Security interests and reorganization: a clash of institutions

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# Security Interests and Reorganization: A Clash of Institutions

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**Rashid Bahar**

Security Interests and Reorganization: A Clash of Institutions
Abstract

The law governing distressed companies is haunted by a fundamental tension: On the one hand, it seeks to coordinate the actions of the creditors and seeks increasingly to preserve firms' capacity to operate as a going concern. On the other hand, through security, it allows sophisticated creditors to acquire an interest in specific assets or pools of assets that entitles them to foreclose upon default. The collective need to shield the debtor's assets from the reach of creditors clashes with the asset-based financiers' reliance on quick and effective means to realize the collateral. This paper examines, from a comparative perspective, different strategies used to reconcile these interests. It concludes however that none were really successful. Therefore it briefly reviews various alternative institutional settings.

I. Introduction

The law governing distressed companies is haunted by a fundamental tension. On the one hand, it seeks to coordinate creditors and increasingly to preserve firms' capacity to operate as a going concern. On the other hand, through security, it allows sophisticated creditors to acquire an interest in specific assets or pools of assets that entitles them to foreclose upon default. This right to force the sale of the collateral encourages creditors to compete for the debtor's assets early on.

This tension is conspicuous whenever the security interest charges a key asset of the firm, without encompassing the entire business. If a creditor holds a security interest in a factory, a piece of equipment or machinery, an airplane, and therefore can force these assets, how can the debtor and the other creditors negotiate a renegotiate to preserve any going-concern surplus? To resolve this question, Part II will show how the tension is rooted in the very different approaches to financial distress that underlies these institutions. Part III contrasts how Swiss and U.S. law failed to reconcile them. Part IV provides a few alternative ways to resolve the conflict or at least to mitigate it.
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II. Bankruptcy and Security: As Two Different Approaches to Financial Distress

A. Collectivization Through Bankruptcy and Reorganization

For modern scholars, bankruptcy law has shed away its punitive component: it no longer seeks to punish and shame failed businessmen.¹ Instead, it seeks to resolve financial distress in a forum where the debtor, its creditors and other stakeholders (employees, contractual partners and shareholders) can negotiate. Its complex procedure sets out how to circumscribe the estate of the debtor, how to ascertain claims, how to liquidate the estate, how to share the proceeds among the claimants and last, but not least, who should carry out these tasks.² In spite of the controversies surrounding its proper policy,³

bankruptcy law is essentially a law of collective debt enforcement; a solution to what economists call a “common pool problem”. The classical approach to this issue focused on liquidation: it took a “salvage view” of the firm and tried to sell each asset piecemeal to the highest bidder on the “courthouse steps”. Doing so, it failed to see that in spite of financial difficulties, some firms rest on sound economic foundations and therefore the whole may be worth more than the sum of the pieces. Instead, reorganization proceedings try to avoid this pitfall and allow the firm to survive after its assets and liabilities are adapted. To stick to the shipping metaphor, they set up a “rescue” mechanism; they permit the debtor to reschedule the repayment of his debts, to get a partial renunciation on the repayment of

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4 Swiss law without contest defines bankruptcy law as a means to enforce collectively claims against a debtor. See Message du conseil fédéral concernant la révision de la loi fédérale sur la poursuite pour dettes et la faillite du 8 mai 1991,FF 1991 I 5 (describing the debt enforcement and bankruptcy act is essentially a law to enforce monetary claims). See also KURT AMOHN/FRIDOLIN WALTHER, Grundriss des Schuldrechts- und Konkursrechts, 7th ed. (Bern: Stämpfli, 2003), p. 281, § 35, n° 3. The issue is more controversial in the United States. The law and economics scholars generally tend to analyze bankruptcy law as a collective enforcement proceeding, whereas other scholars think that other dimensions should also be accounted for. See, e.g., BAIRD/JACKSON, supra note 2, p. 102; JACKSON, supra note 2, p. 8–9; JACKSON, supra note 3, p. 871; WARREN, Bankruptcy Policy, supra note 3, p. 785.


8 See BAIRD, supra note 6, p. 581; BAIRD/JACKSON, supra note 2, p. 101; WHITE, supra note 6.

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the principal and interest or even to convert debt into equity. Reorganization should, in other words, allow the debtor to rearrange its capital structure and enable it to continue its activities.10

The main difficulty that the legal system has to face lies in sorting firms and deciding which can be rescued and which should be scrapped. In theory, the question is easy to answer: reorganization should be favored whenever the firm has a going-concern surplus, or, in other words, whenever the continued existence of the firm is likely to yield more than an outright liquidation. However, the real problem lies in obtaining the information to answer this question.11 Valuation is a complex and uncertain process, and the insiders, those who are in the best position to know the true state of the affairs, are interested in keeping the firm going even if liquidation would be a better outcome, thus creating an adverse selection problem.12 Thus reorganization and its collective procedure is far from being a perfect solution to corporate insolvency.

