The Trustee's Strong Arm Power under the Bankruptcy Code

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THE TRUSTEE'S STRONG ARM POWER UNDER THE BANKRUPTCY CODE

DAVID GRAY CARLSON*

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I. ORIGINS

Perhaps the most fundamental bankruptcy avoidance power is the trustee's status as a judicial lien creditor—and, since 1979, as a bona fide purchaser of real property—on the day a bankruptcy petition is filed. For reasons that are by no means clear, this status has come to be called the strong arm power.\(^1\) Currently described in Bankruptcy Code section 544(a),\(^2\) the trustee's status as a judicial lien creditor is a natural adjunct to the very concept of bankruptcy.\(^3\) Before federal ban-

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1. Professor John C. McCoid traces this term back to at least 1937. John C. McCoid, II, Bankruptcy, the Avoiding Powers, and Unperfected Security Interests, 59 Am. Bankr. L.J. 175, 181 n.52 (1985) (citing H.R. Rep. No. 1409, 75th Cong., 1st Sess. 34-35 (1937)). A search of numerous law review articles and cases dating from 1910 to 1937 reveals no earlier source referring to Bankruptcy Act § 47(a)(2), Act of June 25, 1910, ch. 412, sec. 8, § 47(a)(2), 36 Stat. 838, 840 (repealed 1978), as the strong arm power. Harold Remington refers to Bankruptcy Act § 47(a)(2) as making the trustee a creditor "armed with process." Harold Remington, Remington on Bankruptcy § 1547, at 271 (3rd ed. 1923). Also, in a much-remembered epigram, Judge Edwin R. Holmes remarked that "the trustee in bankruptcy . . . stands here as the ideal creditor . . . armed cap-a-pie with every right and power which is conferred by the law of the state upon its most favored creditor who has acquired a lien by legal or equitable proceedings." In re Waynesboro Motor Co., 60 F.2d 668, 669 (S.D. Miss. 1932). Perhaps this quote gave rise to the appellation "strong arm power." Other than these references, which probably do not count, the first time the strong arm nickname appears is in the reports cited to by Professor McCoid. McCoid, supra.

2. Section 544(a) provides:

The trustee shall have, as of the commencement of the case, and without regard to any knowledge of the trustee or of any creditor, the rights and powers of, or may avoid any transfer of property of the debtor or any obligation incurred by the debtor that is voidable by—

(1) a creditor that extends credit to the debtor at the time of the commencement of the case, and that obtains, at such time and with respect to such credit, a judicial lien on all property on which a creditor on a simple contract could have obtained such a judicial lien, whether or not such a creditor exists;

(2) a creditor that extends credit to the debtor at the time of the commencement of the case, and obtains, at such time and with respect to such credit, an execution against the debtor that is returned unsatisfied at such time, whether or not such a creditor exists; or

(3) a bona fide purchaser of real property, other than fixtures, from the debtor, against whom applicable law permits such transfer to be perfected, that obtains the status of a bona fide purchaser and has perfected such transfer at the time of the commencement of the case, whether or not such a purchaser exists.


3. The trustee's status as a bona fide purchaser of real estate is less so. See infra text accompanying notes 220-313.
Bankruptcy came to monopolize the business of debt collection in this country, creditors could force payment by having the sheriff seize debtor property pursuant to court order and sell it. The cash realized could then be applied to pay the creditor's claim, with any surplus belonging to the debtor. This system, in its simplest form, was highly vulnerable if the debtor conveyed the property to a third party just before the sale. In such a case the sheriff would have nothing to sell, and the creditor's chance to collect would be greatly reduced. To forestall this possibility, the law developed the idea of a lien—a power of sale good against the world at a time prior to the actual sheriff's sale. This moment of lien creation then became the moment in which the debtor was divested of property and the creditor endowed with it. In other words, creation of the lien was a transfer from the debtor to the creditor. Once the creditor, not the debtor, owned the property, the debtor's power of alienation was substantially restricted. 4

If writs of execution were unsuccessful in realizing cash (that is to say, if the legal remedy of execution was exhausted), equity courts would intervene to assist creditors. 5 One equitable remedy courts might supply was a receivership, in which a court officer was appointed to take title to the debtor's property in order to realize cash. 6 Just as the judicial lien was invented to prevent eleventh hour conveyances by the debtor to defeat the sheriff's sale, a receivership came to be associated with the creation of a lien—a transfer from the debtor to the creditor merely by virtue of the appointment of a receiver. 7

Bankruptcy relates to the idea of receivership as a universal creditors' class action, whereby the bankruptcy trustee represents all the prepetition creditors—who among themselves have equal rights. 8 And just as the creation of the receivership constitutes the moment when property is transferred from the debtor to the receiver, the creation of the bankruptcy estate likewise must be viewed as the moment of trans-

5. These equitable powers are what § 544(a)(2) tries to capture. See infra text accompanying notes 173-219.
7. See 1 id. § 235 ("[R]receivers are frequently appointed to aid the judgment creditor in satisfying his judgment."); see also 7B N.Y. CIV. PRAC. L. & R. § 5202(b) (McKinney 1978) (stating that a judgment creditor who has secured the appointment of a receiver has priority over the rights of any transferee except a transferee who gave fair consideration and was without notice of the appointment). For the exact point in time that a receivership represents a transfer from the debtor to the creditor, see Carlson & Shupack, supra note 4, at 296 & n.38.
8. 3 CLARK, supra note 6, § 667.4.
fer from the debtor to the creditors.

This is undoubtedly a pretty story, but, as John McCoid has shown,\(^9\) history does not quite bear it out. Many federal courts, interpreting the Bankruptcy Acts of 1841 and 1867, followed what McCoid calls a successorship idea, whereby the assignee for the benefit of creditors merely inherited the debtor's rights. The difference between the strong arm power and mere successorship is most dramatic with respect to unperfected security interests. Heirs inherit property subject to the rights of unperfected secured parties.\(^10\) In contrast, the rights of judicial lien creditors traditionally have been senior to the rights of these persons. Nevertheless, even without the aid of specific strong arm legislation, some courts reasoned their way to a strong arm power in assignees or trustees.\(^11\)

In 1898 Congress sided with the view that the creation of the bankrupt estate ought to signal the termination of unperfected security interests. To achieve this end, it enacted Bankruptcy Act section 67(a), which announced, "Claims which for want of record or for other reasons would not have been valid liens as against the claims of the creditors of the bankrupt shall not be liens against his estate."\(^12\)

Now the Supreme Court has always delighted in confounding Congress with the imprecision of its bankruptcy legislation. In York Manufacturing Co. v. Cassell\(^13\) it was presented with an unperfected chattel mortgage from Ohio, against which unsecured creditors had no rights. Rather, only judicial lien creditors had rights,\(^14\) in the style of the modern Uniform Commercial Code (UCC).\(^15\) And because section 67(a) did not say anything about creditors with liens, the unperfected chattel mortgage survived the bankruptcy.

In 1910 Congress reacted to Cassell with what we now call the strong arm power. In this legislation, the trustee's status as an ideal lien creditor was described as follows:

[The trustee], as to all property in the custody or coming into the

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10. The list of persons capable of taking priority over unperfected secured parties appears in § 9-301(1) of the Uniform Commercial Code, wherein heirs are conspicuously absent. U.C.C. § 9-301(1) (1972).
11. McCoid, *supra* note 1, at 176-81 (indicating that some courts that have construed the 1841 and 1867 Bankruptcy Acts found that assignees (trustees) were vested with the rights of creditors).
14. "The word 'creditors' in the Ohio conditional sales law includes only judgment creditors." *Id.* at 348.
custody of the bankruptcy court, shall be deemed vested with all the rights, remedies, and powers of a creditor holding a lien by legal or equitable proceedings thereon; and also, as to all property not in the custody of the bankruptcy court, shall be deemed vested with all the rights, remedies, and powers of a judgment creditor holding an execution duly returned unsatisfied.\textsuperscript{16}

After Congress made explicit the bankruptcy trustee's status as a judicial lien creditor, the uniform state law movement picked up the cue. The drafters of the Uniform Conditional Sales Act, adopted in 1918,\textsuperscript{17} and the Uniform Trust Receipt Act, adopted in 1933,\textsuperscript{18} vested similar powers in both assignees for the benefit of creditors and equity receivers. At the time these were important moves because bankruptcy trustees could not reorganize—they could only liquidate. Reorganizations usually were achieved through the device of an equity receiver-ship in federal court, pursuant to a contrived diversity jurisdiction suit for the collection of a debt.

Thus, the story of the strong arm power in collective creditor proceedings is not simply a story of federal law, but is the product of both federal and state law. State law influenced Congress's decision to make the strong arm power explicit, and the strong arm power influenced the uniform laws' movement to modify state law.

A. The Strong Arm Power Compared to Voidable Preference Theory

In time the trustee's status as a judicial lien creditor came to overlap substantially with voidable preference law. Perhaps after 1903\textsuperscript{19} and certainly after 1910,\textsuperscript{20} voidable preference law was amended so as

\begin{footnotesize}
19. Act of Feb. 5, 1903, ch. 457, sec. 13, § 60(a)-(b), 32 Stat. 797, 799-800 (repealed 1978). Professor C. Robert Morris, Jr. convincingly argued that the 1903 amendments were not designed to change contemporaneous exchanges of loans for liens into transfers on antecedent debt. Rather, Congress intended only to extend the preference period for unperfected security interests that were in all other respects voidable preferences. C. Robert Morris, Jr., Bankruptcy Law Reform: Preferences, Secret Liens and Floating Liens, 54 MINN. L. REV. 737, 742-44 (1970).
20. Act of June 25, 1910, ch. 412, sec. 11, § 60(b), 36 Stat. 838, 842 (repealed 1978). For a discussion of the arcane drafting problems in the 1910 amendments, see Morris, supra note 19, at 748. The nature of these problems was that in states that protected only judicial lien creditors, not general creditors, against unperfected security interests, the 1910 Act did not defer the time of transfer. Only if state law protected general creditors was the time of transfer deferred. In addition, courts started using equitable liens to
\end{footnotesize}
to manipulate unperfected security interests that were contemporary exchanges—i.e. lien for loan on the same day—into transfers on antecedent debt. As transfers on antecedent debt, they were eligible for avoidance as preferences. This was achieved by the metaphysically dubious device of declaring a security interest to be transferred, not when the security interest was created, but when it became so far perfected that it would take priority over a subsequent judicial lien creditor.

In light of voidable preference law the trustee's status as a judicial lien creditor now seems repetitive, at least insofar as unperfected security interests are concerned. But, at least under the Bankruptcy Act, there were some differences. Most dramatically, prior to 1979 preferences were voidable only if the creditor had reason to know of the debtor's insolvency at the time they occurred. This question of knowledge gave rise to severe proof problems. The trustee's power as a lien creditor, however, did not require this showing. It was perhaps this advantage that caused the trustee's status as a lien creditor to be nicknamed the "strong arm power."

Even today some differences between the strong arm power and voidable preference theory perdure. There are at least three differences.

First, state-law grace periods are preserved against the trustee under Bankruptcy Code section 546(b), which provides: "The rights and powers of a trustee under section[] 544 . . . are subject to any generally applicable law that permits perfection of an interest in prop-

defeat the right of creditors to defer an unperfected transfer. See, e.g., Sexton v. Kessler & Co., 225 U.S. 90 (1912) (Holmes, J.) (holding that an unrecorded agreement in which the debtor agreed to set aside certain securities as collateral was deemed an equitable lien in favor of the creditor that could not be set aside by the bankruptcy trustee). Amendments in 1938 and 1950 tried to correct these problems. Morris, supra note 19, at 749-52.

21. Professor Morris criticized this fiction and preferred instead an expansion of the strong arm power so that the trustee is deemed a judicial lien creditor on any day that is useful to avoid an unperfected security interest. He also would extend a 21 day grace period to all unperfected security interests whereby perfection would relate back to the day of attachment. His chief interest in making this suggestion is to achieve the same result as the then-existing law, without the use of "fictions." Morris, supra note 19, at 759-61. This, of course, assumes that the hypothetical judicial lien that Professor Morris would assign to the trustee is not itself a fiction. Of course it is, and Morris can be seen as preferring one fiction over another.

22. This was the test after 1938. From 1898 to 1910, the test was "reasonable cause to believe that [the transfer] was intended thereby to give a preference." An Act to Establish a Uniform System of Bankruptcy Throughout the United States, ch. 541, § 60(b), 30 Stat. 544, 562 (1898) (repealed 1978). Between 1910 and 1938, the test was reasonable cause to believe that the transfer "would effect a preference" (whether intended or not). Act of June 25, 1910, ch. 412, sec. 11, § 60(b), 36 Stat. 838, 842 (repealed 1978); see Morris, supra note 19, at 739.

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property to be effective against an entity that acquires rights in such property before the date of such perfection.\textsuperscript{23} The voidable preference statute also provides a grace period, but it is quite different from what state law might provide. Under section 547(e)(2)(A) a transfer is deemed to have occurred on the day a security interest attached, if perfection occurs within ten days thereafter.\textsuperscript{24} Under UCC section 9-301(2) the grace period pertains only to purchase money security interests, and it commences when the debtor receives possession of the collateral.\textsuperscript{25} If goods are shipped to the debtor, the state-law grace period could be substantially longer than the voidable preference grace period. For example, suppose that on March 1, $D$ grants $C$ a security interest in a machine, which is shipped to the debtor. The machine arrives on March 31, and $D$ takes possession. $D$ files for bankruptcy on April 1. $C$ perfects on April 3. The trustee’s strong arm power has no effect on $C$’s security interest because $C$ filed within the grace period provided by UCC section 9-301(2). Bankruptcy Code section 546(b) preserves this grace period against the trustee’s hypothetical judicial lien.\textsuperscript{26} The security interest is, however, a voidable preference under section 547.\textsuperscript{27} The security interest does not qualify for the grace period under section 547(e)(2)(A). Rather, the rule of section 547(e)(2)(C) applies, and the security interest is deemed transferred just before the bankruptcy petition was filed.\textsuperscript{28} The security interest becomes a transfer on antecedent debt that is potentially voidable under section 547(b).\textsuperscript{29} Similarly, some jurisdictions extend the grace period beyond

\begin{itemize}
\item[24.] According to § 547(e)(2)(A), a transfer is made “at the time such transfer takes effect between the transferor and the transferee, if such transfer is perfected at, or within 10 days after, such time.” Id. § 547(e)(2)(A).
\item[25.] U.C.C. § 9-301(2) (1972).
\item[26.] Furthermore, postpetition filing is not subject to the automatic stay. 11 U.S.C. § 362(b)(3) (1988).
\item[27.] Id. § 547.
\item[28.] Section 547(e)(2)(C) provides that the security interest is deemed transferred “immediately before the date of the filing of the petition, if such transfer is not perfected at the later of—(i) the commencement of the case; or (ii) 10 days after such transfer takes effect between the transferor and the transferee.” Id. § 547(e)(2)(C).
\item[29.] Id. § 547(b). Even if the purchase money security interest is voidable under § 547(b), the secured party may still have a defense under § 547(c)(3), which applies to purchase money security interests that technically are voidable preferences under § 547(b) and that are “perfected on or before 10 days after the debtor receives possession of such property.” Id. § 547(c)(3)(B). But § 547(c)(3) has other requirements that the UCC does not have. For example, § 547(c)(3) requires that the creditor extend new value at or after the signing of the security agreement. Id. § 547(c)(3)(A)(i). The UCC contains no such requirement. Hence, if the loan is given on March 1 and the agreement is signed on March 2, the security interest described in the text would be a voidable preference, but it would not fall prey to the strong arm power.
\end{itemize}
ten days. For example, in New York the period is now twenty days.\textsuperscript{30} This too gives rise to differences between the strong arm and voidable preference powers.\textsuperscript{31}

Second, because the voidable preference grace period is not limited to purchase money security interests, some differences arise with regard to nonpurchase money security interests that are unperfected on bankruptcy day. Suppose on March 25, \( D \) grants \( C \) a nonpurchase money security interest on a machine in exchange for a loan. \( D \) files for bankruptcy on April 1, and \( C \) perfects on April 2. The trustee is senior to this security interest because no state-law grace period applies to save \( C \). But the security interest is not a voidable preference because, thanks to section 547(e)(2)(A)’s ten-day grace period, the security interest is deemed transferred on March 25.\textsuperscript{32} Because the security interest was received contemporaneously in exchange for value, \( C \) is free of voidable preference liability.

Finally, a difference probably exists if an unperfected security interest is created by someone other than the debtor. Suppose \( X \) grants a security interest to \( C \), who does not perfect. \( X \) then sells the collateral to \( D \), who knows of the security interest. In this case \( D \) takes only \( X \)’s equity interest. \( D \) then files for bankruptcy. The unperfected security interest succumbs to the strong arm power thanks to section 9-301(1)(b) of the UCC, but the security interest is probably not a voidable preference. Section 547(b) requires that there be a “transfer of an interest of the debtor.”\textsuperscript{33} Because the debtor in the above example never transferred the security interest to \( C \), the security interest probably survives.\textsuperscript{34}

\textsuperscript{30} N.Y. U.C.C. LAW § 9-301(2) (McKinney 1990).

\textsuperscript{31} There is a theory that incorporates state-law grace periods into the voidable preference statute. According to § 547(e)(1)(B), perfection is defined as occurring “when a creditor on a simple contract cannot acquire a judicial lien that is superior to the interest of the transferee.” 11 U.S.C. § 547(e)(1)(B) (1988). In the example just given, after March 1, a subsequent hypothetical judicial lien creditor cannot obtain priority if the secured party files a financing statement before the grace period runs out. Because that did occur, the theory states that \( C \)’s security interest was perfected on March 1, not April 3. Accordingly, the transfer is deemed to occur on March 1 pursuant to § 547(e)(2)(A), and the security interest is not a voidable preference after all. This theory was adopted in General Motors Acceptance Corp. v. Busenlehner (In re Busenlehner), 918 F.2d 928 (11th Cir. 1990) (per curiam).

