealing with a C. XI company in good faith who nevertheless fail to receive their property or other bargained-for benefit.


ill-equipped to consider issues of state regulation, particularly those involving public protection, i.e. consumer or environmental codes. The Court has none of the special expertise of state regulatory agencies nor is it appropriate to ask a commercial law judge to rule on questions of administrative review and agency discretion. Many federal courts faced with the problem would properly abstain, but the Bankruptcy Court cannot do so in light of the grant of exclusive, original jurisdiction. At most, it can lift its injunctions against the pursuit of other actions. The sound exercise of comity indicates that it ought to do that, at least on application of a state law enforcement official seeking injunctive rather than monetary relief.\textsuperscript{52}

5. Conclusion

The remedies afforded the consumer through state law proceedings are limited. The questioned constitutionality of Uniform Commercial Code remedies, the limited nature of relief available under traditional state trust and equity theories, and the exclusive jurisdiction of the Bankruptcy Court present serious obstacles to effective enforcement of state law during bankruptcy to protect consumer creditors. Other remedies are clearly required.

B. Relief Under the Bankruptcy Act

One oft-cited policy behind the Bankruptcy Act is efficient liquidation and equitable distribution of a bankrupt's estate. To effect this policy, several provisions of the Act seek to undo the effects of fraudulent or overreaching behavior by the debtor or his creditors. Thus the trustee is given the power to recover preferential payments, to avoid fraudulent conveyances and to invalidate certain liens which have not been properly or seasonably perfected. It is frequently argued that these provisions strike a wise balance between the interest of all creditors in maximizing the debtor's estate and the individual interests of creditors who through foresight and diligence have

protected their claims. Since we are here urging greater protection for a certain class of creditors, i.e. consumers, it is necessary to consider carefully the limits of the existing provisions which may work on their behalf.

1. Preferential Payments

Section 60 of the Bankruptcy Act\(^{53}\) allows the trustee to avoid preferential payments "made or suffered" by the debtor within four months of bankruptcy. Although this language is probably broad enough to include liens obtained by judicial process, Section 67(a) of the Act\(^{54}\) provides specifically that any such lien obtained within four months of bankruptcy and while the debtor was insolvent\(^{55}\) is void as against the trustee in bankruptcy. To the extent that such preferential payments are avoided, the estate (and resulting distribution to creditors) would be increased.

Where a voluntary payment is involved, the trustee must meet the stricter requirements of Section 60 in order to recover it.\(^{56}\) In short, under Section 60, the trustee must show:

1. That there has been a transfer to the creditor from the debtor within four months of bankruptcy,\(^{57}\)
2. That the transfer was for or on account of antecedent debt,
3. That the transferor was insolvent at the time of the transfer,
4. That the transferee knew of the debtor's insolvency, and

\(^{55}\) Or even if the debtor were not insolvent, where the lien was obtained or permitted with the intent of defrauding others, it will be void under § 67(a). See In the Matter of Warren Windle, 8 Colliers, Bkrcy. Cases, 56 (S.D.Fla., 1976).
\(^{57}\) The time of the transfer is determined by the detailed rules set out in Section 60. With respect to personal property, the basic rule is that the transfer is deemed made when it is perfected against third parties, in particular against a simple contract creditor levying on the property. With respect to real property, a \textit{bona fide} purchaser test is used.
5. That the effect of the transfer was to allow the creditor to receive a greater percentage of his claim than other creditors of his class.\textsuperscript{58}

The aim of these provisions is to protect the rights of all creditors to receive distributions in bankruptcy. However, Section 60 does not assure equitable treatment of all claimants, as it fails to provide a flexible scheme for simplifying pre-petition affairs of an insolvent debtor. The test under Section 60 is mechanical rather than equitable. The crucial question is not whether the creditor was unfairly preferred but whether the transfer took place within the four month period.

2. \textit{Fraudulent Conveyances}

The trustee may attack a fraudulent conveyance under two separate sections of the Act. As with preferential payments, setting aside a fraudulent conveyance will increase the estate for the benefit of creditors. Section 67 (d)\textsuperscript{59} provides that transfers which are fraudulent under its provisions are void as against the trustee. Section 70(e)\textsuperscript{60} gives the trustee the rights possessed by any actual creditor of the bankrupt to attack a transaction under state law. When the transfer in question does not take place within the one year time period required in Section 67(d) and the relevant state law of fraudulent conveyances provides a more generous period, the trustee will proceed under this latter section.

Whether the trustee pursues his remedies under the Bankruptcy Act or under state law, he will be required to show that the transfer was either presumptively fraudulent or perpetrated by the debtor with actual fraudulent intent. Under the law of most states (including those states which have passed the Uniform Fraudulent Conveyance Act) and under Section 67(c), a transfer is presumptively fraudulent, i.e. fraudulent without regard to actual intent, if,

\textsuperscript{60} 11 U.S.C. § 110(e) (1952).
1. It is made without "fair consideration," and
2. a) It leaves the debtor insolvent, or
   b) The debtor is about to do business for which the capital remaining in his hands is unreasonably small, or
   c) The debtor is about to incur debts beyond his ability to pay.\textsuperscript{61}

In this context, fair consideration means a fair equivalent exchanged in good faith and will include the satisfaction or securing of an antecedent debt.\textsuperscript{62} Arguably, a knowing preference is without fair consideration. For example, a debt may not be a fair equivalent if, by virtue of the debtor's financial position, it is worth a small fraction of its face value. Similarly, it could be argued that a knowing preference is neither taken nor given in good faith. But courts have uniformly rejected such arguments and it is settled law that a mere preference without more will not constitute a fraudulent conveyance.\textsuperscript{63}

Where a transfer is not presumptively fraudulent (i.e. not made for a fair consideration) the trustee has the burden of showing that it was made with an actual fraudulent intent to hinder, delay or defraud other creditors. Once again a mere intent to prefer will not be sufficient.\textsuperscript{64} Even where the facts indicate that there has been more than a simple preference, there may be several obstacles to the trustee's recovery. The first of these is the standard of proof he must meet. Although actual fraudulent intent can be shown by conduct or circumstantial evidence, there is some authority for the proposition that a mere preponderance of the evidence will not be enough and that fraud must be shown by clear and convincing proof.\textsuperscript{65}

Secondly, there is the problem of what will be considered an intent to "hinder, delay or defraud." In general, any

\textsuperscript{61} See Bankruptcy Act, Section 67(d) (11 U.S.C., § 107(d)) and Uniform Fraudulent Conveyance Act.
\textsuperscript{62} Id.
\textsuperscript{64} Id.
\textsuperscript{65} Lackawanna Pants Mfg. Co. v. Wiseman, 133 F. 2d 482 (6th Cir., 1943).
intent to deprive creditors of the benefits and protections of the Bankruptcy Act will suffice, but this approach has not been broadly applied. A recent case, In Re Cushman Bakery\(^68\) illustrates an important limitation. In that case, the debtor had granted a security interest to one of his suppliers on account of an antecedent debt. The security interest was taken and filed by a third party, a wholly owned subsidiary of the creditor. Since the supplier was well known in the trade, the nominee was used to prevent other creditors of the debtor who saw the financing statement from becoming aware that the security interest had been given on account of antecedent debt. Here the debtor clearly participated in an attempt to prevent other creditors from placing the debtor in bankruptcy where the preferential transfer could be recovered by the trustee. The court found that this participation was not sufficient intent to invoke Section 67(d). It reasoned that Cushman, the debtor, had given the security in an honest attempt to rehabilitate its business for the benefit of all its creditors. The fact that it knew of and acquiesced in the creditor’s concealment of the true nature of the transaction was considered “entirely consistent with an intent to protect its creditor standing, to continue in business, and to rehabilitate itself financially.”\(^67\) Thus it would appear that a debtor may intend to deprive creditors of the protection of the Act so long as this is incident to an honest attempt at saving his business.

An additional obstacle to the trustee’s recovery often arises where the transferee has the requisite fraudulent intent whereas the transferror does not.\(^68\) In a typical case, the debtor saves his business from certain bankruptcy by granting a preference or other advantage to one of his more insistent creditors. The debtor in such a case intends no more than a preference, and an intent to prefer is clearly permissible. The credi-

\(^{66}\) 526 F. 2d 23 (1st Cir., 1975).

\(^{67}\) 526 F. 2d at 33.

\(^{68}\) The transferee’s intent is sometimes also relevant as where under the Uniform Fraudulent Conveyance Act., Section 9(2) he attempts to obtain a lien on the property for the less than full consideration paid.
tor, however, may have acted fraudulently in the manner of obtaining or concealing the preference.