B. Appropriation Through Security Interests

By contrast to reorganization, which sets out a collective procedure, security interest seeks to resolve financial distress through the allocation of proprietary rights in assets. When a creditor takes a security interest in the debtor’s property, it acquires a proprietary right to realize the assets given as collateral upon default of the debtor and to use the proceeds to pay off the debt in priority to competing claims of third parties.13 This interest can be broken down into two components: a property right, linking a claim with an asset and granting the creditor with a right to seize the collateral,14 and a priority right,

10 BAIRD, supra note 6, p. 581; BAIRD/JACKSON, supra note 2, p. 101; WHITE, supra note 6.
12 See BULOW/SHOVEN, supra note 11; WHITE, The Corporate Bankruptcy Decision, supra note 11; WHITE, supra note 6; WHITE, Does Chapter 11 Save Economically Inefficient Firms, supra note 11.
13 BAIRD/JACKSON, supra note 2, p. 112.
allowing the creditor to be paid off on the secured claim before competing unsecured claims.\textsuperscript{15}

A security interest can also be conceptualized as an anticipated levy on the debtor's assets. A creditor will usually take security before the debtor's financial trouble starts. Doing so, it earmarks the assets that it wants to seize and realize upon default of the debtor.\textsuperscript{16} At first glance, this does not amount to much more than individual debt-enforcement proceedings: each creditor is responsible to protect its own interests and the legal system lets the devil take the hindmost. However, the key difference between security interests and the "grab law" resulting from individual debt enforcement results from the moment when these actions are taken. The security interest is acquired in advance, prior to insolvency, but it cannot be enforced until default; whereas a levy on property will follow the default and will lead immediately to the sale of the seized assets. The grant of a security interest therefore cannot trigger a run on the property of the debtor. Quite to the contrary, it will allot in advance the estate, in such a way that, upon default, the assets will already be shared

\textsuperscript{15} Baird/Jackson/Picker, supra note 14, p. 1; Antoine Eigenmann, L'effectivité des sûretés mobilières (Fribourg: Editions Universitaires de Fribourg Suisse, 2001), n° 144; Merrill/Smith, supra note 14, p. 834; Pierre-Henri Steinhauser, Les droits réels, Tome I, 3\textsuperscript{rd} ed. (Bern: Stämpfli, 1997), n° 26 ***, For the civil lawyers, this priority right one of the consequences of the proprietary nature of the security interest.

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among the creditors and the preference order established, hence avoiding any need to race for the assets when the situation deteriorates.17

Pushing this model to the extreme as English law had done with the floating charge, a single creditor can take a charge over an entire business. This security interest will entitle it to appoint an administrative receiver in the event of a default and, until the passing of the Enterprise Act 2002, 18 thanks to this administrative receiver, decide what to do with the firm during the insolvency. Thanks to this monopoly position, the secured creditor pockets all the benefits of monitoring the debtor's financial situation and avoids the collective action problems that would otherwise plague an uncoordinated group of creditors.19

In terms of debt enforcement, the interaction between security interest and bankruptcy is similar to the one between private property and common production described by Demsetz in his classical paper on property rights and fur trading. The same way hunters can either cut up the hunting grounds and apportion property rights or share it in common, 20 creditors can decide in advance to either appropriate bits and pieces of the debtor's assets through security interests or wait until insolvency to decide exact how to share the assets. The first solution has the advantages of avoiding collective action problems and common pool issues, but implies high transaction costs to attribute the property rights. The second route avoids the haggling in good times, assumes that cash is plentiful, and waits until the firm goes under to share the value among the creditors. Doing so, it tolerates the common pool problems that

arise when the debtor's financial conditions deteriorate and although it tries to mitigate these issues through bankruptcy law, it cannot avoid them.

C. Incompleteness as a Source of Tension

A collective scheme is costly once the creditor goes bankrupt. The pay-out structure based on pari passu treatment of all creditors is a powder keg waiting to explode: a financier prior to bankruptcy can hardly control the amount of debt the borrower can take on; at most it can accelerate call back its loan once the debtor exceeded contractual thresholds. Even then, its claim will rank pari passu with the new debt.

On the other hand, an insolvency law based exclusively on proprietary security interest fails to carry out its promises for two reasons. First, not all creditors take security, quite to the contrary: most big firms refuse to charge their assets and promise not to do so with a negative pledge clause. In the realm of small and medium enterprises, trade creditors and workers forgo this possibility, because of the excessive costs and therefore accept to go unsecured relying only on the prospect of future cash flows and any statutory lien or privilege they may enjoy. The impossibility to take security is even more patent with involuntary creditor (tort creditors, tax authorities, or social security institutions whose claims are defined by law): wanting a negotiation with the debtor, they cannot bargain for collateral.

Second, on the asset sides, few jurisdictions allow a single and all encompassing security interest. Swiss law sets out restrictions on non-possessory security interests and in charges of future property.21 U.S. Article 9 of the Uni-

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form Commercial Code bars super-generic descriptions and sets out different requirements depending on the type of collateral.

These two factors prevent security interests from driving the entire insolvency process and require collective debt enforcement proceedings as a backdrop solution. The interface between a collective process and individual property-based remedies is the source of a clash of institutions. In liquidation, the tension is mild: the collective proceeding and the individual right to sell the assets and specially the collateral at the best available price. The incompatibilities between the systems are therefore limited to the delays imposed on the realization of specific assets in order to warrant an orderly liquidation of the entire estate. The disharmony turns into a conflict when the collective proceeding seeks to reorganize the trouble firm instead of liquidating it. From then on, either the secured creditor must accept to suffer the loss, or at the very least the stay, of its right to force the sale of the collateral, severing the tie between the secured claim and the specific item of property, or the entire reorganization process can be jeopardized by a loose secured creditor.

22 The security agreement must describe the collateral must “reasonably identify the collateral” with sufficient detail to be identifiable. U.C.C. § 9–108(a). In practice, this requirements bars super-generic descriptions such as “all personal property” or “all assets”. U.C.C. § 9–108(c). But it does not prevent blanket liens as the secured creditor can list carefully all the assets or pools of assets he may want to receive as a security for his claim in the security agreement and file for a security covering all assets. See U.C.C. § 9–504(2) and Comment to U.C.C. § 9–504.