\textsuperscript{32} Postpetition perfection is again allowed in spite of the automatic stay because § 362(b)(3) allows any perfection that occurs within § 547(e)(2)(A)’s grace period.

\textsuperscript{33} 11 U.S.C. § 547(b) (1988).

\textsuperscript{34} The trustee could argue that the unperfected security interest is a voidable preference on the following theory: Suppose \( X \) grants \( C \) a security interest in a machine on March 1. \( C \) never perfects. \( X \) sells the equity in the machine to \( D \) on March 15. \( D \) files for bankruptcy on March 31. According to § 547(e)(2)(C), the security interest is deemed transferred, not on March 1, but on March 31, just before the bankruptcy petition.
Hence, the overlap between the strong arm power and voidable preference law, though substantial, is less than complete.

B. The Strong Arm Power Compared to the Trustee’s Subrogation Rights

Usually, the strong arm power is thought to be about destroying—or at least subordinating—unperfected security interests.\(^{35}\) In this regard, it should be compared to the trustee’s subrogation power,\(^{36}\) as interpreted by Justice Holmes in Moore v. Bay.\(^{37}\) According to this subrogation principle, the trustee succeeds to the powers of any creditor who could avoid a transfer by the debtor of her property. For example, if a general creditor exists who can avoid such a transfer, the trustee displaces the creditor and takes over\(^{38}\) this power for the bene-

Because on March 1, the collateral was not debtor property, \(D\) made no transfer of the trustee’s interest. But on March 31, \(D\) owned the equity in the collateral, and therefore only \(D\) could have transferred the security interest to \(C\). Perhaps a court could use this device and pretend that \(D\) transferred the security interest on March 1, even though \(X\) signed the security agreement on March 1.

35. Though this is by no means the only thing that the strong arm power is about. Prior to 1989 in South Carolina, lessees of personal property had to file in the UCC records. S.C. Code Ann. § 27-23-80 (Law. Co-op. 1976) (repealed 1989). The strong arm power therefore was effective to destroy leasehold interests in that state. C.C. Vaughn & Sons, Inc. v. Anderson (In re South Atl. Packers Ass’n), 37 B.R. 244 (Bankr. D.S.C. 1982) (Davis, J.); see In re Ken Johnson Toyota, Ltd., 35 B.R. 18 (Bankr. D.S.C. 1983) (Davis, J.). For the effect of the strong arm power on bailed cows in California, see infra text accompanying notes 256-62.

36. This power is contained in § 544(b) of the Bankruptcy Code:

The trustee may avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor that is voidable under applicable law by a creditor holding an unsecured claim that is allowable under section 502 of this title or that is not allowable only under section 502(e) of this title.


37. 284 U.S. 4 (1931).

38. The subrogation power deprives not only a third party transferee of property but also the creditor to whom the trustee is subrogated—a point that is usually missed. This observation would have strengthened Professor Frank Kennedy’s argument that the subrogation power should allow subrogation to the rights of general creditors only—not secured creditors—a view now expressly set forth in § 544(b).

Under Bankruptcy Act § 70(e) it was not clear whether the trustee also was subrogated to the rights of secured creditors. See An Act to Establish a Uniform System of Bankruptcy Throughout the United States, ch. 541, § 70(e), 30 Stat. 544, 566 (1898) (repealed 1978). Kennedy mounted a vigorous argument that the subrogation power must be limited to general creditors. Otherwise, trustees could subrogate themselves to senior lien creditors and, thanks to the expansive effect of Moore v. Bay, completely eliminate junior secured creditors. Frank R. Kennedy, The Trustee in Bankruptcy as a Secured Creditor Under the Uniform Commercial Code, 65 Mich. L. Rev. 1419 (1967).

Professor Kennedy might have added this point: The subrogation power suggests
fit of all the creditors. What *Moore v. Bay* adds is that even if the
geneneral creditor’s claim is for one dollar and the unperfected security
interest is for one million dollars, the entire million dollar transfer can
be voided for the benefit of the bankruptcy estate.

A comparison of the strong arm power and the subrogation power
yields the following differences: The strong arm power (a) does not de-
pend on the rights of real, living creditors; and (b) it treats the trustee
as a lien creditor on the day the bankruptcy petition is filed. The sub-
rogation right (a) requires the identification of a real, living creditor;
and (b) it gives the trustee rights that existed earlier than the day of
the bankruptcy petition.

Prior to the UCC’s enactment, unperfected security interests were
quite vulnerable to these powers. For example, an unperfected chattel
mortgage often was vulnerable to the rights of a general creditor who
extended credit before the chattel mortgage was perfected.\(^{39}\) These
creditors were sometimes called gap creditors if they extended credit in
the gap between the attachment and perfection of a security interest.\(^{40}\)
If a gap creditor really existed, the trustee’s subrogation power de-
stroyed the entire security interest, thanks to *Moore v. Bay*.

The strong arm power, in contrast, does not feast upon the flesh of
real creditors. Rather, the bankruptcy trustee, as a judicial lien credi-
tor, is a “hypothetical fellow who is not necessarily bound by the limi-
tations within which the actual creditors of the estate must assert their
rights.”\(^{41}\) Hence, through the use of nonexistent and purely hypotheti-

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that the trustee divests the creditor’s avoidance power and adds it to the bankrupt est-
tate. If the subrogation power extended to secured parties, the trustee would take away
the *senior* liens and the junior liens to enhance the estate. The subrogation clause, in a
sense, avoids, but preserves for the estate, both the rights of the person targeted by the
creditor’s avoidance power and the rights of the creditor to whom the trustee is subro-
gated. Hence, both senior and junior liens would be voidable if the subrogation power
extended to the rights of secured creditors.

As of 1990, the Federal Deposit Insurance Corporation and the Resolution Trust
Corporation are immune from this subrogation power and may now compete with a
bankruptcy trustee for fraudulently conveyed assets of a debtor. Indeed, new legislation
even subordinates the bankruptcy trustee who competes for these assets. *See Compre-
ing of this extraordinary exception to the subrogation power is likely to be dramatic,
whatever it is. *See Frank R. Kennedy & Gerald K. Smith, Fraudulent Transfers and
Obligations: Issues of Current Interest, 43 S.C. L. Rev. 709 (1992).*

39. Because this was not the rule in Ohio, the Supreme Court held that the trustee
could not avoid an unperfected chattel mortgage in York Manufacturing Co. v. Cassell,
201 U.S. 344 (1906) (Peckham, J.). The *Cassell* decision prompted Congress to invent
the strong arm power. *See supra* text accompanying notes 13-16.


41. Frank R. Kennedy, *The Trustee in Bankruptcy Under the Uniform Commer-
cal facts, trustees attempted to expand radically the reach of the strong arm power. The strong arm power did specify that the trustee's judicial lien arose only on the day of bankruptcy. (This, as we have seen, describes the transfer of debtor property to the creditors on this day.) But other facts might be imagined.

C. Constance v. Harvey

In the notorious case of Constance v. Harvey, a gap existed between the attachment and perfection of a security interest. If any creditor had advanced credit during that gap and had not been paid, that creditor's eventual judicial lien would have priority over the security interest. No such creditor existed, however, in the bankruptcy. Nevertheless, using only the power of imagination, the trustee was allowed to hypothesize the advance of credit during the unperfected gap. Then, on the day of bankruptcy the trustee imagined that he had a judicial lien which, because it secured gap credit, took priority over the security interest.

This exercise in creative fiction was devastating. In the words of Vern Countryman, "This decision opened limitless vistas for the bankruptcy trustee in any state where delayed filing rendered a transfer forever vulnerable to those who became creditors in the interim between execution and filing."

Subsequent events, however, soon dissipated the threat that Constance v. Harvey represented. First, Article 9, slouching toward completion throughout the 1950's, would disenfranchise general creditors against unperfected security interests. Section 9-301(1) set forth a list of entities who could defeat an unperfected security interest. Priority was given to judicial liens created while a security interest was unperfected, but general creditors without judicial liens were omitted. Instead, the omnibus rule of section 9-201 applied to give the unperfected secured party priority.

42. 215 F.2d 571 (2d Cir. 1954) (per curiam), cert. denied, 348 U.S. 913 (1955).
43. Id. at 575.
46. Section 9-201 provides: "Except as otherwise provided by this Act a security agreement is effective according to its terms between the parties, against purchasers of the collateral and against creditors." Id. § 9-201. Section 9-301(1) constitutes one of many sections that overrules § 9-201, but because general creditors are not mentioned in § 9-301, nor anywhere else, unperfected security interests are perfectly good against general creditors who have not obtained liens.
Second, so great was the hue and cry from bankers\(^47\) that the Supreme Court had to take action and overrule Constance v. Harvey. In Lewis v. Manufacturers National Bank\(^48\) Justice Douglas said that Constance v. Harvey "would give the trustee power to set aside transactions which no creditor could void and which injured no creditor. That construction would enrich unsecured creditors at the expense of secured creditors, creating a windfall merely by reason of the happenstance of bankruptcy."\(^49\) This, Douglas thought, was "too great a wrench for us to give the bankruptcy system, absent a plain indication from Congress which is lacking here."\(^50\) Soon after Lewis the Ninth Circuit, in Pacific Finance Corp. v. Edwards,\(^61\) suggested that, if an actual gap creditor existed,\(^52\) a trustee, under Moore v. Bay, would be subrogated to that creditor and could attribute to that creditor the hypothetical judicial lien of section 70(c).\(^53\) This, according to Grant

For the history of § 9-301(1) and the influence that the trustee's avoiding powers had on it, see 2 GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 45.3.2, at 1295-97 (1965); Hawkland, supra note 40, at 361-63; William E. Hogan, Bankruptcy Reform and Delayed Filing under the U.C.C., 35 Ark. L. Rev. 35, 36-41 (1981); Frank R. Kennedy, The Impact of the Uniform Commercial Code on Insolvency: Article 9, 67 COM. LJ. 113 (1982).

47. See Harold Marsh, Jr., Constance v. Harvey—The "Strong-Arm Clause" Re-Evaluated, 43 CAL. L. REV. 65, 68 (1955) ("It is probably safe to predict that the case of Constance v. Harvey will cause more anguish among secured lenders in some states than any other case since Corn Exchange Bank v. Klauder . . . ."). Professor MacLachlan implied that Constance v. Harvey was a product of the international communist conspiracy. He wrote:

"Courts of recent years seem to have succumbed to the theory that legislation exists for the purpose of creating a new social order, and that the reasonable expectations of businessmen are entitled to only secondary consideration. This sense of values has led to serious blows to the credit structure, which cannot be beneficial to any interest in the long run. This has encompassed a willingness to think of the trustee in bankruptcy as having some power on high, quite divorced from the mundane realities of business."

James A. MacLachlan, The Title and Rights of the Trustee in Bankruptcy, 14 Rutgers L. Rev. 653, 668 (1960).


49. Id. at 608-09.

50. Id. at 610. Congress already had passed a bill to reverse Constance v. Harvey, but President Eisenhower vetoed this bill because certain parts of it adversely affected tax lien priorities. Veto of H.R. 7242, 106 CONG. REC. A7013 (Sept. 16, 1960), reprinted in 1960 U.S.C.C.A.N. 1580.

51. 304 F.2d 224 (9th Cir. 1962) (Jertberg, J.).

52. To be precise, under Washington law, the creditor did not have to be a gap creditor, but could have been any creditor that extended credit subsequent to attachment of the security interest. Id. at 228.

53. The court seems to have gone even further and, in dictum, suggested that, in the absence of a gap creditor, the trustee's strong arm power was no good. Id. at 228 ("Under our construction of § 70, sub. c the Trustee is empowered to exercise the pow-
Gilmore,

brings us back full circle to what we assumed Justice Holmes would have said in Moore v. Bay if he had dotted his i's and crossed his t's: [the strong arm power] merely supplements [the trustee's subrogation power] by conferring lien status on the trustee in his representation of existing or actual creditors if applicable state law provides that only lien creditors can avoid the challenged transaction.64

A second issue involved the question of knowledge of the unperfected security interest. Generally, only creditors sans knowledge were protected from unperfected security interests on personal property. This rule initially was followed in the 1962 version of the UCC, which gave priority to "a person who becomes a lien creditor without knowledge of the security interest and before it is perfected."65 In 1972, however, the knowledge requirement was removed.66

Thus, universal creditor knowledge, at least initially, could have saved an unperfected security interest. What if all the creditors in a particular bankruptcy had knowledge of the unperfected security interest? Could the trustee use the strong arm power to avoid it? Under Constance v. Harvey the trustee could hypothesize the rights of a non-

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64. See supra note 46, § 45.3.2, at 1295. Dean Jackson, an opponent of Moore v. Bay, opposes the Edwards case because it harnesses Moore v. Bay to the strong arm power. Thomas H. Jackson, Avoiding Powers in Bankruptcy, 36 STAN. L. REV. 725, 752 (1984). Instead, Jackson thinks that the trustee should be subrogated only to the real creditors' claims. Thus, if a belatedly recorded mortgage for one million dollars can be avoided by a real creditor who claims one dollar, Jackson would say that the strong arm power, as to this mortgage (which is perfected as of the day of bankruptcy), should be worth only one dollar. Id. at 742-50.


66. The removal of the knowledge requirement may have been the result of a misunderstanding of the spirit of the UCC. There remains a respectable legal and compelling ethical argument that subsequent parties with knowledge ought to be subordinated to prior unperfected secured parties. See David Gray Carlson, Rationality, Accident, and Priority Under Article 9 of the Uniform Commercial Code, 71 MINN. L. REV. 207 (1986); Steve H. Nickles, Rethinking Some U.C.C. Article 9 Problems—Subrogation; Equitable Liens; Actual Knowledge; Waiver of Security Interests; Secured Party Liability for Conversion Under Part 3, 34 ARK. L. REV. 1, 88-92 (1980); see also 2 GILMORE, supra note 46, § 34.2, at 898 ("[T]he argument can be made, with some degree of plausibility, that the apparent meaning of the relevant provisions of the Article should be disregarded.").
existential gap creditor. Given such heroic feats of imagination, it was comparatively easy to imagine that this nonexistent creditor had no knowledge of the unperfected security interest. But after Lewis and Edwards, the strong arm lien could supplement only the rights of actual creditors. This led to the following question: If every creditor had knowledge of the unperfected security interest, could the trustee in bankruptcy pretend to be an unknowledgeable judicial lien creditor? After some early confusion, 57 the Second Circuit issued a firm answer: The trustee wins even if every single creditor has knowledge. 58

The drafters of the UCC, however, tried to influence bankruptcy toward the opposite conclusion. In 1962 UCC section 9-301(3) defined a lien creditor to include a trustee in bankruptcy, a receiver, and an assignee for the benefit of creditors. It also provided, "Unless all the creditors represented had knowledge of the security interest such a representative of creditors is a lien creditor without knowledge even though he personally has knowledge of the security interest." 59 Most commentators rejected this parochial attempt to govern the content of bankruptcy law. 60 Even Grant Gilmore, who helped draft Article 9, predicted that this rule "would in all probability be disregarded." 61 This position, incidentally, contradicts his earlier belief that the strong arm power was merely an adjunct to the subrogation power, where reference had to be made to a real live creditor. 62 If so, then universal creditor knowledge would have been fatal to the trustee's strong arm power. 63

60. Kennedy, supra note 41, at 523-25. For a recent case, see Chittenden Trust Co. v. Sebert Lumber Co. (In re Vermont Toy Works, Inc.), 82 B.R. 258, 296 (Bankr. D. Vt. 1987) (Conrad, J.) ("To the extent that § 544(a) renders such knowledge immaterial and Vermont's adoption of the 1962 version of 9-301(3) appears to be in conflict, § 544(a) will control.") (citation omitted), rev'd on other grounds, 135 B.R. 762 (Bankr. D. Vt. 1991).
61. 2 Gilmore, supra note 46, § 45.3.2, at 1297 n.8.
62. See supra note 54 and accompanying text.
63. For a similar contradiction, see Jackson, supra note 54, at 753 n.86. First, Jackson thinks that any role for knowledge in UCC priorities is unwise. Second, he thinks that bankruptcy law should defer to the UCC, even when it is unwise. Third, he thinks that, if the cost of litigating the issue of knowledge is too high, it is all right after all if bankruptcy law knocks out the unperfected security interest, even if investigation might prove that all creditors had knowledge of the unperfected security interest. Id.

The third point contradicts Jackson's strong opposition to Moore v. Bay. Jackson believes that, if a mortgage for one million dollars is vulnerable to a gap creditor with a one dollar claim, then, contrary to Moore v. Bay, the trustee should be subrogated for
Today, many courts are justly appalled by the prospect that a debtor who enters a secured transaction and knows about its lack of perfection can later, as the debtor in possession, avoid the transaction for the benefit of the creditors and perhaps for the benefit of itself. Ingenious devices have been improvised to prevent debtors in possession from avoiding the unperfected security interests that they themselves created. These devices will be discussed in time. For now, note that these subterfuges bear a kinship to the defunct rule by which universal creditor knowledge of an unperfected security interest could negate the strong arm power.

II. Subordination Versus Avoidance

Is the strong arm power really an avoidance power, as it claims to be? The statute itself hedges its bets. Section 544(a) states that "[t]he trustee shall have . . . the rights and powers of, or may avoid any transfer of property of the debtor . . . that is voidable by" a judicial lien creditor. 66

only one dollar against the mortgage. Id. at 750 ("[Moore v. Bay] is unprincipled to the extent that it forces a particular creditor to share the valuable right to avoid a property interest with the entire class of unsecured creditors.").

Yet Congress deliberately refused to overrule Moore v. Bay after Professor Vern Countryman pointed out that, if it were overruled, the trustee would have to spend valuable resources to determine which creditors had avoidance rights against the one million dollar mortgage and which creditors did not. See S. Rep. No. 989, 95th Cong., 2d Sess. 85, reprinted in 1978 U.S.C.C.A.N. 5871; McCoid, supra note 54, at 178-79. Nancy L. Sanborn, Note, Avoidance Recoveries in Bankruptcy: For the Benefit of the Estate or the Secured Creditor?, 90 Colum. L. Rev. 1376, 1381-82 (1990). Hence, if saving investigative time and expense is a valid bankruptcy principle for the question of universal creditor knowledge of unperfected security interests, as Jackson argues, then it surely is a valid principle in support of Moore v. Bay.