The dominant lender theory (or the Langan rule 69) is sometimes applied under such circumstances. In Langan, a bank held virtually all of a large series of bonds secured by a mortgage on the bankrupt's property. After default, it forced the debtor to cease operations and cancel its contracts. It then foreclosed and put the bankrupt's assets up for sale. The bank then formed a corporation to purchase the debtor's assets for a fraction of the value they would have commanded had the business been sold as a going concern. The New York Court of Appeals, in reviewing a summary judgment for the defendant bank, held that the evidence would support an inference of the bank's intent to defraud, and that if such intent were found, an action for fraudulent conveyance would lie.70

A somewhat different situation arises where the debtor is aware of fraud in the transaction but is coerced into acquiescence. Such was the case in Manufacturer's Finance v. Marks.71 In that case, the chief creditor of the bankrupt not only obtained a preferential assignment of the bankrupt's accounts receivable but also forced the bankrupt to place one of its agents on its payroll and to give him control over every aspect of the business. The court held that this was a fraudulent conveyance, saying:

While the officers of the Candy Company (the bankrupt) made this arrangement under coercion, they must be held to

69 The rule arises from Langan v. First Frust and Deposit Co., 293 N.Y. 604, 59 N.E. 2d 424 (1944).

70 Under similar circumstances, the Supreme Judicial Court of Massachusetts adopted the Langan rule. In Citizen’s Bank and Trust Co. v. Rockingham Trailer Sales, Inc., 351 Mass. 457 (1966), the owner of a trailer park interfered with the sale of one of the trailers located in his park by insisting that the trailer be moved. The prospective purchaser was willing to pay $7,500 so long as he did not have to incur the considerable expense of moving the trailer. Two days before an attempted attachment and after the original deal had fallen through, the trailer park owner purchased the trailer for $2,391 antecedent debt and $609.00 cash. Later he resold the trailer for $6,500 without insisting that it be moved. Confronted with these facts, the court held that the sale of the trailer was a fraudulent conveyance and that the fair market value of the trailer was recoverable by creditors without any credit to the trailer park owner for the consideration paid.

71 142 F. 2d 521 (1944), cert. denied 323 U.S. 721 (1944).
have intended the obvious consequences of their act; and knowing the Candy Company's insolvent condition, to transfer to appellant practically its only liquid asset and to give to appellant the entire control of its business would obviously hinder and delay its other creditors.\footnote{142 F. 2d at 524.}

These two cases illustrate that proof of actual intent on the part of the transferee will be a sufficient indication of a fraudulent conveyance if either the debtor is knowingly coerced into participating in fraudulent conduct without reasonable hope of saving his business or if the transferee actually asserts control over the debtor's business. But there are many cases where these doctrines do not apply. For example, in \textit{In Re Cushman Bakeries},\footnote{See note 53, supra.} the First Circuit held that the Langan rule could not be applied to a situation where the terms of the preferential payment were negotiated between the parties at arms length even though the debtor had practically no bargaining power as a result of his precarious financial position.

In some cases, the fraudulent conveyance sections will work to prevent injustices. In the majority of cases, however, these sections are not well suited to protecting the claims of consumers from the pre-bankruptcy activities of professional lenders. Even in cases where the facts suggest that a fraudulent conveyance has occurred, recovery may be impractical due to inadequate records maintained by the bankrupt and the high standard of proof required.

\section*{3. Improperly perfected security interests}

Section 70(a) of the Bankruptcy Act\footnote{11 U.S.C. § 110(a) (1952).} confers on the trustee the status of a levying creditor. As a result, the trustee can avoid all consensual liens which remain unperfected according to state law at the time of the petition.\footnote{If a security interest is not perfected until the period within four months of bankruptcy, it may be attacked as a preference under Section 60. See text accompanying notes 53-58, above.} In addition, under Section 70(e)\footnote{11 U.S.C. § 110(e) (1952).} the trustee may assert the rights of certain actual
creditors, e.g. gap creditors if any exist, to defeat a lien in its entirety for the benefit of the estate.\textsuperscript{77} Since these powers sometimes increase substantially the amount of the dividend paid to general creditors, some discussion of their role in insuring equitable treatment of all creditors is in order.

In general, state law allows a creditor to take a security interest or mortgage in almost every asset a debtor might possess. Article 9 of the Uniform Commercial Code (covering security interests in personal property) and real estate recording statutes (covering mortgages of real property) provide, with few exceptions, that such liens will not be effective against third parties unless certain steps are taken, e.g. filing, recording, or possession of collateral, to make them notorious. As a result, anyone who is considering extending credit will be able, with the exercise of some diligence, to discover what assets of the debtor are available for his repayment.

Admittedly the availability of this sort of information is only helpful to a certain kind of creditor. Obviously, the filing system does not protect those creditors who have neither the sophistication nor the resources to use it. What is surprising is that the system does not really aid anyone at all except a potential secured creditor. The \textit{Cushman} case discussed above illustrates this point. In \textit{Cushman}, the trustee argued that though there had been technical compliance with the perfection provisions of Article 9, the security interest was nonetheless invalid because, through the use of a nominee, the creditor had obscured the true nature of the transaction. The court rejected this argument and held that a security interest is good against third parties if a financing statement has been filed which meets all of the express requirements of Article 9. In so holding, the court reasoned that Maine's system of notice filing was not intended to insure public notice of the true nature of a transaction but was merely intended to make creditors and potential creditors aware that a third party \textit{may} have a prior claim on a certain part of the debtor's assets. With the cooperation of the debtor, further inquiry may be made under

\textsuperscript{77} Moore v. Bay, 284 U.S. 4, (1931).
Section 9-208 of the Uniform Commercial Code. But this section only compels the secured creditor to disclose the exact amount of his claim and the specific collateral covered by his security agreement. This disclosure is clearly not sufficient for a lender who wishes to make an intelligent decision about extending credit. The reliability of any other information he possesses will usually depend upon the honesty of the debtor. On the other hand, the statutory requirements fully protect a lender who is able to obtain a security interest in the debtor’s remaining assets.

The above-discussed provisions can work for the consumer creditor’s benefit. As unsecured creditors of the debtor they become non-priority claimants and are entitled to a share of the debtor’s estate. Once priority claims are paid, the size of their dividend will be increased by any recovery obtained by the trustee. But it is important not to confuse procedures which may benefit consumer creditors with those which would actually protect them. The precariousness of a consumer’s position does not depend upon actual fraudulent conduct or inadequacy of filed notice. The four month period during which preferences are voidable is too short if a creditor is able to keep the debtor’s business operating by supplying him with secured credit. These provisions are designed to protect creditors who are aware of their status as such and who routinely exercise their own judgment in making credit decisions. Better treatment of consumer claimants in bankruptcy should not be thought unnecessary merely because they are occasionally fortunate enough to receive a benefit at the expense of a secured creditor.

III. LEGISLATIVE REFORM ATTEMPTS AT THE STATE LEVEL

As judicial relief is insufficient to protect consumer creditors in bankruptcy, legislative reform should be explored. In this section, the constitutional and statutory limits on state legislative attempts to help consumers collect their claims after bankruptcy will be explored. The authors believe, in view of these
limits on state action, that the only fair and reasonably efficient resolution of the problem lies with Congress.

A. Limitations on state power to act

The Bankruptcy Act sharply limits the states' power to act in this field. Priorities in distribution are specified in Section 64(a) of the Act. The only state-created priority it recognizes is a priority for partial payment of the bankrupt's landlord. The federal priority scheme has been held to preempt the field and thus state-created priorities are invalid under Congress' Article I power to create uniform laws in bankruptcy and the Supremacy Clause.

B. State-created trusts

To overcome this problem, several states have adopted legislation designed to prevent advance deposits from ever entering the bankrupt's estate. A typical approach is to provide by statute that the funds so collected shall be kept in trust for the benefit of the purchaser (i.e. consumer). Thus, New York has adopted a law which requires landlords and lessors of personal property to keep security deposits segregated from their own funds. When these deposits are placed in a bank account they must designate that account as a trust account naming the lessees as beneficiaries. The lessor must also notify each beneficiary of the name of the bank where the account is kept and the amount held in trust on his/her behalf. Failure to comply with the the statute subjects the landlord to liability to the tenant for converting his deposit and to criminal penalties.