III. Failed Attempts to Reconcile Security and Bankruptcy

A. A Simple but Ineffective Solution

In theory, the clash between secured credit and reorganization can be easily resolved: the very purpose of reorganization is to preserve any going-concern surplus that may exist. Therefore, the reorganized firm should be worth more than, if its assets were sold piecemeal in a quick liquidation process, or if the secured creditor could directly enforce its rights. In principle, the debtor and the unsecured creditors can therefore use this surplus to convince the secured creditors to stay the realization of the collateral and wait until the end of the reorganization.\(^{24}\)

However, this view is untenable in practice for several reasons. First, a reorganization is not a straightforward procedure and the valuation problem plagues the entire system. Neither the secured creditor nor the firms know the value of the firm nor can they easily determine the value of its collateral.\(^{25}\) For most goods, the valuation is far from being straightforward and, hence, the criterion used to measure the right of preference boils down to a guessestimate.\(^{26}\)

In addition to the valuation problem, secured creditors and the debtor have incentives to take very different views. The secured creditor, especially if his claim is covered, is risk averse, because they can only lose if things turn...
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sour although they will not profit from any upturn. They will thus be inclined to take a pessimistic stance, whereas the debtor and the unsecured creditors have little or nothing to lose by betting on a successful reorganization and are thus likely to be too optimistic.

This expectation gap between the secured creditor and the debtor is worsened by an adverse selection problem. The debtor and its management do not only have strong incentives to favor reorganization, but they also have access to more information than the secured creditor. Therefore, even if they know that the firm is not worthy of reorganization, they will be inclined not to tell it to the secured creditor to keep the business running as a going concern. Thus, if the secured creditor has only access to good news regarding the prospects of reorganization, it cannot be confident that the debtor did not conceal the dark side of the story and will discount this risk from its valuation.

In sum, this simple solution of a negotiated agreement between the secured creditors and other stakeholders is bound to fail, or at least can only work if very strict assumptions hold. Therefore, the legal framework has to provide for a way to mitigate the tension between security interests and collective proceedings. However, the appropriate approach is not obvious as highlighted by the differences between Swiss and U.S. laws.


28 BERGSTROM/EISENBERG/SUNGDREN, supra note 27, p. 363. See also BAIRD/JACKSON, supra note 2, p. 107 and 121; JACKSON/SCOTT, supra note 27, p. 158.


30 See WHITE, supra note 6; WHITE, Does Chapter 11 Save Economically Inefficient Firms, supra note 11.
B. Swiss Approach: Deference to Property Law

Swiss law's approach to this clash can be summarized as deference to property law subject to delays and collectivization. Swiss law provides for three types of insolvency proceedings:31

- Liquidation by way of bankruptcy (Konkurs, faillite) focuses on the sale of the assets under the supervision of an administration (Sachwalter, administration), which can include either public officials in charge of bankruptcy proceedings or a group of persons elected by the creditors.

- Ordinary composition (Ordentlicher Nachlassvertrag, concordat ordinaire) is a contract between a debtor and its creditors on the rescheduling or a partial or complete renunciation of claims.32 However, by virtue of a judicial confirmation, it can bind all general unsecured creditors, provided a majority of the creditors holding the two thirds of the aggregate value of the outstanding claims and at least three quarters of the outstanding claims accept it.33 To facilitate the negotiation of the composition agree-


33 LP art. 305(1).
ment, the law allows the debtor to request a stay of all debt enforcement proceedings.\(^{34}\)

Composition by way of disposal of assets (Nachlassvertrag mit Vermögensabtretung, concordat par abandon d'actifs) is similar to an ordinary composition. But instead of allowing the debtor to pursue its existence, it allows the debtor to assign all or part of its assets to the creditors or to a third party as a discharge of its debt, thus simplifying the liquidation process.\(^{35}\)

These procedures affect more or less the position of the secured creditor. Liquidation merely centralizes the enforcement process. As of the beginning of bankruptcy proceedings, the secured creditor is barred from enforcing personally his claim (even if he was contractually entitled to do so) and must hand in to the administration any collateral that it may have in its possession.\(^{36}\) Moreover, subject to a few exceptional circumstances,\(^{37}\) the administration cannot realize the assets until the second creditors' meeting, after it has invited all the potential creditors to produce their claims and it has decided whether or not to admit their claims.\(^{38}\)

\(^{34}\) LP art. 293. The effects of the moratorium are limited to a stay of debt enforcement proceedings and a restriction of the powers of the debtor. LP art. 297 and 298. It does not affect cantonal enforcement proceedings, which have another purpose than seeking the enforcement of a monetary claim. See Luzern, Schuld betreibungs- und Konkurskornmission, 29.11.1983, BISch 50 (1986), p.117; FRITZSCHE/WALDER-BOHNER, supra note 32, p. 607, § 72, n° 23, note 43.

\(^{35}\) LP art. 317. See also AMONN/WALTHER, supra note 4, p. 443, § 53, n° 17; DALLÈVES, supra note 31, p. 349; FRITZSCHE/WALDER-BOHNER, supra note 32, p. 592-593, § 71, n° 8-9; GUGGISBERG, supra note 32, ad art. 314 SchKG, n° 20 (distinguishing ordinary composition from composition by disposal of assets); ALAIN WINKELMANN/LAURENT LEVY/VINCENT JEANNERET/OLIVIER MERKET/FRANCESCA BIRCHLER, in Adrian Stahelin, Thomas Bauer, and Daniel Stahelin (eds.), Kommentar zum Bundesgesetz über Schuld betreibung und Konkurs III (Basle/Geneva/Munich: Helbing & Lichtenhahn, 1998), ad art. 317 SchKG, n° 1.