64. See infra text accompanying notes 312-463. Special attention should be paid to the case of Briggs v. Kent (In re Professional Investment Properties of America), 955 F.2d 623 (9th Cir. 1992) (Nelson, J.), in which the Ninth Circuit held that the trustee is on inquiry notice of any facts contained in a bankruptcy opinion. This inquiry notice might lead to a re-establishment of a defense against the strong arm power on the basis of something like universal creditor knowledge. See infra text accompanying notes 299-306.

65. The claim to be an avoidance power is repeated in § 551, which provides: "Any transfer avoided under section . . . 544 . . . is preserved for the benefit of the estate but only with respect to property of the estate." 11 U.S.C. § 551 (1988).

66. Id. § 544(a) (emphasis added). If I may pick on a small error, Thomas Jackson writes: "The trustee is able to 'avoid' interests that creditors hold in property of the estate if such interests would be subordinate to an execution lien creditor's interest outside bankruptcy." Jackson, supra note 54, at 733. In fact, a careful reading of § 544(a) reveals that the trustee may avoid interests that judicial lien creditors can avoid and subordinate interests that judicial creditors can subordinate. In re Kaneohe Custom
At a high level of generality, it might be thought that the strong arm power is not a true avoidance power. Take a simple state-law analogue involving a real judicial lien creditor. SP claims an unperfected security interest in the equipment of D, but before SP can perfect, LC has obtained a judicial lien on the equipment.

Few people would say that SP's security interest is avoided. Instead, they would say that SP's security interest has been demoted from first to second place, but that the unperfected security interest continues to exist.67

Similarly, it should follow that the trustee's strong arm power does not avoid security interests, but simply subordinates them.68 As a practical matter, in bankruptcy, avoidance and subordination usually are tantamount to the same thing. The trustee in bankruptcy represents all the general creditors. This ordinarily includes SP, if SP has recourse against the debtor personally. This means that, as to proceeds of the property, SP, who is second in line to the trustee, never has to use the subordinated security interest because SP has been paid in full by the time SP's junior priority kicks in. That is, in a sale free and clear of liens, the trustee would take enough cash to satisfy all creditor claims. But this ordinarily includes SP's claim. Thereafter, SP cannot apply for cash proceeds because SP has already been paid. The difference between subordination and avoidance therefore is usually academic.

There is one situation in which subordination and avoidance differ. If SP is a nonrecourse secured party and if the debtor is solvent, avoidance might imply that SP forfeits a property interest to D. A subordination theory, however, would prevent a complete forfeiture. For example, suppose D has granted an unperfected security interest to SP on its only asset, which is now worth only $100, in exchange for a nonrecourse loan to D for $150. Suppose further that in D's subsequent


It is possible to show that avoidance and subordination are the same thing—subordination is partial avoidance and all avoidances are subordinations. But that leap can be established only by a careful Hohfeldian analysis, which I am about to supply in this section.

67. See Kennedy, supra note 38, at 1429 & n.40 (distinguishing the subrogation power as a true avoidance power and the rights of a judicial lien creditor under UCC § 9-301 which involve mere subordination).

68. See Lincoln Nat'l Bank v. Conti (In re Conti), 27 B.R. 175, 180 (Bankr. S.D. Ohio 1982) (Anderson, J.); Ernst v. Sears, Roebuck & Co. (In re Page), 26 B.R. 959, 962 (Bankr. S.D. Ohio 1983) (Anderson, J.) ("Finding that the judgment is avoidable as to the Trustee, however, is not synonymous with finding the lien is invalid."). In Page Judge Anderson refused to invalidate a judicial lien on overencumbered property that properly should have been abandoned and adjudicated under state law.
bankruptcy, D plans to sell the collateral. Finally, suppose D has creditors who, in the aggregate, claim $50. If SP's nonrecourse security interest were perfected, then D is insolvent. SP obtains $100 worth of collateral and the other creditors obtain nothing.

But SP's security interest is not perfected. Hence, it is either "void" or "subordinated" under the strong arm power. If void, SP obtains nothing, D's creditors are fully paid, and D emerges with $50 of equity free and clear of SP's security interest. If subordinated, the creditors are still fully paid because they are senior by virtue of the bankruptcy trustee's hypothetical judicial lien. But SP, not D, is now entitled to recover the $50 surplus by virtue of its valid-but-subordinated security interest. Hence, the choice between void and subordinated makes a great deal of difference in this one case.69

Though they may seem exotic, these are the facts of Vintero Corp. v. Corporacion Venezolana de Fomento (In re Vintero Corp.),70 a case decided under the Bankruptcy Act. In this peculiar case Vintero gave Corporacion Venezolana de Fomento (CVF)71 nonrecourse security interests in two ships, which, under Virginia's UCC, were perfected security interests.72 Later, Vintero's subsidiary sailed the vessels across

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69. Another case in which it appeared to make a difference is Lincoln National Bank v. Conti (In re Conti), 27 B.R. 175 (Bankr. S.D. Ohio 1982) (Anderson, J.), in which the debtor obtained an exempt automobile from the bankrupt estate. The exempt property was encumbered by an equitable lien (justified by the debtor's perjurious fraud). The court declared the equitable lien void under the trustee's strong arm power, but because the strong arm power only subordinates and does not destroy liens, the equitable lien continued to be good outside of bankruptcy and continued to encumber the debtor's exempt automobile. Id. at 180.

This holding was questionable. Under Bankruptcy Code § 522(g) the debtor cannot exempt property that it voluntarily conveyed away in a voidable transfer. 11 U.S.C. § 522(g) (1988). Hence, the trustee should have been able to avoid the equitable lien and retain the car for the benefit of the general creditors. Because the case was wrongly decided in this sense, it does not represent a genuine illustration of the strong arm power as a merely subordinating medium. See also Phelan v. Fleet Consumer Discount Co. (In re Rice), 133 B.R. 722 (Bankr. E.D. Pa. 1991) (Scholl, J.) (holding that § 522(b) allows a debtor to avoid an unperfected mortgage under § 522(b), but not explaining how this was possible given § 522(g)(i)).

One way to read Conti is that it simply upholds equitable liens in bankruptcy. For the respectable authority in favor of this position, see infra text accompanying notes 421-49.

70. 735 F.2d 740 (2d Cir.) (Van Graafeiland, J.), cert. denied, 469 U.S. 1087 (1984).


the Chesapeake from Virginia to Maryland. This easy voyage apparently had the beneficial effect of deperfecting CVF’s security interests. Vintero then filed for bankruptcy under old Chapter XI. Because CVF was a nonrecourse creditor of Vintero, the failure to perfect its security interest arguably implied that CVF had no claim at all in Vintero’s bankruptcy.

Nevertheless, CVF’s unperfected security interest was ruled good against Vintero. Judge Van Graafeiland’s argument was as follows:

[A]lthough Vintero, as a debtor-in-possession, could exercise the rights of a lien creditor, it obviously was not one. Filing requirements

31301(3), (6)(A), 31322(a)(1), (c) (1988). See generally Michael Downey Rice, Asset Financing 318-23 (1989). While the Ship Mortgage Act allows for a certain priority against other maritime liens, it is still possible to perfect a security interest under Article 9, which, while not good against maritime liens, is at least good against state-law judicial lien creditors, id. at 310-13, and hence against bankruptcy trustees. In re H & S Transp. Co., 42 B.R. 164 (Bankr. M.D. Tenn. 1984) (Paine, J.) (holding that the trustee may not hypothesize maritime lien status). But see In re Alberto, 66 B.R. 132 (Bankr. D.N.J. 1985) (Gambardella, J.) (holding that Article 9 perfection was not good against the trustee because the perfection provisions of the Ship Mortgage Act of 1920 were the exclusive source of rights in the vessel), rev’d on other grounds, 823 F.2d 712 (3rd Cir. 1987).

73. It is not clear why this should be so. Presumably ships are mobile goods within the meaning of UCC § 9-103(3)(a), which provides:

This subsection applies to accounts . . . and general intangibles . . . and to goods which are mobile and which are of a type normally used in more than one jurisdiction, such as motor vehicles, trailers, rolling stock, airplanes, shipping containers, road building and construction machinery and commercial harvesting machinery and the like, if the goods are equipment or are inventory leased or held for lease by the debtor to others, and are not covered by a certificate of title . . . .


Ordinarily, perfection of security interests in mobile goods is governed by the law of the state in which the debtor is located. Id. § 9-103(3)(b).

If, however, the debtor is located in a jurisdiction which is not a part of the United States, and which does not provide for perfection of the security interest by filing or recording in that jurisdiction, the law of the jurisdiction in the United States in which the debtor has its major executive office in the United States governs the perfection . . . of the security interest through filing. Id. § 9-103(3)(c). Hence, a filing where the debtor had its major executive office in the United States would have perfected the security interest no matter where the vessels went.

74. According to a more recent Second Circuit opinion, certain security interests in airplanes and vessels covered by Bankruptcy Code § 1110(a) are not subject to the trustee’s avoiding powers. California Chieftan v. Air Vermont, Inc. (In re Air Vermont, Inc.), 761 F.2d 130, 133-34 (2d Cir. 1985) (Pierce, J.). Section 1110(a) provides that the automatic stay lapses 60 days after the bankruptcy petition unless a Chapter 11 debtor “cures” all defaults in a ship mortgage within the 60 day period. 11 U.S.C. § 1110(a)(1), (2)(A) (1988 & Supp. II 1990). But the secured party must claim a mortgage under Title 46, § 30101 of the Ship Mortgage Act of 1920, 46 U.S.C. § 30101 (1988), which the secured party in Vintero was unable to do.
Vintero was given the right to avoid CVF's security interest in order to protect such third parties, not to create a windfall for Vintero itself. Vintero suffered no prejudice because of the lapse in filing, and we see no reason why it should benefit from such lapse. To the extent that other creditors of Vintero are not affected adversely by enforcement of CVF's security interest, there is no reason why such interest should not be enforced.\textsuperscript{26}

This is an odd holding indeed: Vintero has the rights of a judicial lien creditor, but is not one and therefore may not exercise these rights! The metaphysics of unexercisable rights are, however, elucidated by the strong hint that Vintero was a \textit{solvent} Chapter XI debtor. If the security interest were to be avoided, CVF would have no claim against Vintero at all and would lose its security interest as well. Vintero would have received a gift of the artificially created debtor equity. This Judge Van Graafeiland could not abide.

That the debtor was solvent makes sense of the final holding in this strange case. Noting that the nonrecourse nature of CVF's security interest does not rule out a security interest in cash proceeds, Van Graafeiland ruled:

On the other hand, substantial justice and established law mandate that, despite its security interest, CVF shall not be entitled to priority of payment over other creditors but must share alike with them.

On the assumption that [one of the ships] will be sold as part of Vintero's plan of arrangement, we hold that CVF's security interest shall attach to the identifiable proceeds of the sale, but that such security interest shall not entitle CVF to a priority of payment as against Vintero's general unsecured creditors. Such disposition will protect the interests of Vintero's creditors, will recognize the merit of CVF's substantial claim, and will preclude the possibility of Vintero reaping an undeserved windfall.\textsuperscript{26}

Liberally reinterpreted, this opinion stands for the proposition that the security interest was not avoided, but only subordinated.\textsuperscript{27} As a result, the general creditors, through Vintero's strong arm power, had priority to the cash proceeds of the collateral. CVF, as a junior secured credi-

\textsuperscript{26} Vintero, 735 F.2d at 742 (citations omitted); \textit{see} Barkley Clark, \textit{The Law of Secured Transactions Under the Uniform Commercial Code} § 3.2[2], at 3-8 (1980).

\textsuperscript{27} Some read Vintero as giving birth to the notion that the strong arm power can be applied only if creditors are benefited. \textit{Cf.} Greenbelt Coop., Inc. \textit{v.} Werres Corp. (\textit{In re} Greenbelt Coop., Inc.), 124 B.R. 465, 472-74 (Bankr. D. Md. 1991) (Derby, J.) (declining to exercise equitable powers because avoidance, rather than subordination, would further the reorganization plan). This amounts to the view that the strong arm power is founded on subordination, not avoidance.
tor, would then be able to satisfy its nonrecourse claim from the remaining proceeds.78

There is one cavil, however, to this interpretation. Judge Van Graafeiland indicated that CVF should share with the other general creditors in the proceeds. On the numbers used above, if CVF claimed $150, the other creditors claimed $50, and the collateral was sold for $100, then under Judge Van Graafeiland's holding each creditor would receive 50 cents on the dollar. CVF would obtain a $75 recovery on this theory. This result would have been entirely justified if CVF had recourse against the debtor. But CVF had no recourse. Hence, the general creditors should have recovered 100 cents on the dollar, or $50, and CVF should have taken the surplus of $50. Under Van Graafeiland's theory of sharing CVF would obtain more—$75—and the general creditors would have received less—only $25.79

But for this conceptual slip-up, whereby CVF was erroneously made into a recourse lender equal to all the other general creditors of the debtor,80 Vintero stands for the proposition that avoidance does not mean disappearance but rather only subordination.

Yet, at a deep conceptual level it can be said that subordination in turn always implies avoidance. They are in truth the same thing. To use the simple state-law analogue, suppose D grants an unperfected security interest to SP. Before SP perfects, LC obtains a judicial lien on the collateral. When LC's judicial lien attaches, it creates in LC a

78. For another case in which a court refused to declare an unperfected security interest void when the debtor was solvent, see In re Chapman, 51 B.R. 663, 665-66 (Bankr. D.D.C. 1985) (Bason, J.). Although Judge Bason perceived himself as simply refusing to apply the strong arm power at all, the decision is probably better viewed as one that follows the subordination theory of the strong arm power.

79. What Van Graafeiland lacks is a theory under which a nonrecourse unperfected secured party gets recourse solely because a creditor has obtained a senior judicial lien. The tort of conversion comes to mind, but it is hard to argue that the creditor has acted wrongfully when the UCC invites creditors to take priority without regard for the unperfected secured party's rights. In the absence of this theory, one must conclude that Judge Van Graafeiland wrongly granted a recourse claim to the unperfected secured party.

80. Coincidentally, under Chapter 11 of the Bankruptcy Code, a secured party automatically becomes a recourse creditor unless:

(i) the class of which such claim is a part elects, by at least two-thirds in amount and more than half in number of allowed claims of such class, application of paragraph (2) of this subsection; or

(ii) such holder does not have such recourse and such property is sold under section 363 of this title or is to be sold under the plan.

11 U.S.C. § 1111(b)(1)(A) (1988). Vintero, of course, was a Bankruptcy Act case and, in any case, the collateral was likely due to be sold under the plan. See supra notes 70-76 and accompanying text.
power of sale that is good against SP's security interest.\textsuperscript{81} If LC sells the property in a sheriff's sale to X, X will take title free and clear of SP's security interest even if X has full knowledge of SP's security interest at the time of the sheriff's sale. Now buyers with knowledge of unperfected security interests ordinarily take subject to those security interests.\textsuperscript{82} But X's knowledge is irrelevant because LC has the right to sell free and clear of SP's security interest, even to bad faith purchasers. This idea is sometimes called the "shelter principle."\textsuperscript{83}

This superior power of sale in LC represents the moment at which LC has avoided SP's unperfected security interest. Hence, subordination ought to be viewed as partial avoidance.\textsuperscript{84} That is, SP's unperfected security interest is void only as against LC's power to sell good title to X.\textsuperscript{85} It is still good against others, and so SP could still conduct a junior sale—\textit{i.e.}, a sale that would not be good against LC.\textsuperscript{86} Also, if LC sells and there is a surplus, SP's security interest is still good against the surplus cash proceeds. Subordination, then, constitutes only partial avoidance—void against lien creditors but good against the rest of the world. Hence, the strong arm power, by invoking the idea of a judicial lien, is a true avoidance power after all.

Some readers at this point will have recalled that most security interests still unperfected on the day of bankruptcy are not only subordinated to the rights of the trustee as lien creditor, but are voidable preferences as well. Hence, the above analysis of Vintero is threatened

\textsuperscript{81} This senior power of sale was referred to in the Vintero case. 735 F.2d at 742 ("If, as is more likely, the ship has to be sold in order to satisfy the claims of Vintero's creditors, the debtor, of course, must be able to convey a title unencumbered by CVF's lien.").

\textsuperscript{82} See U.C.C. § 9-301(1)(c) (1972).


\textsuperscript{85} Debtor-creditor statutes used to be written in terms of partial avoidance. New York's predecessor to UCC § 9-301(1)(b) read in part as follows: "Every [nonpossessory] mortgage or conveyance intended to operate as a mortgage of goods and chattels . . . is absolutely void as against the creditors of the mortgagor . . . unless the mortgage . . . is filed . . . within ten days after the making thereof." N.Y. LIEN LAW § 230 (McKinney 1966) (emphasis added) (repealed 1964).

\textsuperscript{86} U.C.C. § 9-504(4) (1972) ("When collateral is disposed of by a secured party after default, the disposition transfers to a purchaser for value all of the debtor's rights therein, discharges the security interest under which it is made and any security interest or lien subordinate thereto."). Under this formula a sale by SP cannot affect LC.
by the fact that CVF’s security interest was void as a preference,\(^87\) not just subordinated under the strong arm power.

This anomaly results from the fact that section 544(a) refers (indirectly) to subordination,\(^88\) while section 547(b) uses the word "avoid." It would be convenient in a case like Vintero if the word "avoid" did not mean "disappear" because the equity owners of the debtor could not profit from the fact that CVF’s security interest was a voidable preference. Surely only creditors of Vintero—not the shareholders—should benefit from voidable preference liability.