79 The fifth priority in Section 64(a) includes a state-created priority for rent to the extent that it represents rent due for occupancy within three months of bankruptcy.
81 U.S. Const., Art. I, Section 8.
82 U.S. Const., Art. IV.
83 N.Y. General Obligations Law, § 7-103.
86 N.Y. Penal Law, § 1302(a).
Where the landlord has placed the money in a separate trust account, rights in the account do not pass to a bankruptcy trustee. The result is less fortunate, however, in the common situation where an insolvent debtor has simply ignored the law. Where this occurs the tenants will prevail only in a rare case where they can trace their money into current assets of the debtor. Where non-compliance is only discovered when the landlord goes bankrupt, the penalties for noncompliance are little comfort to his tenants. Their action for conversion is most likely worthless and the criminal penalties, if they are even imposed, do not affect their loss.

California apparently recognized this problem in drafting a similar statute. Under their financial code certain businesses which sell money orders are required to keep the funds received for such money orders segregated in a trust account until they are disbursed in payment of the instrument. If the business fails to do this, the statute imposes a trust on all the business assets for the benefit of people holding the checks. Unfortunately, this latter section will not be enforced in bankruptcy. Thus, in Elliot v. Bump the debtor had kept some of his receipts segregated but mingled others with his own funds. The beneficiary of the trust claimed both the trust fund and, under the statute, all assets of the debtor at the time of bankruptcy. The court decided that the claimant was entitled to the trust funds since these did not pass to the trustee under Section 70(a), but not to any priority in the remaining assets. In so

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87 Under Section 70(a) (11 U.S.C. § 110(a)) the trustee receives title to all the debtor’s property including "powers which he might have exercised for his own benefit but not those which he might have exercised solely for some other person." Since the state trust statute prohibits him from acquiring any beneficial interest in the trust accounts, title to those accounts will not pass to the trustee in bankruptcy.

88 Tracing is made nearly impossible by several factors. Often, the bankrupt business has either not kept or not turned over to the trustee very complete records. Where the deposit has been paid several months earlier it is unlikely that it will be traced to some current asset of the bankrupt. For a thorough discussion of the problems of tracing in bankruptcy see Schrag and Ratner, Supra note 15 at Supra note 33 at 438.

89 CALIF. FIN. CODE, 12300.3.

90 Id.

91 See note 80, Supra.

deciding, it held that the statutory attempt to impose a trust on all the debtor's property without any tracing requirement was nothing more than a state-created priority and, as such, wholly invalid against a trustee in bankruptcy.

C. State-created liens

Another way for the state to protect prepaying consumers would be to give them a lien on certain of the debtor's assets as security for their claims. If a valid statutory lien is created, it has the advantage of being both effective in bankruptcy and not voidable as a preference even if it comes into existence within four months of bankruptcy. Under Section 67, a statutory lien is valid against the trustee unless 1) it first comes into operation upon the debtor's insolvency or 2) it is a lien for rent. Additionally, at the time of bankruptcy the lien must be enforceable against a bona fide purchaser or the lienholder must be able to so perfect under the applicable state statute. Since most liens may be perfected against bona fide purchasers by taking possession and since the second proviso to Section 67(c)(1)(B) allows the lienor to take possession by filing a notice with the Bankruptcy Court, invalidity of a lien under this section is very rare.

Thus, under Section 67(c) it would appear that a lien of the following sort would be operative in bankruptcy.

94 Id.
98 Id.
99 In commenting on Section 67(c)(1)(B), the Commission said that this section "invalidates liens on ambulatory houses in Pennsylvania, the get of bulls, rams and bears in Colorado and vendors' liens in Puerto Rico." Report of the Commission on the Bankruptcy Laws of the United States, July, 1973, Part II, Section 4-606. Note 1(b). Indeed this section has been randomly applied. In Re J. R. Nieves and Company, 446 F. 2d 181 (CA 1, 1971). See also, Statutory Liens in Bankruptcy, 39 MINN. L. REV. 697 (1955) and Note: A Bona Fide Purchaser Test Plus for Statutory Liens in Bankruptcy, 50 N.C.L. REV. 90 (1971).
Whenever a person contracts to purchase property or services for his own personal, family or household use from a business in this state and prepays for such property or service, he shall have a lien on all the assets of the business to secure performance of his contract.

Even though this lien does not fall within any of the exceptions in Section 67(c), there is still a major problem with this approach. A lien is not necessarily invulnerable to the charge of being a mere priority. Under federal case law, the line between a valid lien and a mere priority is less than clear. At a bare minimum it would seem necessary that a lien convey some pre-bankruptcy enforcement rights. If such rights are accorded in a substantial enough fashion to defeat the charge of mere priority, a large element of uncertainty will be interjected into lending transactions.

Traditional statutory liens, such as mechanics' liens or warehousemen's liens tend to apply only to specific property which is related to the underlying transaction. The exception, of course, is tax liens. The federal tax lien for example, extends to "all property and rights to property, whether real or personal, belonging to such person." This lien is subordinate to prior choate interests in the debtor's property and filing is required to make it effective against third parties acquiring interests in the taxpayers property. Despite this fact, the lien has caused considerable worry and uncertainty among secured lenders. Confusion would be even greater where a filing requirement would be impractical and the amount of potential liability is difficult to ascertain. Thus, even if it is possible for a state to create a consumer lien effective in bankruptcy (an assumption

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101 The old Uniform Trust Receipts Act provided for a priority in and lien on the proceeds from collateral obtained within ten days of liquidation proceedings. The cases split upon the validity of this section in bankruptcy proceedings. See In Re Harpeth Motors, 135 F. Supp. 863, (M.D. Tenn., 1955) and In Re Crosstown Motors, Inc. 272 F. 2d 224, (CA 7, 1959). In Harpeth the court held that the lien was valid and in so holding emphasized the fact that the section conveyed certain pre-bankruptcy rights such as the right to demand an accounting.


concerning which we have some doubt) it can do so only at an enormous cost in terms of uncertainty and complexity. A priority in payment upon insolvency is precisely what is wanted. What is not wanted are pre-bankruptcy remedies which place the debtor’s affairs in a state of confusion.

**D. Personal Liability of Corporate Managers**

Another strategy for protecting consumers from business insolvency is illustrated by a Wisconsin statute. Under Wisconsin’s Consumer Act\(^\text{104}\), a consumer who obtains a judgment for violations of the act and is unable to collect from an incorporated business by reason of its insolvency may proceed against the principals\(^\text{105}\) of that corporation providing that it can be shown that they knew or should have known of the violations and that the violations were a meaningful part of the corporation’s business.

Such a statute not only gives consumers a remedy when a business becomes insolvent but also provides ample incentive for corporate managers to comply with consumer laws. Nevertheless in the absence of violations it does not protect consumers where the business is simply unable to deliver by reason of insolvency, nor are consumer creditors protected in the common case where the principals of a bankrupt corporation are also insolvent. Thus, while it is hoped that more states will make such provisions a part of their consumer law, these provisions are far too limited in scope for the consumer’s purposes.

**E. Priority over Secured Lenders**

The final possibility for legislative reform at the state level is the amendment of Article 9 of the commercial code. Accordingly, the claims of consumer creditors could be given priority over security interests created under Article 9. Under current bankruptcy law, however, the effect of such a provision would be far too extreme because all security interests created by the

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\(^\text{104}\) *Wisconsin Laws*, § 425.310.

\(^\text{105}\) Including but not limited to officers of the corporation, its managers and assistant managers.
debtor would be invalidated whenever there is a single consumer creditor on the date of bankruptcy. The reason for this is that Section 70(e)\textsuperscript{106} gives the trustee the power to set aside any transfer which could have been avoided by some actual creditor of the bankrupt. Thus since any security interest would not be good in the face of a consumer claim, the trustee may stand in the shoes of any actual creditor and recover the secured assets. Furthermore, in Moore v. Bay\textsuperscript{107}, the Supreme Court held that the trustee’s recovery was not for the benefit of the creditor whose rights were used but for the benefit of the entire estate and that the size of the trustee’s recovery would not be limited by the amount of the intervening claim. Thus every security interest granted by the bankrupt would be vulnerable to attack even if there is only one consumer creditor with a ten dollar claim.

Even if a state could lawfully enact legislation and limit its applicability to the size of the priority claims, the wisdom of such legislation is questionable. Lending today is truly an interstate activity. Uniformity in state commercial law promotes availability of credit in all markets and facilitates interstate borrowings. If the federal government does not amend the Bankruptcy Act to improve the lot of consumers each state will be faced with the harsh dilemma of the need to protect consumers on the one hand and the possibility of frightening away important sources of credit for its businesses and consumers on the other hand.