\(^{36}\) Inkasso- und Verwaltungsbüro Luzern, ATF 71 III 153, consid. 2, p. 155-156; FRITZSCHE/WALDER-BOHNER, supra note 32, p. 144, § 41, n° 13; ZOBEL, supra note 14, Systematischer Teil, n° 712. However, the administrator is allowed to auction the assets, without the consent of the secured creditor, even if the proceeds are not sufficient to cover the latter's claims. ZOBEL, supra note 14, Systematischer Teil, n° 734. See FINANS & KREDIT A.G., ATF 90 III 18, consid. 3, p. 23-25 See also Gürtnert, ATF 72 III 30, consid. 1, p. 30 (holding that there is no need for a consent to sell the assets), consid. 2, p. 31 (holding that a private sale in principle supposes the consent of the secured creditor except if the sale is certain to cover its claim as in the case). But see Fuchs & Cie., ATF 53 III 12, consid. 2, p. 18-19 (holding that the creditor can refuse a private sale and is not liable for a loss caused by his refusal).

\(^{37}\) LP art. 243(2).

\(^{38}\) LP art. 243 (3).
However, these rules only apply to security interests. They do not extend to quasi-secured transactions, such as fiduciary transfers of property, title retention agreements, which entitle the owner-creditor to vindicate the assets from the debtor and to realize them notwithstanding bankruptcy proceedings. Similarly, a creditor secured by an assignment of receivables is entitled to collect directly all the claims that have arisen prior to the opening of the bankruptcy proceedings.

See, e.g., Finanz & Kredit A.G., ATF 90 III 18, consid. 3, p. 23–25, Konkursmasse Meier gegen Peters & Co., ATF 93 III 96, (on the effect of a non-registered German reservation of property clause in the event of bankruptcy), X. gegen Konkursmasse Y. AG, ATF 119 II 326, consid. 2c and 2d, p. 327–328 (wrongly speaking of a case where the fiduciary owner of the collateral acquires for himself the good—it already owns it). See also Amonn/Walther, supra note 4, p. 319, § 40, n° 28; Lukas Handschin/Daniel Hunkele, in Adrian Staehelin, Thomas Bauer, and Daniel Staehelin (eds.), Kommentar zum Bundesgesetz über Schuld betreibung und Konkurs II (Basle/Geneva/Munich: Helbing & Lichtenhahn, 1998), ad art. 197 LP, n° 66 (on title retention agreements); Carl Jaeger/Hans Ulrich Walder/Thomas M. Kull/Martin Kottmann, SchKG (Zurich: Schultess, 1999), ad art. 197 LP, n° 18–19, and ad art. 212, n° 9. But see Pierre-Robert Gilliéron, Commentaire de la loi fédérale sur la poursuite pour dettes et la faillite du 11 avril 1989, texte en vigueur le 1er janvier 1997. Art. 159–270 LP, (Lausanne: Payot, 2001), ad art. 198 LP, n° 17–19. More accurately, if a good is sold subject to a property reservation clause, in the event of a bankruptcy, the estate has the option either to accept the contract and perform it integrally or reject it. In the second case the debtor can either rescind the contract and vindicate the good or simply file for the unpaid amount of his claim as an unsecured creditor. Dreyfus v. Grimmer, ATF 73 III 166, consid. 2, p. 169–170; Jaeger/Walder/Kull/Kottmann, supra note 39, ad art. 212 LP, n° 6; Renate Schwo, in Adrian Staehelin, Thomas Bauer, and Daniel Staehelin (eds.), Kommentar zum Bundesgesetz über Schuld betreibung und Konkurs II (Basle/Geneva/Munich: Helbing & Lichtenhahn, 1998), ad art. 212 SchKG, n° 4–5.

The creditor must however transfer to the estate the proceeds of the sale, net of the secured claim including interests and expenses. See, e.g., Stadelmann-Vogel gegen Lötscher, ATF 56 II 444, consid. 2, p. 448–449, X. gegen Konkursmasse Y. AG, ATF 119 II 326, consid. 2c–2d, p. 328–329; Eigenmann, supra note 15, p. 10, n° 31; Oftinger/Baer, supra note 14, ad art. 891 CC, n° 62; Zobt, supra note 14, Systematischer Teil, n° 1448.