Such a theory of avoidance is available. According to this theory, avoidance under section 547(b) does not mean that the security interest disappears. It only means that the security interest is partially avoided—so far as the trustee is concerned. As to the rest of the world, the unperfected security interest is still good. Under section 544(a) the trustee, representing the general creditors, holds a judicial lien on the day the bankruptcy petition was filed. Hence, the voidable preference is void only with regard to this judicial lien. Once this judicial lien has exhausted itself—\(i.e.,\) when the creditors have been fully paid—the avoidance power under section 547(b) is exhausted. The unperfected security interest continues to exist, even though it is a voidable preference, and the unperfected secured creditor would be able to use it to establish seniority over the shareholders.

On this view, avoidance is never anything but a form of subordination, and subordination a form of avoidance, whether under the simple state-law priority contest with which we started or under the exotic facts of Vintero. Furthermore, any avoidance theory refers to the strong arm power as an essential element of its mechanism. First, the avoidance theory obliterates the transfer, but only with regard to the trustee’s rights as the representative of the general creditors. Then the

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\(^87\) The transfer seems to have been “on account of an antecedent debt owed by the debtor.” 11 U.S.C. § 547(b)(2) (1988). A “‘debt’ means liability on a claim.” Id. § 101(12) (Supp. II 1990). And “claim” includes a “claim against property of the debtor.” Id. § 102(2) (1988). Because CVF never reperfected its security interest, it is deemed to have received a transfer on antecedent debt the day before bankruptcy. Id. § 547(e)(2)(C)(i). Furthermore, the transfer made the debtor insolvent, id. § 547(b)(3), and allowed the secured party to obtain more from the transfer than the secured party would have received in a hypothetical Chapter 7 liquidation, id. § 547(b)(5). Hence, it would appear that, however nicely Vintero works out a just solution with regard to the strong arm power, the solution is undone with regard to voidable preference law.

\(^88\) Actually, § 544(a) says that the trustee has “the rights and powers of [a judicial lien creditor], or may avoid any transfer of property of the debtor or any obligation incurred by the debtor that is voidable by” a judicial lien creditor. 11 U.S.C. § 544(a) (1988) (emphasis added). Because UCC § 9-301(1)(b) allows only for subordination and not avoidance, see supra text accompanying notes 66-80, subordination is the relevant concept for the strong arm power. See Kennedy, supra note 38, at 1429 & n.40.
strong arm power adheres to the property transferred, but only to the extent necessary to guarantee payment to the general creditors. Hence, the strong arm power, and any other avoidance power, is only a partial avoidance power. It subordinates and never obliterates the object of its hostility.

III. The Strong Arm Power and Lien Preservation

Yet another fruitful way of analyzing strong arm avoidance of an unperfected security interest is to recognize subordination as a transfer of rights from the secured party to the trustee in her guise as a judicial lien creditor. This point is useful to dwell upon because it makes clear that lien preservation under Bankruptcy Code section 551 is logically compelled by the strong arm power. According to section 551, "Any transfer avoided under section 522, 544, 545, 547, 548, 549, or 724(a) of this title, or any lien void under section 506(d) of this title, is preserved for the benefit of the estate but only with respect to property of the estate." The hornbook explanation for lien preservation is that it is a necessary legislative intervention to prevent windfalls to junior secured parties when the senior security interest is avoided. For example, suppose D grants A a senior security interest. A never perfects. D then grants B a security interest. B is junior to A because B has knowledge of A's unperfected security interest. B has perfected. D then files for bankruptcy, and the bankruptcy trustee uses the strong arm power to avoid A's unperfected security interest. It is feared that the only result of the avoidance is that A's security interest disappears, and B moves up from second to first priority with regard to the collateral. Hence, lien preservation is necessary to ensure that D's trustee, not B, obtains the benefit of the strong arm power.

In fact, this would be the proper result whether or not section 551 existed. When the trustee obtains a hypothetical judicial lien, the trustee obtains an involuntary transfer from D and also from A. That is to say, the judicial lien represents a power to sell D's interest in the collateral. But it also represents the power to sell A's interest. Now A already had the power to sell free and clear of B's security interest. The trustee takes over this power when the trustee's judicial lien attached to A's unperfected security interest. Hence, the trustee can sell

91. This could commonly occur under real estate recording statutes, but it also might occur under Article 9 if A has filed a financing statement in the wrong office. See U.C.C. § 9-401(2) (1972).
the collateral free and clear of D, A, and B.\textsuperscript{92} Of course, B continues to have a valid secured claim and would still obtain a junior position with regard to any cash proceeds. Accordingly, the trustee enjoys first priority, by virtue of having seized A's senior position. B has second priority, and the trustee has third priority to any balance because the trustee's judicial lien also attached to the debtor's equity in the property.\textsuperscript{93}

In Robinson v. Howard Bank (In re Kors, Inc.)\textsuperscript{94} Judge Lawrence W. Pierce disagreed with the above analysis. In Kors the debtor Kors wished to obtain equipment in a leveraged leasing arrangement. It did so on several occasions from the same lessor, the Rutland Industrial Development Corporation (RIDC).\textsuperscript{95} To obtain the equipment, RIDC borrowed funds from Howard Bank (the Bank) in exchange for a security interest in the equipment purchased. The Bank perfected the

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\textsuperscript{92} Irrespective of lien preservation theory, the trustee has the power to sell any collateral free and clear of all liens, whether senior or junior, if "the price at which such property is to be sold is greater than the aggregate value of all liens on such property." 11 U.S.C. § 363(f)(3) (1988). Under state law junior lien creditors usually cannot sell free and clear of senior liens. Carlson, \textit{Death and Subordination, supra} note 84, at 565-71. But, \textit{qua} lien creditor under state law, subordination equates with subrogation, so that, on this theory too, the trustee may take over A's senior right of sale. \textit{See also} 11 U.S.C. § 363(f)(1) (1988) (stating that the trustee may sell free and clear if "applicable nonbankruptcy law permits sale of such property free and clear of such interest").

\textsuperscript{93} John McCoid reaches a similar conclusion:

It seems to me that what the antipreference part of bankruptcy law does here resembles subordination. The policy of bankruptcy law is to put preferred-creditor A's claim on a parity with those of the unsecured creditors, not because of consent or fault, but for the purpose of equality. The only way to achieve this limited purpose, without benefiting or harming B, is to give the trustee representing unsecured creditors, who now include A, the benefit of A's priority over B. And that, of course, is exactly what preservation does, thus giving effect to the antipreference policy of bankruptcy law without otherwise modifying the results achieved under nonbankruptcy law.


In his article McCoid worries that bankruptcy creates a circular priority: A is senior to B who is senior to the general creditors that are represented by the bankruptcy trustee, who is senior to A. In his view the function of § 551's lien preservation is to break this circle. In fact, he assumes that lien preservation is inappropriate in any case in which no circular priority is present. \textit{Id.} at 1092-1102, 1116.

Arguably, there is no circle at all. Instead, the trustee is a judicial lien creditor who is junior to B, but the trustee's lien also attaches to the secured claim of A. The trustee thereby is partly senior and partly junior to B. The trustee surrounds B on both sides, but does not create a classic circular priority—or, if lien preservation does create a circle, it does so in a way that is susceptible of easy solution under state law, without the aid of any federal intervention.


\textsuperscript{95} Kors, 50 B.R. at 876.
security interest against RIDC but not against Kors. In short, this was a standard leveraged lease with the Bank taking a perfected security interest in the equipment prior to its lease to Kors.  

At this point the conveyances looked like this:

Now Kors's lease and the Bank's security interest were created at precisely the same time. Which had priority over the other would have been ambiguous if the contract had been silent on the matter. If Kors took free and clear of RIDC's security interest, the Bank could claim only the RIDC's reversion—not Kors's leasehold rights in the equipment. In such a case the Bank could not repossess the equipment from Kors so long as Kors was not in default on its lease. This ambiguity, however, was resolved by contractual language in which Kors agreed

96. The leasehold itself was "chattel paper." U.C.C. § 9-105(1)(b) defines chattel paper as "a writing or writings which evidence both a monetary obligation and a . . . lease of specific goods." U.C.C. § 9-105(1)(b) (1972). As such, it probably was "proceeds" of the Bank's collateral. See id. § 9-306(1); see also Steven L. Harris, The Rights of Creditors Under Article 2A, 39 Ala. L. Rev. 803, 824-25 (1988) (discussing some contrary authority).

97. Today, this result might be mandated by U.C.C. § 2A-307(3), which provides: "A lessee in the ordinary course of business takes the leasehold interest free of a security interest in the goods created by the lessor even though the security interest is perfected (Section 9-303) and the lessee knows of its existence." U.C.C. § 2A-307(3) (1990); see generally Harris, supra note 96, at 816-18. Of course, Article 2A was not operative at the time of the Kors case. Therefore, the case probably depends on § 9-306(2), which provides that "a security interest continues in collateral notwithstanding sale, exchange or other disposition thereof unless the disposition was authorized by the secured party in the security agreement or otherwise, and also continues in any identifiable proceeds including collections received by the debtor." U.C.C. § 9-306(2) (1972). In Kors the lease of the equipment was contemplated in the security agreement between RIDC and the Bank. Whether it was a disposition free and clear of the lease, however, would undoubtedly depend on the intent of the parties, which might be viewed as ambiguous.
that its rights as lessee were "subject and subordinate" to the security interest of the Bank.\textsuperscript{98} Hence, both Kors and RIDC were debtors of the Bank.\textsuperscript{99} Accordingly, the relationships between the parties could be described as follows:

- **Howard Bank** security interest in reversion
- **RIDC Lessor**
- **Kors Lessee** nonrecourse security interest in leasehold

If RIDC defaulted, the Bank could repossess the equipment from Kors whether or not Kors was in default on the lease. Putting these two security interests together—one on the reversionary interest and one on the leasehold interest—the Bank was in a position to sell an absolute fee simple interest in the equipment to any buyer, in case of any default.

To complicate matters, Kors hypothecated its leasehold interest in the equipment to yet another lender—the Small Business Investment Corporation of Vermont (SBIC). SBIC specifically subordinated its security interest to that of the Bank.\textsuperscript{100} This produced the following result:

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\textsuperscript{98} "The lease also provided that the leased property was subject and subordinate to the terms and provisions of a security agreement given by RDIC [the lessor] to the Bank [the secured party] . . ." *Kors*, 64 B.R. at 164.

\textsuperscript{99} According to UCC § 9-105(1)(d):

*Where the debtor and the owner of the collateral are not the same person, the term "debtor" means the owner of the collateral in any provision of the Article dealing with the collateral, the obligor in any provision dealing with the obligation, and may include both, where the context so requires . . . .*

U.C.C. § 9-105(1)(d) (1972). In this case, if Kors was a debtor, it was also in the nature of a nonrecourse guarantor of RIDC's obligation to the Bank. That is, as surety for RIDC's obligation to the Bank, Kors had hypothecated its leasehold interest in the equipment.

\textsuperscript{100} *Kors*, 64 B.R. at 164-65.
If Kors defaulted on its obligation to SBIC, SBIC was in a position to foreclose only on the leasehold, not on the reversion. Given a broadly written default clause in the lease, SBIC’s junior position in this collateral was not very sound. If Kors defaulted on the lease, the leasehold would disappear, leaving SBIC with no collateral.

As sometimes happens, the lease between RIDC and Kors turned out to be a security interest in disguise. As a result, the bankruptcy court reanalyzed the case as follows:

On this analysis, RIDC and the Bank had unperfected security inter-

101. Id. at 167; Kors, 50 B.R. at 879.
ests of equal priority because these security interests attached to the equipment at precisely the same time.\textsuperscript{102} They were also essentially the same security interest because the Bank's direct security interest in the equipment via Kors merely guaranteed RIDC's obligation to pay the Bank. If RIDC were paid first, the Bank would own the payment as proceeds of the collateral.\textsuperscript{103} If RIDC had passed along these proceeds to the Bank, the Bank's claim would have been extinguished, and the Bank's direct security interest would disappear.\textsuperscript{104}

Meanwhile, SBIC had contractually subordinated its security interest to that of the Bank. It seems, however, that SBIC did not directly subordinate itself to the security interest of RIDC, probably because the parties had thought that RIDC was a lessor, not a secured party.\textsuperscript{105}

Neither the Bank nor RIDC filed financing statements against Kors. Accordingly, Judge Charles J. Marro found that the trustee's strong arm power was senior to the Bank's unperfected security interest and, by implication, RIDC's unperfected security interest. These avoided liens were deemed preserved for the benefit of the estate under Bankruptcy Code section 551.\textsuperscript{106} The trustee therefore stepped into the shoes of the Bank and RIDC, taking priority over SBIC, which had specifically subordinated its security interest to that of the Bank.\textsuperscript{107}

\textsuperscript{102} It appears that RIDC was a purchase money lender, while the Bank held a security interest as surety for RIDC's obligation to pay the Bank. UCC § 9-312(4) grants a superpriority to purchase money lenders, but only if they perfect within ten days of attachment. U.C.C. § 9-312(4) (1972). Hence, the question of priority would be settled by § 9-312(5)(b), which grants priority to the first unperfected security interest to attach. Id. § 9-312(5)(b). Because RIDC purchased the equipment directly from the vendor, however, the Bank and RIDC's security interests attached at precisely the same time.

\textsuperscript{103} See id. § 9-306(2) ("[A] security interest continues in . . . any identifiable proceeds including collections received by the debtor.").

\textsuperscript{104} There could be some differences. If RIDC were in the business of profiting from leveraged leasing, the rental payments it could claim from Kors would be larger than the principal and interest that it owed the Bank.

\textsuperscript{105} RIDC had never perfected, and hence there was arguably a circular priority of sorts, whereby the Bank was senior to SBIC, which was senior to RIDC, which was equal to the Bank. This is questionable, however, because SBIC seems to have contemplated taking only a leasehold as collateral. This intent indicates that SBIC was subordinate to RIDC's claim to the reversion. Because the lease was unexpectedly changed into a security interest, the better result is probably that SBIC is subordinate to both RIDC and the Bank.

\textsuperscript{106} Kors, 50 B.R. at 883.

\textsuperscript{107} For a case reaching a similar result, see Collins v. Bank of New England-West, N.A. (\textit{In re Daylight Dairy Products, Inc.}), 125 B.R. 1 (Bankr. D. Mass. 1991) (Queenan, J.). In Hunter v. Ohio Citizens Bank (\textit{In re Henzler Manufacturing Corp.}), 36 B.R. 303 (Bankr. N.D. Ohio 1984), Judge Krasiewski held that the trustee's strong arm power avoided the unperfected security interest, but he specifically reserved judgment on the
On appeal, Judge Pierce reversed. He agreed that the strong arm power had the effect of "avoiding" the bank's unperfected security interest. Furthermore, lien preservation under section 551 is "automatic."\footnote{108}

It was improper, however, for the trustee to be subrogated to the Bank's rights with respect to the subordination agreement . . . . Under Vermont law, subordination agreements will be enforced only between those parties entitled to priority who enter such an agreement. Thus under Vermont law, the trustee would not accede to the benefits of the subordination agreement because Kors was not a part of that agreement. Moreover, the trustee was vested only with the rights the Bank had against Kors.\footnote{109}

Thus, Judge Pierce conceived himself as having applied the strong arm power and as having preserved the avoided security interest. Separate and apart from this, however, the contract between SBIC and the Bank had to be enforced, which resulted in the Bank receiving cash that otherwise would have been paid to SBIC. By pursuing this logic, Judge Pierce analyzed the case differently from Judge Marro. Instead of seeing SBIC as junior to RIDC and the Bank (by virtue of the subordination agreement), Pierce saw SBIC as "naturally" senior, but as having contractually assigned away its rights to the Bank. As a result, Kors's bankruptcy trustee could avoid the Bank's junior unperfected security interest, but not SBIC's senior security interest. Because the subordination agreement was a separate contract between the Bank and SBIC, it was given effect separate and aside from the Bank's junior security interest.\footnote{110} In other words the trustee could avoid and ex-

\footnote{108. Kors, 819 F.2d at 23.}
\footnote{109. Id. at 24 (citations omitted).}
\footnote{110. Judge Marro specifically denied that subordination of lien priority is an assignment. Kors, 50 B.R. at 882. Elsewhere, the Second Circuit has specifically adopted this theory of subordination. Citibank, N.A. v. Tele/Resources, Inc., 724 F.2d 266, 269 (2d Cir. 1983) (Van Graafeiland, J.) ("[W]e think it makes little difference whether the alleged transfer of rights . . . is called a subordination agreement rather than an assignment."). One reading of Kors is that Judge Pierce was overruling Judge Marro's view that subordinations are not assignments.}

In fact, Judge Marro has the better view of this argument. Subordination of an entire claim definitely should be viewed as a form of assignment—to be precise, a nonreourse assignment for security of bankruptcy dividends. David Gray Carlson, A Theory of Contractual Debt Subordination and Lien Priority, 38 Vand. L. Rev. 975, 978 (1985). But this view should not be adopted for mere subordination of lien priority.

A secured party who subordinates a security interest is authorizing a non-senior secured party to sell collateral free and clear of the subordinated lien and to take proceeds from that sale in a senior way. The agreement does not make the junior secured party
propriate the Bank’s junior security interest but not the Bank’s right to priority over SBIC, which SBIC established in a separate agreement.