F. Conclusion

It is clear that certain remedies are available to a willing state to protect its consumers in the event of bankruptcy. Because of the current law’s prohibition against liens effective only upon insolvency, preferential transfers, and the difficulty of enforcing state created liens, it is necessary for a consumer-oriented state to enact generally effective liens for the benefit of consumers in order to act constitutionally as well as effectively for con-

\textsuperscript{107} 284 U.S. 4.
sumer creditors. Any lesser remedy will fail because it will not reach the largest portion of most commercial debtors' property. But generally effective, consumer-benefit liens on a state-by-state basis will insert a new element of uncertainty into lending transactions which does not seem desirable. Any business acting across state lines will have to assure its lenders that they are protected or secured before it will be able to obtain financing. Such assurances could not be given where a state in which the business proposed to operate had granted the consumer lien described above. This infirmity would be resolved, of course, if Congress made such a lien federal, limited its operation to bankruptcy proceedings, and clearly specified the conditions on which it could become effective.

Other infirmities exist, however, with state-created consumer liens effective upon bankruptcy even if allowed by Federal law. A tenant with a security deposit claim in the amount of $200 takes a lien which is superior to the mortgages on the property. If filing is required to give notice, most tenants will fail to do so and no protection will result. If filing is not required, the mortgagee is not given adequate notice that this security is imperfect or may so become. Even if perfected, however, the effort and cost attendant to enforcement of the lien against the estate hardly justify the consumer's time. Foreclosing on a building for the payment of a $200 debt hardly seems an intelligent or efficient way of giving protection to consumers. Similar filing and notice arguments exist with regard to other liens which may secure consumer deposits on or purchases of as-of-yet undelivered goods.

It is possible to design state-created liens for the protection of consumer creditors. But they engender more problems in their operation and enforcement than they seem to cure. We reject this approach. If Congress will permit states to create liens for the benefit of their consumers, Congress should be equally willing to do the job itself and make the solution truly effective. By making protection of consumer claims part of the federal bankruptcy scheme, Congress can provide the desired uniformity, allow for off-setting benefits to secured
lenders who lose their collateral to consumers, and enact an efficient procedure for the proof and payment of consumer claims. We have suggested below one possible direction Congress might take in accomplishing these results.

IV. REWRITING THE FEDERAL BANKRUPTCY ACT TO PROTECT CONSUMER CREDITORS

In 1970, Congress created the National Commission on the Bankruptcy Laws of the United States. The purpose of the Commission was to study the Bankruptcy Act, review the problems which had arisen under it, and to suggest changes to the Congress. The report of the Commission was issued in two-part form in July, 1973. Part I contains findings regarding the operation of the current law and Part II contains the proposal for a new bankruptcy law. Because the Commission largely de-emphasized the role of the judge and the private trustee in bankruptcy proceedings, the bankruptcy judges filed their own bill, tracking the form of the Commission bill but substantially altering it. The Commission bill de-emphasizes the role of the Bankruptcy Judge and the Judge's Bill, as expected, does not. A third bill has also been proposed by the National Bankruptcy Conference and all three are before the House and Senate for consideration.

The Commission bill makes some significant changes in the areas discussed above. The preference sections, for example, have been completely revised. Under proposed Section 4-607 the trustee may recover any preferential payment made while the debtor was insolvent and within three months of bank-

110 Known as H.R. 31 in the House of Representatives and S.236 in the Senate.
111 Known as H.R. 32 in the House of Representatives and S.235 in the Senate.
112 In the form of 200 amendments to HR 31, submitted in March, 1976 informally to the House Subcommittee on Personal and Constitutional Rights.
113 In the House they are before the Subcommittee on Personal and Constitutional Rights of the House Judiciary Committee; in the Senate they are before the Subcommittee on Improvements in Judicial Machinery of the Senate Committee on the Judiciary.
ruptcy whether or not the transferee knew of the debtor's insolvency. In certain cases, however, the preferential period will extend for a full year prior to the petition. This occurs where, "the (preferred) creditor was a member of the immediate family, a partner, an affiliate, a director, an officer or a managing agent of or for the debtor, who had reasonable cause to believe the debtor was insolvent at the date the transfer occurred." Thus the new act distinguishes between creditors who are outsiders and creditors who are insiders and greatly reduces a debtor's ability to prefer the latter. This distinction will increase the trustee's power to recover payments to major creditors who have exercised control over the debtor's business if the courts will broadly construe such terms as "affiliate" and "managing agent." 115

HR 31 also changes the rules governing enforceability of state statutory liens in bankruptcy. As discussed above, the current law makes such liens enforceable with only a few exceptions. Under the proposed act, no statutory liens will be recognized, except:

1) (L)iens which secure a debt for manufacture, repair or storage of an article;
2) certain tax liens; and
3) liens which secure an assessment against the property for the cost of a public improvement.

Thus if the new act were passed as written the trustee could avoid any lien created by the state on behalf of prepaying consumers.

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114 Section 4-607(a)(2) of H.R. 31.
115 Under the new act, "Affiliate" is a defined term. See H.R. 31, Section 1-102(4). This definition includes parent, sub and sister corporations as affiliates. In addition, two persons will be affiliates where one "operates under a lease or operating agreement substantially all of the property" of the other. Section 1-102(4).
116 See discussion accompanying notes 93-103 Supra.
117 This exception covers a mechanic's lien, a bailee's lien, a warehouseman's lien, etc.
118 H.R. 31, Section 4-606.
The proposed act does, however, overrule the problem created by *Moore v. Bay.* Section 4-604 (b) (1) of H.R. 31 provides:

Any transfer of the debtor's property and any obligation incurred by the debtor which is voidable under applicable law by any creditor or creditors having claims allowable in a chapter V case is voidable by the trustee to the extent of such allowable claim or claims for the benefit of such creditor or creditors. (emphasis supplied)

Thus if a state amended its commercial code by making Article 9 security interests ineffective against consumer creditors, the trustee would be able to use this state limitation on the rights of secured parties to recover from the secured creditors enough of their collateral to pay consumer claims.

Finally, it should be noted that the new act continues to preempt the field of payment priorities to the detriment of consumers. The Hon. Millicent Fenwick (R.-N.J.) attempted to change this by filing an amendment to the Commission bill which would improve the status of consumers by creating a preferential class for them in the priority list. That bill has died in committee for lack of support. The authors believe that the Fenwick Amendment is a step in the right direction but we also urge that a more comprehensive approach for protecting consumer interests be considered.

What follows, then, are the suggestions of the authors for amendments to HR 31 which accomplish substantial justice for consumer creditors without doing substantial violence to secured interests or otherwise upsetting traditional notions of an insolvent business' duty to its creditors. These suggestions have been presented to the National Association of Attorneys General by Attorney General Francis X. Bellotti of Massachusetts. They provide four areas of revision favorable to consumers: 1) creation of a limited consumer lien; 2) creation of a limited

119 See note 107 *Supra.*

120 H.R. 31, Section 4-405 provides for the following priorities: 1) administrative expenses; 2) certain claims arising between the filing of an involuntary petition and adjudication; 3) certain wage claims; 4) certain employee benefit claims; 5) certain tax claims.

121 *HR 8336.*
consumer priority; 3) provision for enforcement of state law during bankruptcy proceedings in the public interest and 4) procedural amendments allowing state Attorneys General to intervene in bankruptcy proceedings on behalf of classes of consumer creditors. Each has essentially different functions but all have the same goal. A short commentary follows each proposal.

**PROPOSED LIEN FOR CERTAIN CONSUMER CREDITORS**

It is suggested that the new Bankruptcy Act (HR 31) be amended as follows:

After section 4-402, insert:

Section 4-403 *Lien for Certain Consumer Creditors*—If a consumer creditor has paid money or other property to the debtor in connection with a contract for the sale or lease of property or services and the contract has not been substantially performed, then such consumer creditor shall have

1) a lien upon the property which is the subject matter of such lease or contract which lien shall be superior to all other liens on the property; and
2) a lien upon any property in possession of the debtor at the time of bankruptcy which is not available for distribution to general creditors solely by reason of a lien held by a creditor (whose claim is not subordinated under § 4-406(a)) in such property who possesses liens, effective in bankruptcy, on more than fifty (50) percent in value of the assets in possession of the debtor at the time of the petition, such lien to be superior to the rights of such creditor; PROVIDED THAT such lien shall only arise to the extent that property which is the subject matter of the contract is not sufficiently identified by the contract or by circumstances for a lien to attach under paragraph (1) or, though identified, is insufficient in value to satisfy the purchaser's or lessee's claim which arises under this section,

for the recovery of any unearned portion of the purchase price, security deposit or rent which the purchaser or lessee has paid. Such liens shall not be voidable by the trustee under 4-606 or 4-607.

Renumber § 4-403 — § 4-406 as § 4-404 — § 4-407 accordingly.
This subsection allows a consumer creditor who has made part or full payment to the debtor on a lease or purchase contract to get priority over certain secured creditors (and consequently over unsecured creditors) for the amount of his payment when that contract or lease remains unperformed because of the seller's or lessor's bankruptcy.