See Bank F. gegen Konkursmasse H. , ATF 111 III 73, consid. 3, p. 75–77, X SA contre époux A, ATF 130 III 248, consid. 4.1, p. 254–255; Meier, supra note 3, p. 25. The issue relating to future claims assigned prior to bankruptcy but which have arisen subsequently is more controversial. Compare Bank F. gegen Konkursmasse H., consid. 3, p. 75–77; Jürg Dommer, Der Einfluss des SchKG auf die Forderungsabtretung des Schuldners / Jürg Dommer (Zurich: Juris Druck + Verl., 1987), p. 68–74; Gilliéron, supra note 39, ad art. 197 LP, N° 19; Handschin/Hunkele, SchKG II, ad art. 197 SchKG, n° 82–83; Jaeger/Walder/Kull/Kottmann, SchKG, ad art. 197 SchKG, n° 24; Meier, supra note 3, p. 25 with Daniel Girsb erg, in Heinrich Honsell, Nolim Peter Vogt, and Rolf Walter (eds.), Basler Kommentar zum Schweizerischen Privatrecht: OR I, (Basle, Geneva, Munich: Helbing & Lichtenhahn, 2003), ad art. 164 CO, n° 48 (arguing against the Tribunal federal for the exclusion of all assigned
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The pre-composition moratorium has a similar effect to the bankruptcy stay: although the secured creditor is entitled to remain in possession of any pledged collateral, it is barred from taking any step to enforce its monetary claims. Here again, quasi-security is not affected by the moratorium and certain authors argue that the petition does not affect the validity of assignments of futures claims. However, the differences with liquidation proceedings appear once the composition agreement is confirmed. From then on, in principle, the secured creditor is free to enforce his claim by forcing the sale of the collateral. Exceptionally, on request of the debtor, the judge may stay the enforcement of security interests in real estate for a period of lasting up to a year from the ratification of the agreement. This request is, however, admis-
sible only if the debtor has not defaulted on interest payment on the secured claim for less than a year and if it proves that the property is necessary for the continuation of business.\textsuperscript{46} More generally, the secured creditor is affected by a composition agreement only to the extent of its effective deficiency claim (the valuation of the collateral for the purpose of determining the amount of the unsecured portion of its claim that is entitled to vote on the approval of the composition agreement does not modify the secured claim).\textsuperscript{47}

Compositions by way of disposal of assets are subject to similar rules and cannot impair the rights of secured creditors. At most, the liquidator appointed to realize the property can force the secured creditor to sell the collateral within six months.\textsuperscript{48} Otherwise, the secured creditor remains free to enforce his rights in the collateral including through a private sale if it is contractually entitled to do so.

Swiss law provides a paradoxical solution to the clash between security interest and collective proceedings. On the one hand, it stays the rights of the secured creditor and forces it to join in the collective liquidation process. On the other hand, once the general unsecured creditors agree to a composition, the secured is free to enforce his interest in the collateral. This will force the debtor to directly renegotiate with the secured creditor a rescheduling of the payment of the secured debt or at least a stay of the realization and in this process the secured creditor will be in a strong position. Moreover, Swiss bankruptcy law does not directly affect quasi-security, which rely on title transfers to protect the creditor from insolvency.

In sum, although Swiss law seeks at the same time to protect the secured creditor and to create the condition for an effective reorganization, it does not achieve either of these goals. This failure stems from the inherent contradiction between the collective nature of debt enforcement through bankruptcy

\textsuperscript{46} LP art. 306a (1). See generally Amonn/Walthier, supra note 4, p. 465-466, § 55, n° 12-13; Gilliéron, supra note 45, ad art. 306a LP; Hardmeier, supra note 45, ad art. 306a SchKG; Jäger/Walder/Kull/Kottmann, supra note 39, ad art. 306a SchKG.

\textsuperscript{47} Amonn/Walthier, supra note 4, p. 463, § 55, n° 8; Gilliéron, supra note 45, ad art. 310 SchKG, n° 21-27; Hardmeier, supra note 45, ad art. 310 SchKG, n° 10; Jäger/Walder/Kull/Kottmann, supra note 39, ad art. 310 SchKG, n° 23-26; Zobi., supra note 14, Systematischer Teil, n° 753. See Schüler gegen Ausseramliche Konkursverwaltung, Gläubigerausschuss, Schweizerischer Bankverein sowie Obergericht des Kantons Zürich, ATF 107 III 40, consid. 3, p. 42. See, in the event of a composition by way of disposal of assets, M. in Nachlassliquidation, ATF 84 III 105, consid. 3d, p. 109, B., ATF 104 III 79, consid. 4, p. 83. But see note 48 above.

\textsuperscript{48} LP art. 324(2). See generally Jäger/Walder/Kull/Kottmann, supra note 39, ad art. 324 SchKG, n° 15-20; Gilliéron, supra note 45, ad art. 324 LP, n° 15-18; Winkelmann/Levy/ Jeanneret/Meirken/Birchler, supra note 35, ad art. 324 SchKG, n° 14-25
proceedings, broadly speaking, and the individual right in a specific asset which is conferred by a security interest. The former cannot coexist with the latter and by trying to force them to do that, Swiss law prevents both systems from achieving their goal.

C. U.S. Approach: Protection of the Security’s Value

The U.S. Bankruptcy Code contrasts starkly with Swiss law in its approach to insolvency. It seeks to redeem the debtor and give bankrupt firms a second chance. In particular, Chapter 11 reorganization is by no means comparable with Swiss law composition proceedings. Its very purpose is to create a forum for structured bargaining among all the parties at interest. Furthermore, although nominally the Bankruptcy Code claims to simply transpose state law property and contract rights in the insolvency forum without changing their substance, the mutation of security interests is unquestionable: they lose their property-based nature to become a mere priority right.50

First, the automatic stay upon filing for bankruptcy prevents the creditor from taking any step to “create, perfect or enforce” a security interest in the property or the estate of the debtor.51 The secured creditor may nevertheless ask the judge for a relief from the stay if the value of the collateral is not adequately protected. However, only the value of the collateral is protected and postpetition interest is not included in the scope of the protection.52 Another route available to the secured creditor is to argue that collateral is not necessary for an effective reorganization and that the debtor has no equity in it.53 This second option will however rarely be available when key assets are charged. The third and even more unrealistic way out of the automatic stay