Pierce assumes that, but for the contractual subordination clause, SBIC would have been senior to the Bank. In a real estate case this certainly would not have been true. SBIC’s knowledge of the Bank’s unrecorded security interest would have prevented SBIC from being senior to the Bank; the subordination contract would have merely described the noncontractual priority that the Bank would have held anyway. But, under Article 9, as it is usually read, SBIC had priority over the Bank—in spite of its full knowledge—because it was the first to perfect. Now there is something dreadfully wrong about SBIC having priority in such a case. SBIC thought it was taking a security interest in a leasehold. It had full knowledge that the Bank claimed a prior interest in Kors’s leasehold and in RIDC’s reversion. Nevertheless, but for the subordination contract, we are supposed to believe that Article 9 awards a windfall first priority to SBIC because the Bank—and everyone else—mistakenly thought that Kors had a leasehold interest rather than an encumbered “fee simple” interest. Yet the irrelevance of knowledge or equity in Article 9 priorities is widely (and erroneously, in my opinion) assumed to be the law.\footnote{For the view that Article 9 does allow for the subordination of secured parties with knowledge of earlier unperfected security interests, see \textit{supra} note 56.}

In analyzing the case this way, Judge Pierce (and also Judge

\footnote{In analyzing the case this way, Judge Pierce (and also Judge the owner of the senior claim. A test of this is as follows: If the debtor pays the junior creditor with unencumbered dollars, one expects that this payment may be retained by the junior secured party. If the junior secured party was an assignee of the claim, the payment would be held for the benefit of the senior secured party. In no sense did SBIC promise to forego payment. Rather, it only waived recovery from specific collateral—the equipment leased to Kors. \textit{Id.} at 1019-29.}

11. For the view that Article 9 does allow for the subordination of secured parties with knowledge of earlier unperfected security interests, see \textit{supra} note 56.
Marro) overlooked a key fact: the bank *did* have a perfected security interest in the equipment after all. It was granted by RIDC, and this perfected security interest should have survived with vigor in Kors's bankruptcy. Recall that the parties structured the equipment leases as follows:

Notice that the Bank has *two* security interests: one granted by RIDC and one granted by Kors. The former was perfected and the latter was not. Whereas the strong arm power might suffice to subordinate the second security interest, it is not competent to subordinate the first.¹¹² Hence, the Bank should have prevailed on its *perfected* security interest. This is consistent with the result that Judge Pierce reached, though, of course, his stated theory was radically different.

In *Kors* the collateral had been liquidated for $1.1 million. The Bank claimed about $2.6 million, and SBIC claimed about $800,000.¹¹³ Of this amount, $184,000 represented collateral that SBIC never

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¹¹² See U.C.C. § 9-306(2) (1972) ("[A] security interest continues in collateral notwithstanding sale, exchange or other disposition thereof . . . ."). Steven Harris has suggested to me that the equipment in the hands of RIDC might be "inventory." *Id.* § 9-109(4) (stating that goods are inventory if "held by a person who holds them for sale or lease"). If so, then Kors may have been a buyer that took free and clear under § 9-307(1). *See id.* § 9-307(1) ("A buyer in the ordinary course of business . . . takes free of a security interest created by his seller even though the security interest is perfected and even though the buyer knows of its existence."). This is an interesting theory that destroys the security interest without any help from the strong arm power, but surely Kors's express subordination to the bank's security interest negates any theory based on UCC § 9-307(1). *See supra* note 98.

¹¹³ *Kors*, 64 B.R. at 166.
agreed to subordinate to the security interests of the Bank. 114 Once this amount was distributed, SBIC's claim would be reduced to $616,000, and the fund to which SBIC's security interest attached was reduced to $916,000. 115 Given Judge Pierce's holding, how should this $916,000 have been distributed?

It seems clear that the words of Judge Pierce's opinion required that the Bank should receive only $616,000, the amount otherwise payable to SBIC. The trustee would then take the surplus of $300,000. On this view, subordination of a security interest amounts to an assignment of a secured claim. According to the UCC, assignments need not be perfected. 116 Hence, if SBIC is conceived as having assigned its claim to the Bank, the Bank would have ended up with $616,000—the amount otherwise payable to SBIC.

But on remand, Judge Marro awarded the entire $916,000 to the Bank. 117 Interestingly, this is precisely what would have happened if the court had noticed that the Bank's security interest (granted by RIDC) was perfected and still good against Kors's equipment.

To summarize, what really happened in Kors is consistent with the idea that the Bank had a perfected security interest. Judge Pierce's decision, based on the dubious idea that subordination of a security interest is the same as an assignment of a secured claim, should have gained the Bank $616,000, not $916,000.

IV. The Strong Arm Power After Chapter 11 Confirmation

If avoidance is only subordination, the general creditors, but not the shareholders, should benefit from the strong arm or any other avoidance power. The issue becomes blurred, however, when, as a result of the confirmation of a Chapter 11 plan, the creditors have been frozen into place, so that the strong arm power benefits only the equity shareholders. 118

115. Although the collateral to which SBIC was senior was valued at $184,000, the court actually approved an award of $346,000, representing 13.5% interest between 1982 and 1989. Id. at 653. Nevertheless, $184,000 is the proper deduction from the $1.1 million fund. Just as the $184,000 amount grew from accruing interest, so did the $1.1 million fund; the two accruing interest amounts cancel each other out for the purpose of our analysis.
117. See Kors, 104 B.R. at 650.
118. According to Bankruptcy Code § 546(a), a strong arm action cannot be brought "after the earlier of—(1) two years after the appointment of a trustee under section 702, 1104, 1163, 1302, or 1202 of this title; or (2) the time the case is closed or dismissed." 11 U.S.C. § 546(a) (1988). There is an argument that a case is "closed" once the Chapter 11
If the equity shareholders have survived confirmation, it is because the general creditors have not insisted on their absolute priority rights, or because the equity shareholders have contributed new value to the debtor in exchange for newly issued shares. In either case, postconfirmation use of the strong arm power may not benefit the general creditors at all—only the equity shareholders.

In Greenbelt Cooperative, Inc. v. Werres Corp. (In re Greenbelt Cooperative, Inc.) Judge Derby nevertheless allowed a debtor in possession to bring a postconfirmation strong arm power action. He ruled that such actions are allowed if the general creditors receive any benefit whatsoever from the avoidance action. Judge Derby found that enriching the shareholders confers a benefit on general creditors:

Debtor's plan requires deferred payments to certain classes of creditors. It also provided substantial cash payments to creditors on its effective date. A recovery by Debtor in this proceeding will improve Debtor's financial health to the extent of the recovery. It will thereby increase the likelihood that Debtor's reorganization will be successful and that Debtor will be able to make its deferred plan payments.

Of course, any time the shareholders are enriched, the remaining creditors are rendered more secure. This is self-evident in the nature of

plan has been confirmed, but at least one court has ruled that, if the plan provides for continued court jurisdiction, the case is not closed just because the plan was confirmed. Edleman v. Gleason (In re Silver Mill Frozen Foods, Inc.), 23 B.R. 179, 181 (Bankr. W.D. Mich. 1982) (Howard, J.); Paul David Brusiloff, Note, The Road to Repose: Limitations on Avoidance Actions in Chapter 11 Via 11 U.S.C. § 546(a)(2), 13 CARDOZO L. REV. 2097, 2103-04 (1992).

119. 11 U.S.C. § 1129(b)(2)(B)(ii) (1988). If the general creditors insist, no prepetition shareholder can receive any property from the plan. But if the general creditors consent—and they frequently do—then the old shareholders might retain equity shares, while the general creditors receive debt instruments that are much reduced from their prepetition rights. For an empirical study on this phenomenon, see Lynn M. LoPucki & William C. Whitford, Bargaining Over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies, 139 U. PA. L. REV. 125 (1990).

120. When the buyer of the new shares is the owner of the old shares, the absolute priority rule does not apply, and the old equity owners might end up with the equity over the opposition of impaired creditors. Whether the "new value exception" to the absolute priority rule exists is a matter considerable controversy. See John D. Ayer, Rethinking Absolute Priority After Ahlers, 87 MICH. L. REV. 963 (1989); David Gray Carlson, Game Theory and Bankruptcy Reorganization, 9 BANKR. DEBT. J. (forthcoming 1992); Bruce A. Markell, Owners, Auctions, and Absolute Priority in Bankruptcy Reorganizations, 44 STAN. L. REV. 69, 97-98 (1991); Ralph A. Peeples, Staying In: Chapter 11, Close Corporations and the Absolute Priority Rule, 63 AM. BANKR. L.J. 65 (1989).


122. Id. at 473.

123. Id.

124. Unless, of course, the shareholders indulge in dividends or other forms of loot-
corporations. Yet, when he confirmed the plan, Judge Derby was supposed to have found that the plan was feasible.\textsuperscript{125} This in turn requires a finding that, without the avoidance action, the debtor would be able to meet the payments scheduled under the plan. If a plan is feasible in this sense, then the avoidance action looks like a pure windfall to the old shareholders.\textsuperscript{126}

In addition, a plan cannot be modified after it is confirmed and substantially consummated.\textsuperscript{127} If the debtor in possession’s adversary proceeding is not acknowledged in the plan, then a secured party would have valid grounds to complain if its confirmed security interest were later taken away in derogation of the plan.\textsuperscript{128} But if the plan itself reserves the right to challenge the validity of an unperfected security interest, then a postconfirmation action is not objectionable—at least on this ground.

\begin{footnotesize}

Satisfaction of the feasibility test imposed by § 1129(a)(11) requires the plan proponent to offer relevant evidence showing that the proposed plan is workable and that its economic requirements are reasonable under the particular facts of the case. That evidence should compare funds needed for the short-term requirements of the plan with funds on hand. Economic projections to enable the proponent to meet later funding requirements of the plan must be based upon reasonable forecasts that include sufficient resources to meet plan payments, normal capital requirements of the business and some reserve for unanticipated emergencies. The means contemplated to meet the economic projections must be discussed.


\textsuperscript{126} Judge Derby also speculated that the avoidance action, which was filed before confirmation, might have influenced the general creditors’ decision to consent to the plan:

Further, the possibility of recovery in this proceeding was a factor available to creditors in negotiating or eliciting more favorable plan terms than Debtor might otherwise have proposed. There was an active committee of creditors, and Debtor’s complaint was filed before the confirmation hearing. The postpetition timing of the hearing and decision in this case should not affect the merits of Debtor’s avoidance claim.

\textit{Greenbelt,} 124 B.R. at 473.

For a case in which a postconfirmation voidable preference action was allowed without any discussion of whether the action would enrich the old shareholders, see Fonda Group, Inc. v. Contemporary Packaging Corp. (\textit{In re Fonda Group, Inc.},) 108 B.R. 962 (Bankr. D.N.J. 1989) (Moore, J.).


Judge Derby’s opinion in \textit{Greenbelt} did not indicate whether the plan itself preserved the debtor in possession’s right to pursue its strong arm power after confirmation, but the failure to mention such a clause certainly implies that it did not exist.

\end{footnotesize}
Sometimes a confirmed Chapter 11 plan turns the general creditors themselves into equity shareholders. When they are preferred shareholders, it is possible that postconfirmation avoidance does not benefit the old equity owners who retain common shares—though this depends on the precise valuation of the firm.

Preferred shareholders appear in *Funding Systems Asset Management Corp. v. Chemical Business Credit Corp. (In re Funding Systems Asset Management Corp.)*, a case in which the secured party filed its security interest in the office of the recorder of deeds of Allegheny County, rather than with the prothonotary. For this error the secured party became a general creditor in the bankruptcy.

The avoidance action, however, was conducted after the Chapter 11 plan had been confirmed. Under the plan the general creditors (including the secured party) received forty-five cents on the dollar, plus preferred stock. The plan was adequately funded, so that the avoidance action would not increase the cash payout to the general creditors. The secured party therefore argued that the strong arm power should be suspended because avoidance would simply increase the value of the equity shares.

Judge Bernard Markovitz rejected this argument. It was true that the avoidance of the security interest would serve only to increase the value of equity shares in the reorganized debtor, but the preferred shares were all held by general creditors—including the secured party. Hence, so long as the extra value adhered only to the preferred shares, the avoidance action would enrich only general creditors.

V. THE FEATURES OF THE TRUSTEE’S HYPOTHETICAL JUDICIAL LIEN

A. Credit Advanced and Lien Obtained the Same Day

Anyone reading of the hypothetical judicial lien for the first time will be struck by some oddities. First, we are supposed to imagine "a creditor that extends credit to the debtor at the time of the commencement of the case." Second, we are supposed to imagine that this

130. Id. at 509-10.
131. Id. at 523.
132. 11 U.S.C. § 544(a)(1) (1988). Section 544(a)(1) overrules *In re Federal's, Inc., 553 F.2d 509 (6th Cir. 1977)* (Engel, J.), in which the court ruled that under the Bankruptcy Act the trustee may not hypothesize that credit was extended on the same day as the bankruptcy petition. Id. at 513-14.

In *Federal's* a seller of goods on credit tried to reclaim goods from the bankruptcy trustee under UCC § 2-702. U.C.C. § 2-702 (1972). But Michigan's version of § 2-702(3) stated that the seller's rights are "subject to the rights of a buyer in ordinary course or
creditor "obtains, at such time and with respect to such credit, a judicial lien on all property on which a creditor on a simple contract could have obtained such a judicial lien." Finally, we are supposed to imagine the trustee to be this remarkably efficient judicial lien creditor "whether or not such a creditor exists." Nonexistence is, as always, a powerful lubricant in the mechanics of civil procedure.

Is it possible to extend credit, obtain a judgment, and procure a judicial lien all on the same day? Given the crowded nature of modern judicial dockets, the assumption demanded is heroic. Some states allow consent judgments. Under this procedure the creditor may submit a defaulted debtor's signed confession of judgment to the court and obtain a judgment against the debtor without any judicial proceedings. Perhaps this odd form of cognovit note is what Congress had in mind.

Pressed too far, however, the simultaneous exchange of credit for judicial lien makes the trustee sound like a bona fide purchaser for value, a status that would affect claimants to personal property possessed by the bankrupt estate. No bankruptcy court, however, has

other good faith purchaser or lien creditor under this article.' " Federal's, 553 F.2d at 511 n.4 (quoting Michigan version of § 2-702(3)). The court found that under Michigan law a judicial lien creditor is superior to a credit seller's rights only if the lien creditor extended credit "after the delivery of the goods." Id. at 512. Judge Ralph Freeman of the district court had ruled that the trustee could hypothesize the extension of credit some time after the seller delivered possession of the goods. In re Federal's, Inc., 402 F. Supp. 1357, 1362-63 (E.D. Mich. 1975), rev'd, 553 F.2d 509 (6th Cir. 1977). Judge Engel reversed, holding that the trustee could not imagine that credit was extended at any determinate time. Federal's, 553 F.2d at 514.

Under the Bankruptcy Code credit is deemed extended on bankruptcy day. 11 U.S.C. § 544(a)(1) (1988). But § 546(c) now subordinates the strong arm power to the state-law rights of sellers to reclaim their goods. Id. § 546(c). Hence, there is no longer any need to analyze reclamation rights under the strong arm power.

134. Id.
135. Upon the demise of Constance v. Harvey, 215 F.2d 571 (2d Cir. 1954) (per curiam), cert. denied, 348 U.S. 913 (1955), in Lewis v. Manufacturers National Bank, 364 U.S. 603 (1961), Professor Frank Kennedy wrote, "It is perhaps arguable that the trustee can now assume that he extended creditor [sic] hypothetically at the same instant he obtained a lien, which is the moment the petition in bankruptcy was filed. This gets one into absurdities . . . ." Kennedy, supra note 46, at 115-16.
136. Professor Kennedy feared this possibility. Id. at 116 n.31; Kennedy, supra note 41, at 527 n.41.
137. For example, constructive trusts would be affected because bona fide purchasers take free of them. Security interests would be largely unaffected, even though buyers occasionally take free of some perfected security interests. For example, automatically perfected purchase money security interests are susceptible to subsequent consumer buyers, see U.C.C. § 9-307(2) (1972), but a bankruptcy trustee claiming a judgment in exchange for contemporaneous credit would not be considered such a buyer. Security interests in chattel paper, if perfected by filing, are subject to subsequent buyers "in the ordinary course" who take possession of the chattel paper. Id. § 9-308. It is unlikely,
chosen to exploit this tantalizing invitation to make judicial lien creditors into purchasers.\textsuperscript{138}

Obviously, by requiring us to imagine that credit was extended and a judicial lien obtained \textit{on the same day}, Congress was striving to prevent a revival of \textit{Constance v. Harvey},\textsuperscript{139} which authorized the trustee to imagine that "gap credit" had been extended before bankruptcy day.\textsuperscript{140} Although gap credit can no longer sink an Article 9 security interest in personal property,\textsuperscript{141} it might bring down real estate conveyances in many states. Recording acts in this country are extremely diverse. Many protect only purchasers, not judicial lien creditors. Some protect only judicial lien creditors, as does Article 9.\textsuperscript{142} Some protect only good faith creditors without knowledge, while others protect

\begin{footnotes}
\item[138] One point of vulnerability would be the security interest in fixtures in which perfection is achieved through a nonfixture filing. An ordinary UCC-1 is good enough to protect against ordinary judicial liens. \textit{Id.} § 9-313(4)(d). But if the trustee as a judicial lien creditor is also an "encumbrancer," i.e., one who exchanges a loan for a lien on the same day, the secured party would need a fixture filing to prevail over the trustee. \textit{Id.} § 9-313(4)(b). Of course, the secured party can argue that the trustee is a bona fide purchaser of real estate "other than fixtures," 11 U.S.C. § 544(a)(3) (1988), and hence, with regard to fixtures, the trustee is \textit{not} a purchaser, but is only a judicial lien creditor. This view counteracts the implication that a judicial lien creditor is a purchaser by virtue of obtaining a judicial lien on the same day that it extends the loan.


\item[140] In his attack on \textit{Constance v. Harvey}, Harold Marsh called for such an assumption to defeat this hated case:

\begin{quote}
It is suggested that the trustee under Section 70c should be considered a creditor without notice who levied legal or equitable process at the time of bankruptcy and who also extended credit \textit{at the time of bankruptcy}. If it be thought anomalous to consider the trustee as a creditor who levied execution or other process simultaneously with his extending credit, with no time intervening for the debt to become due and judgment to be recovered, it should be remembered . . . that the measurement of the rights of the trustee under the strong-arm clause is a purely hypothetical process. Any interpretation can be adopted, however anomalous, which seems best to effectuate the intent of Congress.
\end{quote}

\item[141] \textit{See supra} notes 45-50 and accompanying text.

\item[142] \textit{See U.C.C.} § 9-301(1)(b), (3) (1972).
\end{footnotes}
“creditors” with no limitations at all. Under some of these statutes, an imaginative trustee might try to revive Constance v. Harvey by imagining a lien on bankruptcy day for credit extended during an unperfected gap. Hence, by limiting the trustee’s strong arm power to a hypothetical extension of credit on the same day as the bankruptcy petition, Congress has saved real estate transactions in which the recording followed the closing by some small amount of time.