The lien given in paragraph 1 gives the consumer creditor first priority in the property which is the subject matter of his contract. Thus, for example, if the consumer has paid a $500 deposit on a car which is, upon bankruptcy, part of the dealer's inventory, his claim of $500 must be paid before the inventory lender may foreclose on his security. Similarly, one who has paid a security deposit on a residential apartment must be repaid from the proceeds of sale of the building before the mortgagee.

The lien given in paragraph (2) allows the consumer to have first priority on certain of the debtor's assets which are subject to liens. Any creditor who has a security interest covering fifty (50) percent of the debtor's assets at the time of bankruptcy will find that his interest in the security is subordinated to the claims of consumer creditors under this section. In determining whether a creditor's lien is subordinated under this section, an asset does not count as being covered by that creditor's lien if his lien is for any reason voidable by the trustee. On the other hand, an asset should be considered covered by the lien of a particular creditor whether or not there is another creditor who has a lien on that asset and even if the other lien has priority.

EXAMPLE 1: Creditor 1 has taken a security interest in Debtor's inventory, equipment, accounts receivable, etc. Creditor 2 has a properly filed purchase money security interest in one piece of the Debtor's equipment. The value of that piece of equipment must be taken into account in determining whether Creditor 1 has secured fifty (50) percent of Debtor's assets. Nevertheless, the consumer does not have a lien on that piece of equipment since its unavailability for distribution to general creditors is not solely by virtue of Creditor 1's interest.
EXAMPLE 2: If Creditor 1 has a security interest in a given piece of collateral but is not secured by more than fifty (50) percent of the debtor’s assets and if Creditor 2 has a priority purchase money security interest in the same piece of collateral and is secured by more than fifty (50) percent of the debtor’s assets, a problem of circular priorities is presented. The interest of the consumer is superior to that of Creditor 2 under §4-602(e). Creditor 2’s interest is superior to that of Creditor 1 under state commercial law (UCC §9-312). And finally, Creditor 1’s interest is superior to the consumer’s by virtue of his perfected security interest. This issue should be resolved by deciding that since Creditor 1 has no enforceable interest in the collateral (because of Creditor 2’s priority), the property is not available for distribution “solely by reason of” Creditor 2’s security interest. Thus the order of distribution of the collateral would be: 1) Consumer; 2) Creditor 2; and 3) Creditor 1.

The proviso contained in paragraph (2) aims solely at making it plain that a consumer acting under this section must first seek to satisfy his claim by taking advantage of the lien in paragraph (1) before proceeding under paragraph (2).

The ability of a creditor under the Uniform Commercial Code, Article 9, to take a security interest in nearly every asset possessed by the debtor means in certain cases that consumer creditors will not be paid in bankruptcy regardless of the priority given to their claims. While it is probably unwise for the Bankruptcy Act to interfere indiscriminately with security interests created under state law, certain equitable considerations make it desirable to give the consumer a few well defined rights against secured creditors. Briefly these considerations are:

1) Bargaining Power. The rights of creditors in bankruptcy are determined to a large extent by negotiations with the debtor prior to his insolvency. A creditor who advances money or goods with expectations of repayment will usually have much greater bargaining power with the debtor than a consumer who advances a smaller sum in exchange for future
delivery of goods or services. In a typical situation, whatever small bargaining power the consumer has is not exercised because of his ignorance that these pre-bankruptcy negotiations will determine his share in the event of liquidation.

2) A Consumer's Lack of Intent to Become a Creditor. Closely related to the above is the fact that a consumer typically makes no conscious decision to become a creditor of the seller. Even if the consumer did suspect that such was the case, he does not possess and probably would not be able to acquire any of the information which would normally be considered relevant in deciding to make a loan.

3) Other Creditors are Compensated for Their Risk. While professional lenders extract either interest or other concessions for extending credit, the consumer often does not pay less for the desired items because he has contracted to pay in advance.

Outweighing these considerations is the burden placed on business financing if a creditor's interest in his security is subject to potentially large liabilities the amount of which he is unable to estimate. Thus, the aim of this subsection is to provide remedies for the consumer which can, as a practical matter, be noted by secured creditors. For this reason, the consumer lien created only arises with respect to a certain class of consumer claims, i.e. those which are for repayment of amounts paid to the debtor in connection with unperformed contracts. The amount of such claims at any given time will be a definite sum, and the total potential liability under this section is readily calculable by interested creditors with the cooperation of the debtor. In addition, the lien only affects the interests of certain creditors. The mortgagee of a residential apartment building, the inventory financier of a retail seller, and the major creditor of any particular debtor will have reason to consider potential claims under this subsection. The interests of other creditors, e.g. suppliers and other minor lenders, are not affected. Secured creditors of a large number of businesses which do not ordinarily do business with consumers also remain unaffected.
The secured creditor whose rights are affected should be able to estimate the potential liability arising under this section and to protect himself in various ways.

Mortgagees of Leased Residential Buildings. Under this section, mortgages of residential property will be subordinated to claims for return of security deposits and unearned rent. The potential liability can be easily calculated by an inspection of outstanding leases. Since the terms of outstanding leases are frequently a major determinant of the value of a rented building such leases are usually available in connection with the sale or mortgage of a building. In cases where apartments are let on a month to month basis pursuant to an oral agreement, a prudent lender might require a statement from each of the tenants of the amount of any security deposit he has paid. Since oral rental agreements are usually found where the building contains only a few apartments, such a requirement would not be unduly burdensome.

Once the amount of the outstanding deposits is known, the mortgagee can protect himself in one of two ways. On the one hand, he could require the debtor as a condition of his mortgage to place all tenant security deposits in a special bank account and to grant him a security interest in that account. By perfecting this security interest in accordance with Article 9 of the U.C.C., he is assured of alternative security which will offset the amount subtracted from the proceeds of the mortgaged property by reason of the lien given in §4-403.\textsuperscript{122} Alternatively, he could require the debtor to place all tenant security deposits in a trust account which would name the tenants as beneficiaries. If this is done, the money in the account would not become property of the bankruptcy estate under §4-601.\textsuperscript{123}

\textsuperscript{122} This section makes use of the definition of "consumer creditor" proposed at p. 52 infra.

\textsuperscript{123} Section 4-601(a)(1) provides that "all property of the debtor as of the date of the petition" is property of the estate. A bank account to which the debtor has nominal title as trustee but which is subject to a trust for the benefit of third parties is not, by established principles, "property of the debtor" for bankruptcy purposes. Deposits to this account within three months of bankruptcy will not be voidable as preferences at least so long as the leases pursuant to which security deposits are paid require that the deposit be held in trust for the tenant.
and would be available for refunds of security deposits. Since the tenants' claims against the debtor would be extinguished by payment from this account, the mortgagee will receive the full benefit of his mortgage.

It is of course possible that a mortgagee will take neither of these steps to protect his mortgage. Whether he does so or not will depend on a number of factors including his estimate of the likelihood of the debtor becoming insolvent and the size of the potential liability as compared with the value of the security less the amount of the loan.

**Inventory Lenders.** When there are consumer creditors who have contracted to purchase goods from the debtor, the security interest of the inventory lender will be vulnerable under this section. Under existing state law a creditor's security interest in a debtor's inventory is subject to certain perils. Under U.C.C., §9-307(1) his security interest in a given piece of merchandise may be defeated by one who buys the merchandise in the ordinary course of the debtor's business. Thus, where a sale is completed and title is transferred under normal business conditions, the inventory lender loses his interest in the item sold and gains under section 9-306(2) an interest in "identifiable proceeds" of the sale. It is necessary then for the lender if he/she is to keep his loan maximally secured to police his/her collateral by requiring the debtor to keep the proceeds of the sale in identifiable form until the portion of the loan secured by the sold collateral is repaid.

An inventory lender could protect itself in a similar fashion from the lien given in paragraph (1) of proposed section 4-403. A down payment on merchandise pursuant to a contract of sale should be considered "proceeds" within the definition

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124 At first glance, one might think that the buyer's protection under U.C.C. § 9-307 extends to buyers who have contracted to buy but not completed a sale. This view is especially plausible in light of the definition of "buyer" contained in Section 2-103(1)(a) as a "person who buys or contracts to buy goods." Unfortunately, the definition of "buyer in the ordinary course of business" (Section 1-201[9]) precludes such an interpretation. The reference in the definition to "the sale to him" is strongly suggestive that to be a buyer in the ordinary course, one must have obtained title by a complete sale.
of §9-306(1).\textsuperscript{125} All the inventory lender need do then to avail himself of the protection of §9-306(2) and (3) is to be sure that proceeds are covered in his original financing statement and to require the debtor to keep such down payments in identifiable form. A separate security agreement or the kind of trust recommended above for mortgagees will not be necessary in this instance. Thus, the burden of policing collateral imposed on inventory lenders by proposed section 4-403 is not markedly different from that that they already bear under prevailing state commercial law.