50 See United Sav. Asso. v. Timbers of Inwood Forest Associates, Ltd., 484 U.S. 365 (Supreme Court 1988). See also Baird/Jackson, supra note 2, p. 116; Bebchuk/Fried, supra note 7, p. 2399; Eisenberg, supra note 26, p. 952; Howard, supra note 26, p. 313 (stating that the secured creditor in bankruptcy is entitled to the value of its property rights; Jackson, supra note 2, p. 211-212; Westbrook, supra note 18, p. 812.
51 11 U.S.C. § 362(a)(4) and (5).
52 See United Sav. Asso. v. Timbers of Inwood Forest Associates, Ltd.
supposes that the trustee in bankruptcy, or the debtor itself in Chapter 11 cases, accepts to abandon the property to the secured creditor. The second strong attack on secured creditors takes place at the confirmation of the plan. U.S. law provides for two ways to adopt a reorganization plan: either all impaired classes of claimants approve the plan or the debtor crams down the reorganization on dissenting classes assuming that at least one class approves the plan and that absolute priority is respected. Both routes are gateways to water down the rights of secured creditors. First, the debtor can avoid putting the plan to a vote if the plan does not impair the rights of the secured creditor. Usually, however, the secured debt will already be in default and, therefore, the secured creditor, if his rights are not affected by the plan, will be entitled to sell collateral once the plan is effective. To avoid this consequence, the debtor can cure the default. If it reinstates the maturity of the claim in capital and interests and compensates the creditor for any damage incurred as a consequence of reliance on the contractual acceleration clauses, the claim will be deemed unimpaired and the secured creditor will not have the right to realize the collateral unless another event of default arises. This feature provides the debtor with the option to cherry pick and allows it to keep good credits, while discarding the bad ones. Nevertheless, this possibility does not substantially worsen the position of secured creditors, at least not to the same extent as the second alternative: the cram-down provision.

This feature is typical of U.S. bankruptcy law and enables the debtor to force a plan on a dissenting class of creditors, with the benefits of two safeguards. First, at least one class must accept the plan. Second, the absolute priority requires, in the context of secured claims, that the plan must either maintain rights of the creditor in the collateral or at most substitute them with their absolute equivalent. Thus, in appearance, the secured claim remains untouched. But this is not the main risk for a secured creditor. Indeed, a claim is deemed secured only to the extent it is covered by the value of the collateral. Hence, if a claim is considered to be undersecured – again a valuation hearing,
with all the problems it entails, will determine the outcome – the claim is irremediably split in two: a secured and an unsecured one. The former remains strongly linked with the collateral as mentioned above. By contrast, the latter will be treated like an ordinary claim. As such it can be crammed down if the plan offers the creditor a claim of an amount equal to the value of his entitlement and if the absolute priority is respected, which in this context implies that all the claimants which are junior to the ordinary claims, and equity in particular, are wiped-out.

As the automatic stay does not warrant protection for postpetition interest, a secured creditor may have incentives to accept a plan that deprives it of its right to realize the collateral in order to receive payment as soon as possible. Although such a deal will provide equivalent value to the secured portion of its claims, the property right aspect of the security interest is thus totally set aside and the value of the collateral will not be determined by a market test but by the parties in the shadow of the court through a more or less arbitrary valuation process.

In sum, the security interest as a right to appropriate the collateral is totally removed from the Chapter 11 picture; all that really matters is a negotiated value and the amount of the priority afforded to the secured creditor. In other terms, when Swiss law sacrifices the effectiveness of composition agreements for the benefit of secured creditors, U.S. law sacrifices asset-based finance for the benefit of reorganization. However, asset-based financiers return through structured finance.

Indeed, facing the erosion of the secured creditors' rights to the assets in bankruptcy, structured finance appeared to offer various techniques to avoid the effects of bankruptcy law: using special purpose vehicles (SPVs), financiers were able to confer the property of the "collateral" to a separate entity, which is not legally and financially affected by a bankruptcy of the firm. Thus,

60 See above nn. 25–28.
63 See above nn. 25–28.
64 Rating agencies accept to treat secured loans as pure asset-based structured finance if bankruptcy law does not interfere with the full and timely payment of the securities or if the interference is limited and quantifiable. See Standard & Poor's, Legal Issues in Rating Structured Finance Transactions (1998), p. 127.
65 The term collateral is strictly speaking inappropriate for SPVs as they do not hold security interests, but buy assets and, in some instances, lease them back to the firm.
although the firm is still subject to ordinary bankruptcy proceedings, the transfer of the asset to another entity, which does not belong to the estate of the debtor, shields the transaction from the substantial effects of bankruptcy proceedings.66 These techniques allow the asset-based financier to continue financing companies based on the value of certain goods. However, when they imply a transfer of key assets, they are likely to jeopardize the very purpose of reorganization. Therefore, it did not take long for some courts to set aside structured finance transactions, exposing these deals to similar tensions as ordinary secured credit.67

In conclusion, under Swiss law and U.S. law, bankruptcy and security interests clash with each other. Swiss law tames the disruptive power of the secured creditor only for the duration of insolvency proceedings. Once the proceedings are over and a composition confirmed, the secured creditor can enforce the collateral at its leisure. Moreover, quasi-security interests are beyond the reach of insolvency proceedings. The collateral does not belong to the estate and the financier; their legal owner is entitled to repossess and sell it at its leisure. U.S. bankruptcy law takes the opposite view: it freezes the rights of the secured creditor right and, in fact, changes them into a pure priority right determined by the estimated value of the collateral, removing any property component from security interests. Thus, before closing this analysis


of security interests and bankruptcy, I will briefly consider a few alternatives to the current institutional arrangements.