B. Imaginary Procedures

The judicial lien, as always, is supposed to arise on the day that the bankruptcy petition was filed. But judicial liens come in a wide variety of sizes and shapes. In New Jersey a judicial lien arises when a creditor delivers a writ of execution to the sheriff. But this lien is no good against bona fide purchasers of personal property who give value before the sheriff levies specific personal property. In Michigan there is no judicial lien at all until the sheriff levies the property. In Georgia mere entry of the judgment creates a lien on all property located in the state, though bona fide purchasers for value are protected until the creditor docket the judgment in the county where the property is located. Which of these many features can the trustee imagine?

The answer is, all of them. Whatever must be done the trustee can imagine that, on bankruptcy day, it has been done. As a result, insofar as an Article 9 security interest is concerned, it is hardly worth the trouble of learning the intricacies of state debtor-creditor law because whatever kind of lien is provided for, the trustee has it on bankruptcy day. Under UCC section 9-301(1)(b) it only matters that the trustee has become a lien creditor. And under section 9-301(3) the trustee is deemed a lien creditor.

Outside of Article 9 jurisprudence, the scope of a bankruptcy trustee’s imagination still remains important. One case that has restricted what the trustee may imagine is Balaber-Strauss v. Marine Midland
Bank, N.A. (In re Marceca). In this case a creditor had served a writ of execution on the sheriff. Under New York law this creates a judicial lien on all personal property of the debtor. This lien is quite weak, however. Subsequent judicial lien creditors might take a higher priority. If a judgment creditor obtains a receiver before the sheriff levies property pursuant to the writ of execution, the receiver's lien takes priority. Or, if the creditor serves a subsequent execution on a judicial officer who levies before the original officer, the subsequent creditor will take priority over the earlier judgment creditor. Hence, if the trustee can hypothesize a receiver's lien or an execution lien on which some other judicial officer was the first to levy, then the trustee takes priority over the actual creditor who served the execution on a real sheriff.

In Marceca a creditor had delivered an execution to the sheriff, but the sheriff had not levied by the time of the bankruptcy. Judge Howard Schwartzberg refused to allow the trustee to imagine that he was an execution creditor whose judicial officer had levied first. Hence, the execution creditor had a valid lien that survived the strong arm power and, because the lien was more than ninety days old by bankruptcy day, the voidable preference power as well.

This restriction on what the trustee can imagine is not without implications for Article 9 security interests. Two authors have wisely suggested that, in New York and other states that create a weak execution lien, a person should not be deemed a judicial lien creditor, for the purposes of UCC section 9-301(1)(b), until no subsequent bona fide purchaser could take free and clear of the execution lien. The reason for the suggestion is that the UCC definition of "lien creditor" is quite indeterminate and does not mention executions. Meanwhile, section

153. Id. § 5234(c).
154. Id. § 5234(b).
155. Marceca, 129 B.R. at 370; accord Barr v. National Aircraft Servs., Inc., (In re Cosmopolitan Aviation Corp.), 34 B.R. 592 (Bankr. E.D.N.Y. 1983) (Parente, J.) (holding that for voidable preference purposes a judicial lien is deemed to be a transfer when execution is delivered to the sheriff, even if levy is beyond the grace period provided in § 547(e)(2)(A)).

In contrast, Judge Luongo, in London Grove Contractors, Inc. v. J. Robert Pierson, Inc. (In re J. Robert Pierson, Inc.), 44 B.R. 556 (E.D. Pa. 1984), seemed to show a great deal of skepticism about this idea. Though the exact holding of the case is that unliquidated debts cannot be garnished in Pennsylvania, Judge Luongo thought to rule otherwise "would place extraordinary powers in the hands of creditors armed with a writ of garnishment." Id. at 561.

156. Carlson & Shupack, supra note 4, at 299-317.
157. U.C.C. § 9-301(3) (1972) (stating that a person becomes a lien creditor by "at-
9-301(1)(b) directly contradicts New York judicial lien law when an unperfected security interest is created after an execution is served. For example, suppose that on Monday A serves an execution on a sheriff. On Tuesday B obtains an unperfected security interest. On Wednesday B files a financing statement in the appropriate UCC office. According to UCC section 9-301(1)(b), A has priority if A "became a lien creditor" when A served an execution on the sheriff. But according to New York's Civil Practice Act, B has priority because B is a subsequent transferee for value. To resolve this conflict, it was suggested that, for UCC purposes, A does not become a lien creditor until A's sheriff levies.

If Judge Schwartzberg's holding that the trustee cannot imagine a levy is correct—and if a person can become a lien creditor only by levying—then unperfected security interests created in New York always survive the trustee's strong arm power.

To the opposite effect—or at least so it seems upon first impression—is Kellman v. Palese (In re Italiano), in which Judge Rosemary Gambardella ruled that "the trustee holds the status under § 544 of a hypothetical judicial lien creditor who has levied upon the debtor's property." As such, the trustee defeated an earlier creditor who had a judicial lien on real estate but who had not effectively levied.

Although the trustee was allowed to imagine a levy, this should not have made one whit of difference in New Jersey, where the first creditor to serve an execution on the sheriff establishes priority. Levying is irrelevant in the Garden State. Hence, the maximum

159. Carlson & Shupack, supra note 4, at 306-10.
160. Unperfected security interests would survive the similar voidable preference test as well, which also tests perfection by the time the security interest is sufficient to beat a subsequent judicial lien. If the trustee cannot levy, and if that is what it takes to become a lien creditor, then security interests are always deemed transferred when they are created. 11 U.S.C. § 547(e)(2)(A) (1988). As such, many will not be voidable preferences.
162. Id. at 478.
163. The sheriff tried to levy, but because the creditor failed to search in good faith for personal property before resorting to real property, as required by New Jersey law, the court found that the levy was not proper. Id. at 479.
165. Id. Judge Gambardella woefully misread In re Blease, 605 F.2d 97 (3d Cir. 1979) (per curiam). In that case the state of New Jersey had filed tax liens, which have the status of judgment liens, against the debtor. The court wrote:

The state does not claim a status higher than that of an ordinary judgment creditor. Thus if the dispute were between the state and a subsequent judgment creditor who had actually levied, the state concedes that its lien
imaginary benefit a trustee can have in New Jersey is to dream that a writ of execution has been delivered to the sheriff. This is what Judge Schwartzburg ruled in Marcera, though, in New York, his ruling was incorrect.

Another case insists that the trustee cannot fantasize an execution sale. In Arkison v. Gitts (In re Gitts) the debtors had not filed the required homestead notice in the real estate records. Under Washington law a debtor can file a homestead notice anytime before the execution sale. Because the trustee could not imagine that the execution sale took place on bankruptcy day, the debtors’ homestead was preserved against the trustee’s status as a hypothetical judicial lien creditor. Of course, the trustee is also a bona fide purchaser of real estate, and this status would have been fatal to the unfiled homestead rights, but apparently the trustee forgot to argue the case from the perspective of a bona fide purchaser.

If the trustee could hypothesize an execution sale, then, upon first impression, it might seem that certain Article 9 security interests would not take priority. The state contends, however, that the trustee’s [strong arm power] does not give him the status of a judgment creditor with a levy.

Id. at 98. The court disagreed and allowed the trustee to imagine a levy. But this case is not good authority for Italiano because the Blease court also wrote: “A levy relates back to the date the writ of execution is delivered to the sheriff. This rule is based upon a construction of statutes requiring the sheriff to endorse on the writ of execution the date and time of receipt and to execute first the writ first delivered.” Id. (citations omitted). Because the creditor in Italiano had delivered its execution first, the trustee, as a hypothetical judicial lien creditor who levied first, still should have been subject to the creditor’s senior execution lien.


Oddy, New Jersey is one of the states where the trustee does better as a hypothetical judicial lien creditor of real estate than as a bona fide purchaser. In New Jersey the first creditor to deliver an execution has priority to real estate. N.J. STAT. ANN. § 2A:17-13 (West 1987). Yet no bona fide purchaser for value can take free of the judicial lien after the judgment is docketed because, at an execution sale, the sheriff can offer the buyer “as good and perfect an estate . . . as the execution debtor was seized of . . . before the judgment for the enforcement of which the execution issued.” Id. § 2A:17-41. If the sheriff issues a deed for such title, the claim of any bona fide purchaser that arose between the time of docketing and the time of the deed would necessarily disappear.


167. 116 B.R. 174 (Bankr. 9th Cir. 1990) (Perris, J.), aff’d, 927 F.2d 1109 (9th Cir. 1991).

168. Id. at 178.

169. Id. at 179-80.

170. Id. at 179 n.9. The bona fide purchaser argument is so clearly a winner that it is fair to list Gitts as among those cases in which courts simply have refused to enforce the strong arm power because to do so would be unjust. See infra text accompanying notes 312-480. In Gitts the debtors would have filed a timely homestead declaration but for an error by a messenger service. 116 B.R. at 180.
would be threatened in bankruptcy, most notably the automatically perfected purchase money security interest in consumer goods. According to section 9-302(1)(d), creditors need not file a financing statement with regard to such security interests; they automatically take priority over judicial lien creditors. Yet, section 9-307(2) provides:

In the case of consumer goods, a buyer takes free of a security interest even though perfected if he buys without knowledge of the security interest, for value and for his own personal, family or household purposes unless prior to the purchase the secured party has filed a financing statement covering such goods.

If the trustee could hypothesize an execution sale in which the buyer was another consumer, would the strong arm power outrank an automatically perfected purchase money security interest? The answer is, probably not. The Supreme Judicial Court of Massachusetts has decided that a buyer at an execution sale is never a “buyer” for the purpose of Article 9. The New Hampshire Supreme Court has ruled that section 9-307(2) never applies unless a consumer seller sells to a consumer buyer. Given these two rationales, it ought to be clear that a hypothesized execution sale will not threaten unperfected purchase money security interests.

Hypothesized execution would threaten security interests in fixtures, however, if the secured party has not made a fixture filing. This would thwart a major goal of the 1972 amendments to the UCC, which aimed to preserve security interests in fixtures if the secured party files only an ordinary UCC-1 with regard to the collateral.

172. See Ledford v. Easy Living Furniture (In re Jackson), 52 B.R. 706 (Bankr. S.D. Ohio 1985) (Clark, J.) (holding that the trustee could not pretend to be a purchaser with regard to such security interests). The trustee in Jackson also argued that § 9-301(2), which appears to require that purchase money security interests be filed, overrides the automatic perfection rule. Obviously, § 9-302(1)(d) would be read out of the UCC if this were right, and the claim was properly rejected. Id. at 710.
176. See U.C.C. § 9-313(4)(b) (1972). Fixture filings are described in § 9-402(5): a fixture filing “must show that it covers this type of collateral, must recite that it is to be filed [for record] in the real estate records, and the financing statement must contain a description of the real estate.” Id. § 9-402(5) (brackets supplied by statute).
177. See id. § 9-313(4)(d) (stating that a secured party prevails over “a lien on the real estate obtained by legal or equitable proceedings after the security interest was per-
C. The Imaginary Creditors' Bill in Equity

Not only may a trustee dream of a judicial lien on the day of bankruptcy, but she may also fancy having the rights of "a creditor that extends credit to the debtor at the time of the commencement of the case, and obtains, at such time and with respect to such credit, an execution against the debtor that is returned unsatisfied at such time, whether or not such a creditor exists." 178 Now a creditor whose execution has been returned has the right, in most states, to equitable relief because the legal remedy of execution has been exhausted. 179 This recourse to equity requires some detailed knowledge of archaic state law, which few modern lawyers have. As a result, lawyers have under-exploited this mysterious aspect of the strong arm power. Some very important uses of this equitable power have emerged, however.

1. Piercing the Corporate Veil

One important way this power can be used is to pierce the corporate veil. As a matter of equity, the corporate form will be disregarded for a number of reasons. A court of equity might, however, insist that legal remedies against the corporate debtor be exhausted before the shareholders are disturbed. 180

Not all courts agree that section 544(a)(2) constitutes a tool whereby the trustee can capture the assets of a shareholder. In Mixon v. Anderson (In re Ozark Restaurant Equipment Co.) 181 the bankruptcy court allowed a trustee to pierce the corporate veil and obtain assets of shareholders. This seems a good use of the strong arm power.

178. 11 U.S.C. § 544(a)(2) (1988). This clause was added to the Bankruptcy Act in 1966. See Act of July 5, 1966, Pub. L. No. 89-495, sec. 5, § 70(c), 80 Stat. 268, 269 (codified at 11 U.S.C. § 110(c) (Supp. IV 1965-68)) (repealed 1978); Countryman, supra note 57, at 651. Its history is related to the use of the strong arm power to reach fraudulent conveyances. In some states fraudulent conveyances of the debtor to a third party can be pursued only after the legal remedy of execution against the debtor has been exhausted.

179. See Harkin v. Brundage, 276 U.S. 36, 52 (1928) (Taft, C.J.) ("The true rule in equity is that under usual circumstances a creditor's bill may not be brought except by a judgment creditor after a return of 'nulla bona' on execution.").


A hypothetical judicial lien creditor with a veil piercing theory could indeed levy on the assets of a shareholder. On appeal, however, Judge Frank Magill thought that he was compelled by *Caplin v. Marine Midland Grace Trust Co.* to rule otherwise.

In *Caplin* the trustee sought permission to sue, on behalf of bondholders, an indenture trustee for negligence. The Supreme Court refused to allow the trustee to be a mere class action representative. From a strong arm perspective *Caplin* is undoubtedly correct. Perhaps one can hypothesize that the trustee, as a hypothetical judicial lien creditor, is also a bondholder—though such an assumption is probably barred by *Lewis v. Manufacturers National Bank.* But a bondholder with a judgment against the debtor could not levy the property of the indenture trustee without adjudicating the trustee's personal liability. Such liability is strictly in personam and does not resemble the in rem qualities of a fraudulent conveyance right against a third party.

*Caplin,* however, does not bar the trustee of a debtor corporation from maintaining a claim against a shareholder based on piercing the corporate veil. Such a claim depends on the theory that the corporation and the shareholder are the same person—that the property of the shareholder is property of the debtor. A creditor with an execution against a corporate debtor returned nulla bona could prove that the corporate debtor and the shareholder are the same person and could therefore obtain a judicial lien against property of the shareholder without having to establish personal tort or contractual liability against a third party.

185. 364 U.S. 603 (1961) (Douglas, J.). In *Lewis* the trustee was not allowed to supplement the hypothetical judicial lien with the assumption that the lien creditor had advanced gap credit good against an unperfected security interest under pre-UCC law.

"The dividing line is whether the cause of action is one which is purely per-
Judge Magill does make the following argument from the language of section 544(a):

[W]e note that Sections 544(a) and (b) are flavored with the notion of the trustee having the power to avoid "transfers" of the debtor, as were its predecessors, sections 70c and e of the [Bankruptcy] Act. . . . Section 544 gives the trustee the power to avoid transfers of, or liens and encumbrances on, the debtor's property that he would be unable to challenge under other sections of the Code, such as 11 U.S.C. §§ 547 (preferences), 548 (fraudulent transfers or obligations), or 549 (post-petition transfers). An alter ego action, however, does not entail invalidating of a transfer of interest, but instead imputes the obligations of one party to another regardless of any "transfers." 1188

This argument confuses the familiar with the necessary. To be sure, alter ego rights do not involve a transfer from the corporate debtor to its shareholder. But avoidance of transfers is only one of the things mentioned in section 544(a). The section also says that "[t]he trustee shall have, as of the commencement of the case . . . the rights and powers of . . . a creditor that . . . obtains . . . a judicial lien on all property on which a creditor . . . could have obtained such a judicial

sonal, in which no other claimant or creditor of the corporation has an interest, or whether the cause of action is one in favor of creditors in general, which may be availed by 'any' one creditor either suing alone . . . or as a representative of all the creditors. In the one case the only liability is to the particular person injured . . . while in the other case the liability is to all creditors of the corporation without regard as to any personal dealings . . . ."


For the record Judge Jones's distinction between claims that all creditors have and those that only some creditors have is not successful. Under Moore v. Bay the trustee may subrogate itself to a claim that only one creditor could make and could use this claim to benefit all creditors. Hence, the particular-general distinction cannot distinguish Caplin from Koch Refining v. Farmers Union Central Exchange, Inc., 831 F.2d 1339 (7th Cir. 1987) (Grant, J.) (discussed infra at text accompanying notes 193-195). A better distinction is the purely in personam nature of the creditors' lawsuit in Caplin and the in rem right of a creditor to place a lien on property of a shareholder.


liens.'" Surely such a creditor could have obtained a lien on the property of the shareholder, if a court of equity decided that the shareholder and the corporation were the same person. Judge Maigill, however, ruled that section 544(a)(2) is meaningless.

Section 544(a)(2) was derived from section 70c of the Bankruptcy Act, and like section 70c, was intended to merely protect the trustee against "quirks of local procedural law," where certain remedial rights flowed to a creditor who had an execution returned unsatisfied. . . . As further noted by Collier, however, this section "lacks real importance because of the general abolition of the distinctions between law and equity." Yet piercing the corporate veil is exactly the kind of remedy that equity provided a creditor who could not recover from the corporate debtor.

In contrast, Judge Robert Grant, in *Koch Refining v. Farmers Union Central Exchange, Inc.*, thought that section 544(a) did support a theory whereby the trustee could pursue assets of the shareholders. Judge Grant cited section 544(a)(1), but perhaps he should have

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190. "Therefore, the trustee does not bring this as a cause in action on which the debtor-corporation could have sued outside of bankruptcy; he brings it simply to establish the identity of the alter egos with the corporations in order to determine what are the assets of the estate." *Western World Funding*, 52 B.R. at 784.

191. *Ozark*, 816 F.2d at 1229-30 n.12 (citation omitted) (quoting 4B COLLIER ON BANKRUPTCY ¶ 70.64, at 730-33 (Lawrence P. King et al. eds., 14th ed. 1978)).