Before considering the lien given in paragraph (2), it should be noted that the lien of paragraph (1) overlaps to some extent with that given in §4-602(d). Under §4-602(d), a purchaser whose executory contract to buy property is rejected by the trustee gets a lien on the property for the recovery of the portion of the purchase price he has paid. This lien is available both to commercial and consumer purchasers. Although a consumer purchaser may have a remedy under §4-602(d), this remedy is limited by the fact that the §4-602(d) lien only extends to the debtor’s interest in the property.\textsuperscript{126} Thus, where there is an outstanding security interest in that asset, the consumer’s only effective remedy would be to proceed under proposed section 4-403.

\textit{Major Secured Creditor’s of the Debtor.} Frequently a business has one major creditor with which it participates in an on-going and close relationship. Typically this creditor has a security interest in the majority of the debtor’s assets. In such cases, the secured creditor is likely to have notice that there are potential claims which will under section 4-403 subordinate his security interest and, in view of the debtor’s dependency on his continuing advances, is likely to have suf-

\textsuperscript{125} U.C.C. § 9-306(1) states ‘‘proceeds’’ include ‘‘whatever is received when collateral or proceeds is sold, exchanged, collected or otherwise disposed of.’’ Though there has not been a sale, a portion of the collateral has been otherwise disposed of.

\textsuperscript{126} The § 4-602(d) lien is further limited by the fact that it arises only in connection with executory contracts. A contract which has been fully performed by the consumer buyer but not by the seller may not be executory under this section. \textit{See} Countryman, \textit{Executory Contracts in Bankruptcy}, 57 Minn. L. Rev. 439 (1973).
ficient bargaining power to minimize the effect of section 4-403 upon his lien. The prudent lender will require the debtor either to place the consumer deposit in a special account as discussed above or to reinvest the proceeds in assets covered by his security agreement. In this way, the lender can protect himself from any diminution in the value of his collateral as a result of the priority given the consumer's lien. On the other hand, it should be noted that the proposed lien does prevent the collateral of the secured lender from being increased by virtue of the consumer's unreturned deposit.

If it is thought wise to make notice an explicit requirement for the lien to arise, a second proviso could be added to paragraph (2) as follows:

Provided that: such lien shall arise only if 1) the property . . . and 2) the creditor whose security interest is subordinated by this paragraph knew or should have known at the time the security interest was taken or filed that the debtor was receiving or would receive advance deposits or payments in connection with consumer sales or leases.

In determining whether the creditor "knew or should have known" various factors may be considered. It would be relevant for instance that the creditor is substantially engaged in financing businesses of the type owned by the debtor. Thus, for example, GMAC might be charged with the knowledge that consumer purchasers frequently make deposits on automobiles to be delivered at a later date. Other relevant factors would be whether the creditor has a right to inspect the books and accounts of the debtor, the size of the debt in relation to both the assets of the debtor and the size of loans made by the creditor to other businesses.

An even stronger requirement could be placed on the operation of this section by replacing the proviso suggested above with:

2) the creditor whose security interest is subordinated by this subsection exercised control over or substantially interfered with the debtor's business while the debtor was insolvent and within three months of bankruptcy.
If this alternative is adopted, the only creditors affected by subparagraph (2) will be those who have attempted to run the debtor’s business prior to bankruptcy. Since such intervention is often aimed at improving the creditor’s position in the event of bankruptcy and since the interests of consumers are frequently prejudiced by such interference, the equity of subordinating such a creditor’s claim cannot be disputed. Occasionally, though the creditor moves in in order to make an honest attempt to rehabilitate the debtor. From the creditor’s point of view, an informal attempt at rehabilitation will be easier and cheaper than instituting proceedings under Chapter VII. But, from the consumer’s point of view, a successful Chapter VII reorganization (under the amendments proposed in the next section of this paper) would mean full payment of his claim. It seems only fair that if the plans for rehabilitation backfire, a creditor who chooses for reasons of his own to act informally should be subordinated in the enjoyment of his collateral to the consumer creditor who has been denied recourse to the proposed payment provisions of Chapter VII.

**Proposed Priority For Certain Consumer Claimants**

In §4-405 of HR 31 priorities of distribution are specified as follows:

1.) administrative expenses,
2.) certain claims arising between the filing of an involuntary petition and adjudication,
3.) certain wage claims,
4.) certain contributions to employee benefit plans, and
5.) certain tax claims

There are many reasons for adding consumer creditors to this list of priorities. Many of them were discussed in the last section in connection with the proposed Section 4-403. Additionally, one goal of bankruptcy administration ought to be to minimize the impact of business failure on the surrounding community. In this context, it is relevant to consider
whether the amount of the claim is significant to the creditor but insignificant to the estate. While this could hardly be made into a general rule of priority, consumer claims (like wage claims) are normally within this category and consequently deserve special consideration.

Assuming the advisability of some kind of priority the chief questions are where it should be placed and what consumer claims should be covered. As for placement of the priority, there appear to be two fair alternatives. It could be placed fifth (after wage claims and employee benefits) or it could share a third priority with employee wage claims. If the latter alternative is adopted, probably some dollar limit should be set on the priority. Since the consumer priority covers a number of situations from the five dollar layaway to the deposit paid to a developer on the purchase of a home, a dollar limit is difficult to set. Consequently, it is recommended that section 4-405 be amended by inserting after paragraph (4):

(5) fifth, among allowed claims arising in connection with a sale or lease of goods, real estate or services by the debtor to a consumer where such goods, real estate or services were purchased or used primarily for personal, family, or household purposes subject to the limitation that the priority shall not exceed the amount paid in money or property to the debtor in connection with such sale or lease prior to the filing of a petition under sections 4-202 or 4-207, such amount to be reduced by the fair market value of property or services received by the consumer. A secured creditor whose rights to collateral are impaired by a consumer creditor’s exercise of the lien given in section 4-403 may be subrogated to the extent of impairment to the consumer creditor’s rights to priority under this paragraph if the claim of such consumer creditor has been paid in full.

Renumber paragraphs (5) – (9) as (6) – (10) accordingly.

By placing the consumer priority in the fifth position behind the priority allowed to certain employee claims, the need for a dollar limit on the priority is eliminated.

The language advocated above is sufficiently general to include all claims arising out of consumer transactions including, for example, claims for breach of warranty, for unearned deposits, and even for such technical claims as for truth in
lending violations. It must be noted, however, that some of these claims will not receive priority because they have not resulted in actual harm (as measured by the amount paid minus the fair market value of the property or services received) to the consumer. In fact, to the extent that the consumer's claim represents a penalty or is a claim for multiple or punitive damages, it will not even be provable as a general, nonpriority claim but will be subordinated under §4-406 (a) (3) to all other allowable claims.

Under these proposals some consumer creditors of the debtor will have both a lien under §4-403 and a priority under §4-405. But, because of their lien, these consumer creditors will become secured creditors and, under section 4-402(b), entitled to prove only the amount by which their claims exceed the value of their lien. When this occurs and the consumer is paid from the collateral of a secured lender, the lender whose collateral is impaired gets a right of subrogation to the extent of impairment under the last sentence of proposed paragraph (5). Arguably, this would be the case even without explicit statutory authority\footnote{The general rule of subrogation is that one who pays the debt of another and does not do so as a volunteer shall be subrogated to the rights of the person he pays as against the person primarily liable.} but it seems wise to settle whatever doubt there may be on the matter. The net effect of these changes is that the interests of secured creditors will be affected only when there are insufficient funds to pay off priority claimants.

The priorities of §4-405 prescribe the order of payment in all liquidation proceedings under Chapter V. They perform a different function in Chapter VII reorganizations. As currently written, HR 31, section 7-303(2) provides that no plan of reorganization may be approved unless all of the claims entitled to priority under section 4-405, paragraphs (1) - (5) (i.e., administrative, post-petition, wage, employee benefit and tax priorities) are paid in full. Since under the proposals made here consumers will have the fifth priority and tax claims are demoted to the sixth, the reference in section 7-303(2) to §4-405(a) (1) - (5) should be changed to §4-405(a) (1) - (6).
Thus, the net effect will be that payment of consumer claims covered by the fifth priority will be a prerequisite for a successful plan of reorganization.