IV. A Few Alternatives

As we have seen above, security interests and reorganization do not work well together, because they are based on two different paradigms: security interests are grounded in a language of property law and individual remedies, while the bankruptcy and reorganization form a procedural framework seeking to collectivize the enforcement of debts. The resulting clash between these two systems led to the downfall of both the Swiss and U.S. approach to security interests and reorganization. In the light of this failure to match security and bankruptcy, I would like to suggest a few alternative solutions.

A. Replacement of Specific Charges by a General Preference

The first solution involves a radical redefinition of security interests: instead of linking the right of the creditor with specific assets, the interest could charge an entire business, a general hypothecation, or be defined as a contractual insolvency privilege. This all-encompassing priority right ensures that creditor will be paid out first. It also facilitates restructuring. First, the valuation problem is resolved. Second, the secured and the unsecured share incentives to focus on putting the entire pool of assets to the best possible use, avoiding conflicts between selling the collateral for the best price and maximizing the firms' value. To a certain extent, the English floating charge led to this very result.68

However, this approach is not a panacea: it simply shifts the conflict of interests between the secured and the unsecured from the choice of maximizing either the value of the collateral or that of the estate to a variation of the debt-equity agency conflict. If the collateral value roughly matches the secured claims, the secured creditor will generally be excessively risk averse,

68 See generally ARMOUR/FRISBY, supra note 18, p. 73; ARMOUR/MOKAL, supra note 18; WESTBROOK, supra note 18, p. 818–820, 852–854.
whereas the unsecured are likely to be inclined to bet the firm to improve their payouts.\textsuperscript{69}

Moreover, a general hypothecation scheme severs the link between specific assets and claims, thus it prevents any kind of asset-based lending. Yet, this form of financing complements traditional general corporate finance: instead of focusing on the valuation of cash-flows potential, the asset-based financier specializes in valuing and redeploying specific asset-classes.\textsuperscript{70} Wanting a direct right to such assets, financiers will no longer be able to carry out this task. Nevertheless, the general hypothecation approach remains a valid alternative to a blanket lien made out of a patchwork of specific security interests.

\textbf{B. Bankruptcy Auctions}

Instead of adjusting security interests to reorganization, a strand of law and economics scholars focuses its efforts on trying to streamline the liquidation process.\textsuperscript{71} The Swedish experience is instructive in this perspective: instead of trying to reorganize firms, it sells them through auctions as a going-concern or piecemeal. This process achieves similar results to U.S. Bankruptcy law but in substantially less time.\textsuperscript{72} Switzerland could easily implement such a solu-

\textsuperscript{69} See Armour/Mokal, supra note 18.

\textsuperscript{70} Michel A. Habib/D. Bruce Johnsen, The Financing and Redeployment of Specific Assets, J. Fin. 54 (1999), p. 693.


tion through *Auffanggesellschaft* based structures, transferring all the assets to subsidiary or a new company, which can then be sold off to an acquirer.73 However, to carry out this solution effectively, the liquidation process should be changed to allow for more flexibility.74

Auctions do not resolve the conflict between insolvency procedure and security interests: either the security interest survives the sale of asset and continues to charges the collateral after the completion of the transaction or the secured claims are paid out with the proceeds of the auction and the security interest is extinguished. The first option forces the acquirer to deal with the secured creditor and does not allow for a reorganization of secured creditors as under Swiss composition law. The second alternative leads to the same valuation problem that arises under U.S. law.75 Nevertheless, auctions reduce the time spent in bankruptcy and thus limits the conflict between secured creditors favoring liquidation to be paid out as soon as possible and unsecured creditors preferring reorganization to maximize the value of the firm.

C. Preemption Rights: An Exit Right for the Secured Creditor

A third alternative consists in giving secured creditors a right to force the liquidation of the collateral upon default, thus waiving the automatic stay. This sale would be subject to a right of preemption of the reorganizing firm. In usual circumstances, the estate will be cash constrained and will not be able to carry out this purchase at ordinary terms. To overcome this obstacle, this acquisition could be financed with a debtor-in-possession loan that would enjoy the same priority as other administrative costs and expenses (or even a preferable right) and thus rank ahead of pre-bankruptcy claims. This way, the debtor can simplify its balance sheet structure by substituting interests in specific property with priority rights and, at the same time, it would benefit

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73 On this type of reorganization, see generally ANDRES BAUMGARTNER, Fortführung eines Unternehmens nach Konkursersöffnung (Fribourg: Universitätsverlag Freiburg Schweiz, 1987); ANDRES BAUMGARTNER, Das Unternehmen im Konkurs: Ein Diskussionsbeitrag zur derzeitigen Revision des Schweizerischen Schuldrecht- und Konkursgesetzes, RSJ 84 (1988), p. 241; MEIER, supra note 3.

74 See generally MEIER, supra note 3, p. 11.

75 See BEBCHEK/FRIED, supra note 7, p. 2406; ROE, supra note 26, p. 594; ROE, supra note 56, 1708, p.602-603.
from a tool to overcome a debt-overhang, which often prevents it from accessing new money.