192. A better rejection of § 544(a)(2) appears in *Still v. Congress Financial Corp. (In re Southwest Equipment Rental, Inc.)*, 102 B.R. 132 (S.D. Tenn. 1989) (Edgar, J.). This opinion squelched the exciting promise of Citicorp Industrial Credit, Inc. v. Brock, 483 U.S. 27 (1987) (Marshall, J.), to shift the burden of all wage claims to the secured creditor. In *Broch* Justice Marshall found that the foreclosure sale on inventory when laborers had not been paid was the sale of "hot goods" in violation of federal labor law. *Id.* at 33. In *Still* Judge R. Allan Edgar found that only the secretary of labor had standing to prevent such sales. Neither wage creditors nor the trustee had any such right. *Still*, 102 B.R. at 136.

The trustee in *Still* also argued that through § 544(a)(2) the trustee could obtain an injunction against the sale of inventory until the wage earners were paid. But Edgar cited *Caplin* as authority for the proposition that the trustee was not subrogated to the rights of individual creditors to sue third parties. *Id.* at 137-38. He might have added, however, that just because the trustee is deemed a hypothetical lien creditor on the day of bankruptcy, this does not make up for a general lack of standing that apparently exists for any wage creditor, other than the secretary of labor.

193. 831 F.2d 1339 (7th Cir. 1987).

194. *Id.* at 1342-43. An entirely separate notion is that property of the shareholders is property of the estate under § 541(a). This separate theory also has been followed, from time to time, but it usually is thought to require sympathetic state law on the question. See generally Halverson v. Schuster (*In re Schuster*), 132 B.R. 604, 608-12 (Bankr. D. Minn. 1991) (Krishel, J.) (holding that avoidance of transfer of shares
cited section 544(a)(2) instead.\(^{195}\)

2. Marshaling Assets

A second way that section 544(a)(2) might be used is to authorize the trustee, as a hypothetical judicial lien creditor, to invoke the equitable doctrine of marshaling assets.\(^{196}\) This powerful and revolutionary idea, if creatively abused by a bankruptcy trustee, could severely harm the status of junior secured parties in bankruptcy.

Marshaling\(^{197}\) assets is an equitable doctrine\(^{189}\) that a junior secured party can invoke against a senior secured party.\(^{199}\) The requirements for marshaling are as follows: (1) There must be two pools of collateral,\(^{200}\) (2) one creditor must be senior with respect to both pools,

\(^{195}\) Koch, 831 F.2d at 1343-46; see Stephen E. Boyce, Koch Refining and In re Ozark: The Chapter 7 Trustee’s Standing to Assert an Alter Ego Cause of Action, 64 AM. BANKR. L.J. 315, 322-23 (1990).


\(^{197}\) Judge Francis G. Conrad cautions us to spell “marshaling” with a single \(l\). Vermont Toy Works, 82 B.R. at 205 n.2.

\(^{198}\) According to Justice Tom Clark:

[I]t is well to remember that marshaling is not bottomed on the law of contracts or liens. It is founded instead in equity, being designed to promote fair dealing and justice. Its purpose is to prevent the arbitrary action of a senior lienor from destroying the rights of a junior lienor or a creditor having less security. It deals with the rights of all who have an interest in the property involved and is applied only when it can be equitably fashioned as to all of the parties.


\(^{199}\) See Vermont Toy Works, 135 B.R. at 766-67 (“[M]arshaling is ... an equitable principle designed to benefit junior secured creditors.”).

\(^{200}\) See Warren v. Warren, 30 Vt. 530 (1858) (Poland, J.).

When one man holds security on two funds, with perfect liberty to resort to either for his pay, and another party has security upon only one of the same funds, equity will compel the first to exhaust the fund upon which he alone has the security, before taking any part of the other, and thereby depriving the
and another creditor must be junior as to only one pool, (3) a court must have jurisdiction over both pools of collateral,201 (4) no inconvenience of any sort can be caused to the senior secured party, and (5) no third secured party can be harmed by marshaling.202 If all these elements are present, a court of equity will insist that the senior secured party pursue the once-encumbered collateral, thereby freeing up the twice-encumbered collateral to satisfy the claim of the junior secured party.

Bankruptcy is the ideal forum for marshaling of assets. Indeed, marshaling elsewhere is likely to be a rare event. Hence, if it were eliminated from bankruptcy courts, the doctrine would lose almost all of its utility.

Now the bankruptcy trustee is a secured creditor by virtue of section 544’s hypothetical judicial lien. Hence, some courts have held, on the strength of section 544(a)(2), that a bankruptcy trustee can insist that other perfected secured parties marshal their assets for the benefit of the trustee as a junior judicial lien creditor.

This has occurred most dramatically where the secured party also holds the guaranty of an insider of the debtor. Courts have been willing to insist that the secured party go after the assets of the insider before seeking to collect from the assets in the bankrupt estate.203 This violates one of the rules of marshaling—that the senior secured party be put to no inconvenience. Leaving the bankruptcy forum and proceeding against a third party in another forum would certainly appear to be inconvenient.204 Yet courts have required secured parties to do so

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other party of his security.

Id. at 535.

201. Judge Conrad thought that if a corporate debtor is merely the alter ego of the shareholder, there is no problem in marshaling the assets of debtor and shareholder, presumably because the same bankruptcy court has jurisdiction over both estates. Vermont Toy Works, 82 B.R. at 291-92, 321. But see Vermont Toy Works, 135 B.R. at 770-73 (reversing because the facts did not warrant piercing the corporate veil). This, of course, depends on an aggressive position on the question of whether a bankruptcy trustee may pierce the corporate veil, a subject on which courts disagree. See supra text accompanying notes 180-95. In any case, as Judge George Brody has pointed out, there is no sense in marshaling with regard to a shareholder guarantor’s assets if the trustee can pierce the corporate veil and bring those same assets into the estate. Marshaling adds nothing to a theory of piercing the corporate veil. In re Dealer Support Servs. Int’l, Inc., 73 Bankr. 763, 765 n.3 (Bankr. E.D. Mich. 1987).


203. E.g., Berman v. Green (In re Jack Green’s Fashions for Men—Big & Tall, Inc.), 597 F.2d 130 (8th Cir. 1979) (Henley, J.).

204. See Vermont Toy Works, 135 B.R. at 773 (denying the trustee the right to marshal assets because the senior secured party was inconvenienced by having to give up liquid collateral and pursue the guarantor in a separate action).
anyway. A guarantor, however, is subrogated to the rights of the benefitted creditor. Thus, the bankruptcy trustee ordinarily gains nothing by ousting the secured party from the bankruptcy and forcing it to pursue its guarantor. To avoid the neutralizing effect of subrogation, marshaling must be coupled with a theory that equitably subordinates the guarantor's subrogation claim in the bankruptcy. Equitable subordination implies that the ousted secured party would be replaced by a subrogee who is junior to the general creditors. As subordination to the bankruptcy trustee is exactly what the strong arm power does to unperfected security interests, marshaling-plus-subordination is pretty much the same as avoiding the security interest altogether, so far as the guarantor and the creditors of the bankrupt debtor are concerned.

Another aggressive way a trustee can use marshaling is to prevent any other two secured parties from marshaling. Suppose A is a senior secured party with regard to two pools of collateral. B has a junior security interest in the second pool only. Their common debtor is bankrupt. This is the classic circumstance for marshaling of assets. If A can be compelled to leave the second pool of collateral alone until the first is exhausted, B will recover more from the second pool than B's Article 9 priority would otherwise allow.

\[
\begin{array}{cc}
\text{First Pool of Collateral} & \text{Second Pool of Collateral} \\
\uparrow & \uparrow \\
A & B
\end{array}
\]

B has no right to insist upon marshaling of assets, however, if a third party would be harmed. For example, if C is a junior secured party with regard to the first pool of collateral, but not the second, B cannot insist on marshaling because it would harm C's right to collect.

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205. Lachman, supra note 202, at 684-86.
207. See supra text accompanying notes 65-88.
Indeed, in these circumstances C has as valid a claim to marshaling assets as B does. The two equally valid marshaling claims cancel each other out.

The trustee in bankruptcy has occasionally claimed to be C in the above example, by virtue of holding a hypothetical judicial lien. If B is allowed to marshal, the trustee's hypothetical judicial lien is compromised. Because the trustee is the third party who must not be harmed by B's marshaling demand, the strong arm power implies that B is not entitled to marshaling.

The Ninth Circuit took this position in Owens-Corning Fiberglas Corp. v. Center Wholesale, Inc. (In re Center Wholesale, Inc.) (Center Wholesale I). The court found that California judicial lien creditors generally have the right to insist on marshaling assets. Accordingly, the trustee was able to block B's request for marshaling by assuming C's position in the above diagram.

There are two problems with this theory. First, the trustee is always a third lien creditor. Center Wholesale I therefore eliminates the possibility of marshaling assets between two secured parties in all bankruptcies. Yet bankruptcy court is overwhelmingly the most im-

208. 759 F.2d 1440 (9th Cir. 1985) (Pregerson, J.).
209. Id. at 1447 (citing Shedoudy v. Beverly Surgical Supply Co., 100 Cal. App. 3d 730 (1980) (Wiener, J.)). In Miller v. Steward (In re Forester), 529 F.2d 310 (9th Cir. 1976) (Trask, J.), the Ninth Circuit had held that the trustee could not block a junior secured party’s request for marshaling. The Shedoudy opinion allowed, however, Judge Harry Pregerson to overrule the earlier Ninth Circuit precedent and allow the trustee to block a junior secured creditor’s marshaling request. Center Wholesale I, 759 F.2d at 1447; see also Duck v. Wells Fargo Bank (In re Spectra Prism Indus., Inc.), 28 B.R. 397, 399 (Bankr. 9th Cir. 1983) (Katz, J.) (also holding that Shedoudy required the rejection of Forester).
210. Center Wholesale I, 759 F.2d at 1447; see also Fundex Capital Corp. v. Balaber-Strauss (In re Tampa Chain Co.), 53 B.R. 772, 777 (Bankr. S.D.N.Y. 1985) (Buschman, J.) (“Neither the language of the statute nor its legislative history gives the slightest indication that Congress contemplated that such 'strong arm' rights and powers are not to apply in a marshaling context.”).
211. As one commentator put it:
portant forum for marshaling claims to be adjudicated because it is one of the few occasions when one court has jurisdiction over two pools of collateral. Center Wholesale I therefore threatened to reduce marshaling to a second-rate probate doctrine.\(^{212}\)

Second, because Center Wholesale I prevents B from marshaling, it implicitly allows the bankruptcy trustee to marshal the estate’s assets to B’s disadvantage. That is, the trustee can insist on marshaling and B cannot. Yet by marshaling, the trustee violates the very same rule that she just asserted to prevent B from marshaling.

Having lost the first appeal, the junior secured party in Center Wholesale I valiantly appealed again, and in Owens-Corning Fiberglas Corp. v. Center Wholesale, Inc. (In re Center Wholesale, Inc.) (Center Wholesale II)\(^{213}\) a different panel of the Ninth Circuit reversed field and ruled that the trustee could not “require a senior lienor to satisfy its claim out of a junior lienor’s collateral.”\(^{214}\) Hence, the trustee could not purport to be the third lien creditor harmed by B’s marshaling claim. Center Wholesale I, of course, could not be disavowed entirely. In order to reconcile the two opinions, Judge Robert Beezer ruled that the senior secured party was free to raid the double-encumbered fund\(^{215}\) because the junior secured party was not entitled to a marshaling order. But just as the junior secured party was not free to insist on marshaling, neither was the bankruptcy trustee, as a judicial lien

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As a result of Center Wholesale, junior security interests become impossible unless the security agreement completely parallels the scope of the senior security interest. That is, the junior secured parties, like the one in Center Wholesale, must now take a security interest in both of the inventory pools since the senior secured party is free to choose the double-encumbered fund to the prejudice of the junior secured party.

Lachman, supra note 202, at 688.


To allow the Trustee to invoke the marshaling doctrine, by virtue of his status as a hypothetical lien creditor, would be a use of the strong-arm clause not contemplated by Congress. In this Court’s opinion, the Trustee’s construction would frustrate the Code’s policy by enriching unsecured creditors over secured creditors.

Id. at 70-71. For other cases contrary to Center Wholesale I, see Caplinger v. Patty, 398 F.2d 471, 475 (8th Cir. 1968) (Van Oosterhout, J.); Canal Nat'l Bank v. Larry's Equip. Serv., Inc. (In re Larry's Equip. Serv., Inc.), 23 B.R. 132 (Bankr. D. Me. 1982) (Goodman, J.).

213. 788 F.2d 541 (9th Cir. 1986) (Beezer, J.).

214. Id. at 544.

215. Id. at 543 ("[W]e spoke in the prospective, suggesting that [the senior secured party] might or might not choose to satisfy its $990,000 claim out of [the junior secured party's] inventory.").
Hence, Center Wholesale II seems to stand for the proposition that the senior secured party has the absolute right to take whatever assets she wants; she cannot be compelled to choose one encumbered fund over the other. In Center Wholesale II the senior secured party had been paid already, but it was not clear from which pool of funds the payment came. Judge Beezer therefore remanded the case with orders to find out where the money actually came from. Wherever the payment could be traced, whether it be from the junior secured party’s collateral or from the other pool of collateral, tracing would determine whether the junior secured party or the bankruptcy trustee would take the loss. Furthermore, the debtor in possession had the burden of proof to show that the payment actually came from the junior secured party’s collateral.

Center Wholesale II, then, continues to admit that the trustee is a hypothetical judicial lien creditor for the purpose of marshaling assets, but—vis-a-vis other junior secured parties—neither the trustee nor the junior secured party is entitled to demand how the senior secured party is paid. As a result, a secured party is immune from predations

216. Id. at 544.

217. In Western Farm Credit Bank v. Teresi (In re Teresi), 134 B.R. 392 (Bankr. E.D. Cal. 1991), Judge Joseph Hedrick read Center Wholesale II in this fashion. In Teresi a secured creditor moved to lift the automatic stay because the debtor had no equity in the collateral. See 11 U.S.C. § 362(d)(2)(A) (1988). If marshaling were applied, the debtor would have had equity. Teresi, 134 B.R. at 394-95. Judge Hendrick held, however, that Center Wholesale II prevented the compulsion of any marshaling on the secured party. Because the secured party’s motion to lift the stay implied an opposition to marshaling, id. at 394, Judge Hedrick ruled that no equity existed after all. Hence, the stay was lifted. Id. at 398-99. But see Murdock v. Security State Bank (In re Murdock), 134 B.R. 417 (Bankr. D. Mont. 1991) (Peterson, J.) (asserting that Center Wholesale II is consistent with forcing the secured party to marshal in favor of a junior secured party and against the bankruptcy trustee).

218. Center Wholesale II, 788 P.2d at 544.

219. Competing marshaling claims occasionally arise under state law. One solution, adopted in Connecticut, is to prorate A’s claim from each of the two pools so that the two junior secured parties share the loss of marshaling against each other. Grant S. Nelson & Dale A. Whitman, Real Estate Finance Law 722-45 (2d ed. 1985).

In Cullen v. Revere Copper & Brass, Inc. (In re John I. Paulding, Inc.), 76 B.R. 7 (Bankr. D. Mass. 1987) (Lavien, J.), the trustee occupied C’s position and was able to marshal at the expense of B. In this case, however, the trustee claimed to be a lien creditor by virtue of having avoided security interests as voidable preferences, not by virtue of the strong arm power. Judge Harold Lavien reserved judgment on the wisdom of Center Wholesale II, but he thought that a voidable preference case was different from a strong arm case. He wrote:

In this case, the trustee has exercised his power and voided the preferential transfer. He now occupies their earlier position of junior lienholder on the debtor’s personal property. This would all be a futile exercise, if his posi-
by the trustee but is fully subject to the malice of a senior secured party who contumaciously opposes a junior creditor’s marshaling request.

VI. THE TRUSTEE AS A BONA FIDE PURCHASER OF REAL ESTATE

One innovation of the Bankruptcy Code is its extension of the strong arm power beyond judicial lien creditor status to the status of a bona fide purchaser of real estate.\textsuperscript{220} The reason for this extension was the drafters’ belief that some unperfected security interests in real estate might survive the debtor’s bankruptcy. The recording acts of many states protect bona fide purchasers but not creditors. Hence, an unrecorded mortgage (or any other real estate conveyance) is not affected by the attachment of a judicial lien.\textsuperscript{221}

To the drafters of the Bankruptcy Code, this must have seemed irrational. Unperfected security interests in personal property were avoided by the trustee’s status as a judicial lien creditor, but unrecorded mortgages were valid in any state that protected only bona fide purchasers. Hence, to smooth out this inconsistency, the trustee was made a bona fide purchaser of real estate.\textsuperscript{222} Since all states protect bona fide purchasers from unrecorded real estate conveyances, all unperfected mortgages are rendered void in bankruptcy. Meanwhile, the trustee continues to be a judicial lien creditor with regard to real estate.\textsuperscript{223} This helps destroy unperfected mortgages in some states where

\textsuperscript{220} 11 U.S.C. §§ 547 and 551 are to be meaningful, then he must be allowed to maintain the benefits of his position and institute the primary marshalling [sic] against [A] as against a secondary contrary claim against [B].

\textsuperscript{221} Id. at 9. This same argument also could be applied to the strong arm power. The strong arm power is meaningless unless the trustee, in C’s position, can marshal against B.

\textsuperscript{222} Professor McCoid approves of Paudding, but inexplicably thinks that Judge Lavien based his decision on state law. McCoid, supra note 93, at 1122. In fact, Lavien cited a federal policy—the avoidance powers would be useless unless the trustee were allowed to cancel out B’s marshaling claim. Cullen, 76 B.R. at 9.

\textsuperscript{223} 11 U.S.C. § 1122. After 1984, fixtures were exempted from the trustee’s bona fide purchaser status. See infra text accompanying notes 307-08.

\textsuperscript{222} Although the strong arm power was useless against a great many unrecorded real estate transactions, voidable preference law deferred the transfer until a real estate conveyance was recorded. Act of June 22, 1938, ch. 575, sec. 60(a), § 60(a), 52 Stat. 840, 869-70 (repealed 1978). Because voidable preference law and the strong arm power are largely duplicative, the extension of the strong arm power to the bona fide purchaser test makes some sense.