ENFORCEMENT OF STATE LAW

In Chapter 7 reorganizations a tension may develop between the goal of bankruptcy administration to benefit creditors by maximizing the profitability of the debtor’s business and the state’s interest in fair treatment of its consumers. At a minimum, the federal policy should be limited by the requirement that the debtor’s business be operated in compliance with state law. One effective way to insure such compliance is to allow state officials to bring an action for injunctive relief in state court. As presently written, §2-202 makes a state forum unavailable by providing for removal of all actions against a trustee or a debtor in possession to Bankruptcy Court. To remedy this, the following exception is recommended.

In Section 2-202, after subsection (a) insert:

(b) Exception—Action by State Officer Against a Trustee, Receiver or Debtor in Possession—If a trustee, receiver or debtor in possession is authorized to operate the business of the debtor under this title, an action maintained by an appropriate state officer seeking enforcement of state law regulating such business and seeking injunctive relief only may not be removed without the consent of the state officer maintaining such action.

Reletter subsections (b) and (c) as (c) and (d) accordingly.

Similarly, §405-1 as currently written provides that a petition in bankruptcy acts as a stay of civil actions affecting the debtor’s estate. For the reasons presented above, such a stay should not be available where a state official seeks only injunctive relief. To accomplish this result, relief from the stay should be provided as follows:

In Section 4-501, subsection (c) insert after paragraph (4):

(5) The action is one which could not be removed to Bankruptcy Court by reason of Section 2-202(b).
One important exception to the jurisdiction of Bankruptcy Courts should be noted. In §202-1(d), Bankruptcy Courts are denied jurisdiction to try federal criminal offenses. In order to avoid the implication that debtors or trustees operating a business are exempt from state criminal law or that state crimes may be tried in Bankruptcy Court, the following change is suggested.

Section 2-201(d)
In place of "of the United States", line 12, insert "of a State or of the United States".

ASSISTANCE FOR CONSUMER CREDITORS IN BANKRUPTCY

It is suggested that the following changes be made in HR 31 with the aim of recognizing a special class of consumer creditors and empowering the attorney general of each state to act on their behalf.

Consumer Creditors

In section 1-102 after paragraph (12) a definition of a "consumer creditor" should be inserted as follows:

(13) The term "consumer creditor" shall mean one to whom the debtor owes money or some other duty of performance in connection with (A) the sale or lease (by the debtor to the consumer) of goods, services or real estate purchased or used primarily for personal, family or household purposes or (B) a deposit of household funds or personal savings with a landlord or financial institution.

In section 1-102, renumber paragraphs (13) - (46) accordingly.

Under this definition, a person becomes a consumer creditor merely by having a claim against the debtor which stems from a consumer transaction. It is the purpose of the transaction rather than the type of claim which is controlling. The status of consumer creditor conferred by this definition determines both the applicability of the proposed notice and procedural provisions which follow and, together with other criteria, the consumer’s right to a priority under section 4-405 or lien under section 4-403.
Clearly anyone who is a consumer creditor within the above definition will also be within the definition of "creditor" contained in section 1-102(15) of the Act as written. The two concepts should not be considered mutually exclusive. To make this explicit, a sentence should be added at the end of section 1-102(15) as follows:

The term "creditor" shall include a "consumer creditor" as defined in section 1-102(13).

State Attorney General

In section 1-102 after paragraph (44), a definition of "state attorney general" should be inserted as follows:

(45) The term "state attorney general" means the attorney general of a state or his agent if he is charged under the state law with the enforcement of consumer law. In states where the primary responsibility for consumer protection rests with some other state officer, the term shall include such other state officer.

In section 1-102, renumber paragraphs (45) and (46) accordingly.

This definition recognizes the fact that the state attorney general’s office may not, in all states, bear the primary responsibility for protecting consumers. Where this is the case, the above definition allows the state officer who does bear this responsibility to perform the functions allotted to state attorneys general under these proposals.

Debtor’s Responsibility to Schedule Consumer Creditors

Unlike the current Bankruptcy Act, HR 31 does not itself explicitly require the debtor to file a schedule of debts. However, the Commission’s comment to section 4-502 explains that "it is contemplated that the administrator will by rule prescribe the form and content of such information to be submitted by the debtor." 128 Although the rules will certainly require the debtor to list his creditors, it is recommended that section 4-502 be amended as follows:

In subsection (a), after paragraph (5), insert: (6) provide the names and addresses of all known consumer creditors who may have claims against him. Renumbe paragraph (6) as paragraph (7).

This change has two objectives. First, consumer creditors are often forgotten when the debtor lists his creditors. It is hoped that by requiring a separate schedule of potential consumer claimants, a debtor will be reminded that some of his customers or tenants have or may have claims against him. Secondly, it is essential to the notice provisions which follow that consumer creditors be identified as such as quickly as possible.

**Notice to Consumer Creditors**

Section 4-307 as written requires the administrator to notify all creditors (including presumably consumer creditors) of the proceedings. Since under the recommendations which follow certain state attorneys general may have an interest in the proceedings, notice should be given to them as follows:

In Section 4-307, after subsection (g), insert: (h) **Notice to State Attorneys General** - Whenever the administrator or trustee has reason to believe that there may be consumer creditors with provable claims, he shall give to the attorney general of the state in which he believes such creditors to be residing,

1. notice of all matters specified in subsections (a) and (b) of this section,
2. a list of the names and addresses of all known consumer creditors,
3. the amount of each such claim if known, and
4. if the attorney general so requests, the notices required under subsection (c) of this section.

The notice here required will aid each attorney general in making an initial determination as to whether he/she should involve himself in the proceedings and, if he/she decides to do so, gives him/her the information needed to inform consumers of the availability of assistance in filing claims.

**Standing For State Attorneys General**

In addition to aiding individual consumers in proving their claims, the attorney general may wish to raise issues affecting
consumer interests before the administrator of the bankruptcy court. There seems to be no reason why he/she should not be allowed to do so in cases where consumer interests are substantial. Thus, the following change is recommended:

In Section 2-205, after subsection (b) insert:

(c) Standing for State Attorneys General - Whenever the administrator finds that 1) the claims of consumer creditors are likely to be greater than twenty-five (25) percent of the outstanding indebtedness, 2) the claims of consumer creditors are likely to exceed $10,000, 3) there are individual consumer creditors with claims greater than $1000, or 4) that the interests of consumer creditors is otherwise substantial in the administration or distribution of the estate, the Attorney General of any state in which such consumer creditors reside shall have standing to raise any issue affecting the interest of consumer creditors before the trustee or by complaint or intervention before the Bankruptcy Court.

The first three standards specified in this section are intended to provide guidelines for the state attorneys general and for the administrator to use in assessing the appropriateness of intervention in any particular case. These standards recognize that consumer interests may be substantial either by virtue of their absolute size, the size of individual consumer claims or the preponderance of consumer claims in the administration of the estate. Nevertheless, these standards are not definitive. The desirability of intervention may be affected by a number of factors including the pre-petition conduct of the debtor, the conduct of any of the debtor's major creditors, and the efficiency and experience of the intervening attorney general. To allow for these factors, the catch-all standard (4) promotes flexibility and should be interpreted liberally to allow intervention by the attorney general whenever it appears that such intervention would not be frivolous.

Role of The Attorney General in the Proof and Handling of Consumer Claims.

The following provisions aim at providing an alternative procedure for the filing and proof of consumer claims.
In Section 4-401, after subsection (c), insert:

(d) **Filing by State Attorney General** - If a consumer creditor of the debtor has failed to file a claim within the time prescribed pursuant to subsection (a) of this section and if the Attorney General of a state would have standing in the proceedings under the criteria specified under Section 2-205(c), the Attorney General of a state may execute and file a proof of claim on behalf of the consumer creditors of his state in accordance with rules set out by the administrator. Nothing in this section or in Section 4-402 (b) shall be construed to create an attorney-client relationship between the Attorney General of a state and a consumer creditor unless such relationship is expressly claimed by both parties.

In Section 4-402, after subsection (a), insert:

(b) **Treatment of Estimated Claim Filed by State Attorney General** - When a state Attorney General has filed a claim pursuant to Section 4-401 (d), the trustee, the debtor, and the state Attorney General shall examine the claims filed by consumer creditors pursuant to Section 4-401 (a) and any documentation of unfiled claims in the possession of the Attorney General. The trustee shall disallow any improper claims and, where appropriate in view of the similarity of the separate claims and with the consent of the consumer creditor, consolidate the remaining claims for ease of administration. The value of the consolidated claims and any allowed consumer claims not thought appropriate for consolidation shall replace the Attorney General's estimated claim as the claim of such consenting consumer creditors. The consolidated claims shall then be allowed as claims against the estate. If any consumer's claim is disallowed or reduced under this section, the consumer creditor whose claim is affected shall be notified by the trustee of such disallowance or reduction and the reasons therefore.