Moreover, this solution provides a market test for the valuation of the collateral and converts a security interest in a specific asset into a general bankruptcy privilege. It avoids the problems of the "bargain and litigate" approach to bankruptcy law. It also avoids the conflict between the right to foreclose and the imperatives of reorganization. The preemption right, which permits the bankrupt firm to step in the shoes of a third party acquirer, and buy the collateral at the same terms. The exercise of this right preserves any going-concern surplus derived from the ownership of the collateral.76

This right to realize subject to a preemption right may seem similar to a model suggested by BECHUK AND FRIED, which is based on the auction of a note incorporating a non-recourse loan secured by the collateral.77 In this model, the non-recourse component of the secured loan isolates the value of the collateral from the solvency of the debtor, whereas the auction provides a market price for this claim. However, my suggestion presents a few advantages over this model. First, by relying on debtor-in-possession finance, it resolves the liquidity constraints, which the debtor may face. Second, by allowing the secured creditor to exercise his right at any time, it protects him from the toll taken by the automatic stay due to the lapse of time between the initiation of insolvency proceedings and the confirmation of a plan.

The effectiveness of this approach is however not foolproof. It depends on two assumptions. First, the firm should be able to access to new money to finance its preemption right. The administrative privilege can alleviate this first problem, but, if the recovery prospects are grim or if the adverse selection problem is significant, the cost of such financing may jeopardize the entire reorganization.

Second, there must be a market for the collateral. In principle, this condition is likely to hold whenever the secured transaction based on a specific asset class and does not simply seek to provide the creditor with a priority claim or control over the debtor, because the pricing of the loan depends fundamentally on the market price of the collateral and the ability to sell it. However, if

76 See BECHUK/FRIED, supra note 7, p. 2411 (making the same observation in context of his option).
77 See Ibid.
78 Through a non-recourse secured loan, the secured creditor waives his right to recover any deficiency claim from the debtor. Therefore, it will lose any portion of the secured claim that exceeds the value of collateral.
the collateral is not a standard commodity but presents certain firm specific characteristics, the redeployment is costly and therefore the option conferred by this right and the idiosyncratic benefits rig the realization process in favor of the debtor, inducing third-party acquirers to be reluctant to invest in search costs.\textsuperscript{79} If third parties do not take part in the realization process, the market-test underpinning this system unravels, reducing it to a bilateral bargaining game between the debtor and the secured creditor.

Overall these three reform proposals, general hypothecation, auctions and preemption rights, offer alternative, but not mutually exclusive, techniques to integrate security interests within the system of bankruptcy law and vice versa. The general hypothecation scheme merges them together in to a single institution, where the enforcement of the security interest matches the insolvency process (as under English law) or, from the opposite perspective, where the insolvency process absorbs the security interests which is reduced to a simple and outright preferential claim. The bankruptcy auction speeds the entire proceedings, thus decreasing the time lag during which the secured creditor is barred from enforcing its rights in the collateral. Finally, the preemption right scheme recognizes the financier’s right to sell the collateral, but protects the debtor and the reorganization process by offering the possibility to redeem the debt by buying the collateral.

None of these proposals is perfect. The English floating charge, a real world form of general hypothecation causes various governance problems and severs the links between specific assets and claims thus preventing any form of asset-based finance, leaving this task to other legal institutions such as the fixed charge or title finance. Streamlining the process and focusing on auctions supposes that a market for distressed firms exists, or at least can be created. Moreover, it merely shortens the period during which bankruptcy law and security interests clash, but does not resolve the clash itself. Finally, preemption rights suppose the existence of a market for the collateral, an assumption that only holds when the assets are significantly commoditized and requires the availability of new money for distressed debtors. Nevertheless, at the end of the day, these institutions can mitigate the tension between secured credit and reorganization and thus deserve more attention from lawmakers.

\textsuperscript{79} This argument is a variation on a classical one in the takeover debate. See \textit{Frank H. Easterbrook/Daniel R. Fischel}, \textit{The Proper Role of a Target’s Management in Responding to a Tender Offer}, 94 Harvard L. Rev., p. 1161 (1981).
V. Conclusion

This paper analyzed the interaction between security interests and reorganization and highlighted the contradictions between these institutions. The former is an extension of the creditor's right to enforce individually its claim and attaches this right to a piece of the debtor's property. The latter, by contrast, seeks to collectivize the dealings with distressed firms with an aim to preserve any going concern surplus, which may exist.

Because of their underlying approaches, these goals conflict with one another. Swiss and U.S. bankruptcy law try to reconcile them, with little success however. Swiss law tries to fulfill both purposes by hampering the enforcement during the pre-composition stay, without providing any safeguards once the unsecured creditors approve the composition agreement. U.S. law is more consistent. It favors reorganization and transforms secured claims in privileged claims. This conversion is, however, troublesome as the amount of the privilege is directly linked to the value of the collateral, which can only be guessed by experts, without a real market-based test. Moreover, this approach falls prey to structured finance and the use of bankruptcy remote vehicles, which seek to protect collateral from the automatic stay. Hence, the overall situation prevailing under current Swiss and U.S. law is grim.

The reconciliation of reorganization and security interests is thus not easy. I offer three potential routes deserving further investigation: the replacement of asset-specific charges by a priority right or general hypothecation; a streamlining of insolvency proceedings by auctions; and, a full compliance with the enforcement rights of a secured creditor subject to a preemption right and to the availability of new money financing. These schemes are far from perfect. The contradiction between security interests and reorganization is deeply grounded in two very different paradigms. Therefore, it cannot be resolved, unless one of the institutions is entirely redesigned around the other. Nevertheless, in spite of their shortcomings these various proposals, if they are adequately implemented, may serve as a stepping point for the development of a bridge between security and reorganization and avoid the clash of institutions.