Reletter (b) - (d) as (c) - (e) accordingly.

Since the deadline for filing claims frequently works to deprive consumer creditors of their remedy, the attorney general is given authority (if he has standing under the provisions recommended above) to file an estimated claim which will preserve the rights of consumer creditors until such creditors are identified and the amount of their claims can be ascertained.
Rules governing time limits and procedures for filing such estimated claims are to be prescribed by the administrator.

Proposed §4-402 (b) aims at authorizing a flexible procedure whereby the bankruptcy trustee or administrator and the state attorney general can work together to handle consumer claims accurately and efficiently. For example, in a given case, the attorney general may file an estimated claim based on the debtor's business records. He might contact potential claimants and ask them to fill out a simple form stating the basis and amount of their claims and to attach any receipts or documents they possess. The form might also contain space for the consumer to consent to have his claim consolidated. The administrator, the debtor, and the attorney general can then go through the claims received, allowing them where appropriate and consolidating them where their similarity warrants. When distribution of the estate is finally made, the attorney general may be authorized by the administrator to distribute to individual consumers the dividends on consolidated claims.

It is hoped that the above changes will make it possible for more consumers to prove claims in bankruptcy. In states where the attorney general's office is already active in helping consumers to enforce their rights, the advantages of having that office as a place to file claims are considerable. These include 1) personnel specifically trained to assist consumers with legal problems; 2) in some offices the availability of foreign language assistance; and 3) more convenient locations. In addition, a state consumer office frequently is able to publicize its activities and may, by this means, alert consumers to come in and file their claims.

Selection of a Trustee

In a Chapter V proceeding, a private trustee may be elected by certain eligible creditors. In its present form, § 5-101(b) provides that creditors who are secured or have priority are entitled to vote only the amount of their claims which are in excess of the amount of their security or priority. While there
are good reasons for not allowing certain priority claimants (e.g. tax claimants, those who will have administrative claims) to vote for a trustee, such reasons do not apply to consumers possessing a priority under proposed § 4-405(a)(5)\textsuperscript{129}. Especially where it is unclear that the unsecured assets will be sufficient to pay priority claims, consumers have a real interest in the selection of a trustee. Accordingly, it is recommended that the last two sentences of § 5-101(b) be omitted and that the following be substituted in their place:

A creditor whose claim is secured shall be allowed to vote only to the extent that his claim is enforceable for any excess of the claim over the value of his security. A creditor whose claim is given priority under paragraphs (1) - (4) or paragraph (6) of §4-405 shall be allowed to vote only to the extent that his claim is enforceable for any excess of the claim over the amount of his priority. For the purposes of this section, the administrator may temporarily allow claims pursuant to § 4-402.

It should be noted that § 5-101 (a) authorizes the administrator to prescribe rules under which proxies may be solicited. Such rules should allow for a state attorney general to obtain proxies from consenting consumer creditors.

In Chapter VII proceedings the trustee is chosen by the administrator with the approval of the courts. Since under the changes here recommended no plan can be approved without payment of consumer claims, consumers are not so vitally affected by the choice of trustee.

\textit{Creditors' Committees}

As presently written HR 31 allows only actual creditors to serve on creditors' committees. Since few consumer creditors

\textsuperscript{129} For example, it is impractical (if not impossible) to allow administrative claimants a vote. Such people are not properly speaking "creditors" and often their identity and the amounts of their claims will not be known prior to selecting a trustee. As for tax claimants, there are legitimate policy reasons for not allowing federal and local taxing authorities a disproportionate voice in the selection of a trustee. Admittedly, though, there may be good reasons for allowing wage claimants a vote should the unions or some other group ever be interested in soliciting their proxies.
have sufficient experience or a sufficiently large claim to participate, it seems appropriate to allow a state attorney general who has intervened in the proceedings to serve on such committees. This is accomplished by the following amendments to § 5-102 and § 7-101.

At the end of § 5-102(a) add:
In any case where the Attorney General of a state has standing under Section 2-205, he shall be eligible for appointment to a creditors’ committee.
Before the last sentence of § 7-101(a) add:
In any case where the Attorney General of a state has standing under Section 2-205, he shall be eligible for appointment to a creditors’ committee.

Involuntary Petitions

Occasionally, the attorney general of a state learns in the course of handling consumer complaints that a business is receiving down payments for the future delivery of goods or services while hopelessly insolvent. Under state law, there may be a number of ways in which the attorney general can protect consumers from an insolvent business. He may, for example, be able to initiate some form of state insolvency proceedings. Or, alternatively, he might be able to get an injunction preventing the business from continuing to receive such deposits unless they are placed in escrow. In cases where bankruptcy proceedings are reasonably anticipated, a far more efficient remedy would be to allow an attorney general to file an involuntary petition in bankruptcy. Empowering him to do so would prevent useless last minute expenditures by the debtor in litigating issues properly before a bankruptcy court. Consequently, § 4-205 should be amended as follows:

After subsection (b) insert:

(c) Attorney General’s Petition - Whenever the attorney general of a state has reason to believe that a person

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130 For example, many states have consumer protection statutes outlawing "unfair and deceptive practices." Under such a standard, a compelling argument might be made that it is unlawful to take advance payments from consumers while knowing that one's insolvency makes full delivery of goods or services unlikely. An attorney general with enforcement powers under the state law might be able to obtain an injunction against further receipt or commingling of such deposits.
doing business in his state has harmed or will harm consumer creditors in an amount greater than $2500 by reason of his insolvency, the state Attorney General may file a petition against such person for relief under Chapter V.

Re-letter subsection (c) as subsection (d), and after that subsection insert:

(e) Relief may be granted on a petition by a state Attorney General-

(1) if any of the conditions contained in paragraphs (1) - (3) of subsection (d) of this section are met; and

(2) it appears that the Attorney General would have standing in the proceedings under the criteria specified in §2-205(c).

The net effect of these changes is that whenever the attorney general determines that there is a probability that the consumers of his state will be harmed in an amount greater than $2,500, he has the same ability to file a petition as a creditor with a non-contingent claim for $2,500. But, in seeking relief, he has the additional burden of showing that consumer creditors will have a substantial interest in the proceedings. Since an attorney general would under 4-210(f) be liable for damages caused by wrongful filing to the same extent as any creditor, it seems reasonable not to make it substantially more difficult for him to file an involuntary petition.

Recovery of Expenses

Certain expenses incurred by the attorney general in assisting consumer creditors should be recoverable from the debtor’s estate as an administrative expense.

In section 4-403, subsection (a), after paragraph (11), insert:

(12) expense incurred by the attorney general of a state in notifying consumer creditors of the availability of his assistance in filing proofs of claim; in cooperating with the trustees in consolidating consumer claims, or in performing any of the functions for which a creditor could be reimbursed under paragraphs (1) - (4) or (8) - (10) of this section.
Thus, the attorney general is allowed to recover expenses actually incurred for notifying consumers and aiding the administrator in handling consumer claims. Even if some state attorneys general would undertake these responsibilities without reimbursement, this provision provides incentive for the administrator and creditors to cooperate fully with an intervening attorney general. A wise administrator might, for example, invite the attorney general to join his notice of available assistance with the notices sent by the Bankruptcy Court thereby saving the expense of a second mailing.

In addition under this proposal, the attorney general may recover for certain services rendered to the estate to the same extent as other creditors.

Conclusions

Something is basically wrong with the Bankruptcy Act that it allows a large group of unsuspecting individuals—consumer creditors—to receive little or no recovery in the vast majority of commercial bankruptcies. The remedies available to consumers under state law and through traditional bankruptcy routes all fail to do one essential thing—to assure that some funds will be distributed to this class. While amendments to the federal law might be drafted to allow individual states to protect consumers, the goal of uniform administration of the bankruptcy laws as well as security for lenders operating across state lines will be upset. Furthermore, it is hard to conceive of appropriate state remedies which are neither overbroad nor ineffective in securing justice for consumer creditors. The job is clearly a federal one.

The suggestions made here for specific amendments to the proposed new Bankruptcy Act will certainly strike some as too novel and others as dangerous. They are not intended as threats to the commercial community. Rather their purpose is to secure a just result from the Bankruptcy Court so that all segments of the community injured by the bankrupt's insolvency can mitigate their losses equitably. If bankruptcy proceedings cannot be made to operate fairly on behalf of consumer creditors
as well as business creditors they have failed of their purpose. While Congress considers reform of the bankruptcy laws it should give careful attention to these proposals and others like them.