\textsuperscript{223} 11 U.S.C. § 544(a)(3) (1988). After 1984, fixtures were exempted from the trustee’s bona fide purchaser status. See infra text accompanying notes 307-08.


bona fide purchasers may be on inquiry notice of real estate claims—i.e., the transferee is in possession of the real estate—but where a judicial lien creditor’s knowledge is irrelevant.224 For example, in Connecticut225 and Tennessee226 lien creditors take priority regard-

224. See Jeffrey Davis, Equitable Liens and Constructive Trusts in Bankruptcy: Judicial Values and the Limits of Bankruptcy Distribution Policy, 41 FLA. L. REV. 1, 28 (1989).


226. This conclusion follows from the wording of the Tennessee recording statute, which provides that any deed not properly recorded “shall be null and void as to existing or subsequent creditors of, or bona fide purchasers from, the makers [of the deed] without notice.” TENN. CODE ANN. § 66-26-103 (1982).

Tennessee law, as interpreted by the bankruptcy courts, is currently in disarray. In Lancaster v. Key, 24 B.R. 897 (E.D. Tenn. 1982) (Taylor, J.), buyers of real estate from the debtor failed to record a deed, but did move into the house they bought. In such a case a bona fide purchaser is on inquiry notice of the rights claimed by those who possess the land. Id. at 899; see infra text accompanying notes 245-53. Judge Robert Taylor conceded this, but still had to deal with the fact that the trustee was a hypothetical judicial lien creditor to the land, as well as a bona fide purchaser. He ruled that judicial lien creditors have no rights against the land either, citing the ancient case of Leech v. Hillsman, 76 Tenn. 747 (1882) (Freeman, J.) Lancaster, 24 B.R. at 898-99.

In Leech A conveyed land to B by a deed that indicated B was to have fee simple absolute. In fact, B was only a mortgagee, and A remained in possession. A creditor with a judgment against B then tried to levy on the land that B seemed to own. A sale was held, and a buyer emerged to claim title. The buyer then sued A to quiet title. The court held for A, ruling that the levying creditor, as well as the buyer at the sheriff’s sale, were on inquiry notice of the rights of any possessor of the land—that is, A. Leech, 76 Tenn. at 751.

Lancaster was disavowed in McAlester v. Aldridge (In re Anderson), 30 B.R. 995, 1004-05 (M.D. Tenn. 1983). There, Judge George Paine, as special master for District Court Judge John Nixon—these were the days in which Northern Pipeline Construction Co. v. Marathon Pipe Line Co., 458 U.S. 50 (1982) (Brennan, J.), disrupted the bankruptcy court system—thought that Judge Taylor had misread Tennessee law. Judge Paine was quite shrewd in his reading of Leech. He interpreted the Leech case as holding that a debtor who never owned fee simple absolute could not convey fee simple absolute, even though the other co-owners of Blackacre never recorded. Though phrased in language of inquiry notice, Leech does not stand for the proposition that creditors must be bona fide. Rather, it simply means that when a debtor does not purport to own fee simple absolute, the creditor can levy only what the debtor has. Anderson, 30 B.R. at 1004-05.

Judge Paine stated the law of Tennessee as follows: The trustee as bona fide purchaser cannot avoid conveyances to persons who have actually taken possession. Id. at 1007. However, he noted:

This finding is of little consolation to the defendants . . . since the trustee may still avoid these transfers through his powers as a judgment lien . . . creditor under § 544(a)(1) and (2). The case law of Tennessee is well established that such creditors may avoid a defectively acknowledged deed regardless of whether they have notice of the improperly recorded transaction.

Id. at 1008.
less of this inquiry notice.

Even without the enactment of section 544(a)(3), it might have been possible for a trustee, through the power of imagination, to hypothesize that a judicial lien obtained on the day of bankruptcy would culminate in a sale to a bona fide purchaser who takes free of the unperfected mortgage.\footnote{See Cape Sable Corp. v. McClurg, 74 So. 2d 883, 885 (Fla. 1954) (Sebring, J.) (holding that a purchaser at a judicial sale takes free of an unrecorded mortgage if the purchaser is without notice); Note, Execution Sales-Rights of Bona Fide Purchasers, 24 Minn. L. Rev. 805 (1940). But see Arkison v. Gitts (In re Gitts), 116 B.R. 174 (Bankr. 9th Cir. 1990) (Perris, J.) (holding that the trustee may not hypothesize an execution sale for the purpose of avoiding an unrecorded homestead exemption), aff'd, 927 F.2d 1109 (9th Cir. 1991). For a discussion of this case, see supra text accompanying notes 167-70.} We saw earlier that Congress has attempted to limit some exercises in imagination. To prevent a resuscitation of \textit{Constance v. Harvey}, Congress has taken care to bar trustees from imagining that the judicial lien was associated with "gap credit."\footnote{See supra text accompanying notes 139-40.} Today, trustees must imagine that credit was extended on bankruptcy day, not some earlier point in time. Nothing in section 544(a), however, prevents the trustee from imagining things that occur \textit{after} bankruptcy if they strengthen the hypothetical judicial lien that arises on bankruptcy day. An execution sale might be one of those things; indeed, a judicial lien \textit{without} an eventual sale or collection seems incoherent. Hence, it is possible that section 544(a)(3) was not even necessary to finish off unrecorded real estate transactions in bankruptcy. In any case, even if this is a wrongful use of the imagination,\footnote{There is also the matter of whether a judicial lien creditor who sells to a bona fide purchaser, who takes free of the unrecorded mortgage, can retain the cash proceeds against the foreclosed mortgagee. It is possible that such an execution sale constitutes the wrongful conversion of the unrecorded mortgagee's property interest. For this to be the case, one must believe that the judicial lien creditor has a duty to the unrecorded mortgagee not to sell free and clear of the mortgage. See Jackson, supra note 54, at 740 & n.41.} voidable preference law, since 1938, has made unrecorded real estate conveyances into voidable preferences.\footnote{See 11 U.S.C. § 547(a)(2) (1976) (current version at 11 U.S.C. § 547(e) (1988)). A transfer of real property shall be deemed to have been made or suffered when it became so far perfected that no subsequent bona fide purchaser from the debtor could create rights in such property superior to the rights of the transferee. If any transfer of real property is not so perfected . . . against such liens by legal or equitable proceedings prior to the filing of a petition initiating a proceeding under this title, it shall be deemed to have been made immediately before the filing of the petition.} Section 544(a)(3) is entirely duplicative of the voidable

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Paine went on, however, to let the homeowners stay in their homes, by essentially refusing to institute the bankruptcy trustee's strong arm power. \textit{Id.} at 1013-15; \textit{see infra} text accompanying notes 351-58.

\footnotetext[227]{See Cape Sable Corp. v. McClurg, 74 So. 2d 883, 885 (Fla. 1954) (Sebring, J.) (holding that a purchaser at a judicial sale takes free of an unrecorded mortgage if the purchaser is without notice); Note, Execution Sales-Rights of Bona Fide Purchasers, 24 Minn. L. Rev. 805 (1940). But see Arkison v. Gitts (In re Gitts), 116 B.R. 174 (Bankr. 9th Cir. 1990) (Perris, J.) (holding that the trustee may not hypothesize an execution sale for the purpose of avoiding an unrecorded homestead exemption), aff'd, 927 F.2d 1109 (9th Cir. 1991). For a discussion of this case, see supra text accompanying notes 167-70.}

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\footnotetext[229]{There is also the matter of whether a judicial lien creditor who sells to a bona fide purchaser, who takes free of the unrecorded mortgage, can retain the cash proceeds against the foreclosed mortgagee. It is possible that such an execution sale constitutes the wrongful conversion of the unrecorded mortgagee's property interest. For this to be the case, one must believe that the judicial lien creditor has a duty to the unrecorded mortgagee not to sell free and clear of the mortgage. See Jackson, supra note 54, at 740 & n.41.}

\footnotetext[230]{See 11 U.S.C. § 547(a)(2) (1976) (current version at 11 U.S.C. § 547(e) (1988)). A transfer of real property shall be deemed to have been made or suffered when it became so far perfected that no subsequent bona fide purchaser from the debtor could create rights in such property superior to the rights of the transferee. If any transfer of real property is not so perfected . . . against such liens by legal or equitable proceedings prior to the filing of a petition initiating a proceeding under this title, it shall be deemed to have been made immediately before the filing of the petition.}
preference power. For this reason, it is possible to view section 544(a)(3) as not innovative after all.

Section 544(a)(3) does require supplementation through imagination. In almost all states mere bona fide purchasers have no protection under the recording act; only bona fide purchasers for value are protected. Hence, trustees must imagine that they paid for the land. Indeed, because a trustee represents the general creditors of a debtor, the trustee can imagine that the debtor voluntarily transferred land to the estate for the benefit of creditors in exchange for the trustee’s promise to pay the creditors as present consideration for the conveyance. This third party beneficiary theory should establish a means by which a trustee is considered a bona fide purchaser for value. On the other hand, since it’s all hypothetical, trustees can equally imagine that they paid cash in small, unmarked bills, if they want to.

In addition, prior to 1984, trustees had to hypothesize that they had recorded the bona fide purchase on the day of bankruptcy. In a great many states only subsequent bona fide purchasers who record first take priority over unrecorded real estate conveyances. Mere bona fide purchase for value is not enough in these states. To remove any doubt, Congress made clear that the trustee was a bona fide purchaser who “has perfected such transfer at the time of the commencement of the case.”

A. Inquiry Notice

If a security interest is perfected, it is usually said that all subsequent transferees are on constructive notice of the security interest. “Constructive” is a lawyer’s word that means, “It’s a lie, but pretend it’s true.” Hence, once a security interest is perfected, a subsequent transferee is treated as a bad faith purchaser, even if the purchaser is in good faith.

231. See supra note 189.
232. See Alexander M. Burrill, A Treatise on the Law and Practice of Voluntary Assignments for the Benefit of Creditors 239 (2d ed. 1858); see also Eno Inv. Co. v. Protective Chems. Lab., Inc., 83 S.E.2d 637, 640 (N.C. 1951) (Johnson, J.) (“[B]y . . . the appointment of the receiver, the creditors at large of the corporation, represented by the receiver, became in legal contemplation creditors for a valuable consideration within the meaning of our registration statute . . . ”).
Constructive notice is a legal fiction—the surest sign of a weakness in theorizing about law. It is not really necessary or even desirable to speak this way. It would be better if lawyers learned to discuss recordation in Hohfeldian terms. Under this simple terminological system, so long as the transfer is unperfected, the debtor retains a power to convey good title to a certain class of persons—for example, to subsequent bona fide purchasers for value who record first. Correlatively, the secured party has a liability to the debtor's power. But this power comes to an end when the security interest or other conveyance is properly perfected or recorded. At this point, the debtor no longer has the power to convey good title free and clear of the security interest, but rather the debtor has a disability in this regard. This Hohfeldian terminology avoids the legal fiction of constructive notice and instead describes perfection as the expiration of the debtor's power to convey good title to certain persons.

This Hohfeldian analysis of recordation is especially appropriate for Article 9. If a security interest is properly perfected, it is useless to speak of subsequent transferees having constructive notice. It is usually assumed that subsequent judicial lien creditors and secured parties are not subordinated if they have knowledge of the earlier security interest. If actual knowledge is useless against these parties, so is constructive—i.e., nonexistent—knowledge.

235. See Wesley N. Hohfeld, Fundamental Legal Conceptions as Applied in Judicial Reasoning and Other Legal Essays (1923). According to Hohfeld's famous system of opposites and correlatives, all law can be described by eight terms. Arranged by correlatives, any legal relationship between A and B can be described as follows:

If A has a: right privilege power immunity
then B has a: duty no-right liability disability.

236. For arguments that creditors and secured parties have a duty of good faith to each other and hence Article 9 is not a crude "race priority" statute, see supra note 56.

237. Thus, in RCA Corp. v. Video East, Inc. (In re Video East, Inc.), 41 B.R. 176 (Bankr. E.D. Pa. 1984) (Goldhaber, J.), a secured party (RCA) had properly perfected one security interest, but not three others. The properly perfected security interest referred to "television/radio broadcasting and receiving" equipment and a bare contract number. Id. at 180. A reader of this financing statement could not identify the equipment described by the contract number and, RCA argued, would have contacted RCA for further information. At that time, RCA would have disclosed the existence of other security interests.

Judge Goldhaber ruled that "RCA failed to prove by a preponderance of the evidence that a hypothetical creditor searching the UCC files . . . would inquire at RCA about [the contract number] and would necessarily be apprised by RCA of the three other security agreements that were improperly filed." Id. at 181. To orthodox readers of the UCC, even this showing would have been irrelevant because, after 1972 when the UCC was adopted, creditor knowledge is supposed to be irrelevant to priority. Goldhaber did go on to emphasize that "the debtor in possession has the status of a hypothetical lien creditor without regard to any knowledge of the trustee, the debtor in possession or
Constructive notice relies (unnecessarily) on the fiction that the subsequent transferee has visited the recording office and read the documents that were properly recorded there, even if no visit occurred. 238 If these documents reveal a transferee's interest, a subsequent purchaser is deemed to have knowledge. Such purchasers cannot be bona fide purchasers and cannot take free of the recorded interest. "Recorded," in this sense, is a delicate term of art. It does not mean recorded "in the sense it was physically placed in the records of the town clerk." 239 Rather, it means recorded in the sense that, because all the technical rules about filing were followed, the debtor has lost the power to convey good title to a subsequent transferee. In Hohfeldian terms recordation terminates the debtor's power to convey better title to someone else.

Constructive notice refers to the fictional knowledge of clear and plain statements of ownership on the record. But if recorded documents are not clear—if they merely hint at someone's ownership—then we have passed into the realm of inquiry notice. The distinction seems to be based on the clarity of expression in the record. 240

any creditor," id. (footnote omitted), but inquiry notice, a form of constructive knowledge, would override the trustee's statutory ignorance, if indeed knowledge is relevant to Article 9 priorities. This is implied by Judge Goldhaber's finding that a hypothetical creditor searching the UCC files would not have inquired at RCA. Id.

Hence, Judge Goldhaber wrote his opinion as if inquiry notice might be effective to save an unperfected security interest under Article 9.

Inquiry notice saved one secured party who claimed a vehicle in In re Microband Cos., 135 B.R. 2 (Bankr. S.D.N.Y. 1991) (Conrad, J.). In that case a lessee was really a secured party in disguise. The certificates of title to the leased vehicles showed the secured party as owner, not lienholder. The debtor in possession claimed that, under the vehicle certificate of title acts of Maryland, Michigan, and New Jersey, these security interests were not perfected by virtue of this mistake. Judge Conrad ruled that a searcher would be on inquiry notice about the true nature of the secured party's rights and held that the secured party's lien was perfected. Id. at 6.

The question that the strong arm power asks, however, is whether a judicial lien creditor is on inquiry notice; for that is what the bankruptcy trustee is with regard to vehicles. Hence, Conrad implied that judicial lien creditors are on inquiry notice.

Although these security interests were governed by certificate of title statutes, this limitation is limited solely to the means of perfecting a security interest. See U.C.C. § 9-302(3)(b) (1972). The effect of perfection continues to be governed by the UCC, which awards priority to judicial lien creditors whose liens attach while a security interest is unperfected. Id. § 9-301(1)(b); 1 GILMORE, supra note 46, § 20.8 at 577-78.

238. See United States v. Smith (In re Hagendorfer), 803 F.2d 647, 649-50 (11th Cir. 1986) (Thomas, J.) (holding that the trustee is deemed to have read the entire chain of title, from which the trustee could have deduced that the properly recorded document contained an erroneous description of the property therein).


240. Judge Levin Campbell analyzed inquiry notice as a special kind of constructive
Exactly what in the record constitutes a clue that needs further investigation is fairly mysterious. One aggressive case is *Elin v. Busche (In re Elin)*, 241 in which an ex-husband intended to make a conveyance of real estate to his ex-wife. The deed that his attorney prepared and recorded inexplicably purported to convey his right of curtesy, a right that does not arise in conjunction with a tenancy by the entirety. 242 Hence, the conveyance was nonsensical.

Judge Dickinson Debevoise thought that the ex-husband's bankruptcy trustee held the real estate in constructive trust for the ex-wife under state law, 243 and the question was whether the trustee's strong arm power negated this constructive trust. Judge Debevoise decided that the nonsensical deed put a purchaser on inquiry notice of the constructive trust:

The deed on its face purports to transfer a non-existent interest . . . . Since any purchaser would know that it is highly unlikely that the parties to the deed intended to record an instrument having no effect, the deed constituted a "clue" which a purchaser would have an obligation to follow—to find out just what the parties to the deed were about when they executed and recorded it. An inquiry would have brought to light plaintiff's interest in the real estate. 244

Besides a visit to the recorded documents, a second visit attributed to the hypothetical bona fide purchaser is a tour of the real estate

knowledge. He wrote:

But we do not believe "inquiry notice" is a type of notice separate from "actual" or "constructive" notice. . . . Inquiry notice follows from the duty of a purchaser, when he has actual or constructive knowledge of facts which would lead a prudent person to suspect that another person might have an interest in the property, to conduct a further investigation into the facts. The most common type of "inquiry notice" is present when some person other than the grantor in actual possession of the property. In that situation, the purchaser is charged with constructive knowledge of this possession; as a result, the purchaser is "on inquiry" to determine whether the possessor has some interest in the property.

*Id.* at 507 (citations omitted) (footnote omitted).


242. *Id.* at 1013.

243. *Id.* at 1015-16.

244. *Id.* at 1020; accord Maine Nat'l Bank v. Morse (*In re Morse*), 30 B.R. 52 (Bankr. 1st Cir. 1983) (Glennon, J.) (holding that a recorded discharge of a mortgage followed by a notice of foreclosure was so nonsensical that a bona fide purchaser would have inquired and found out that the discharge was a mistake). But see Collins v. Bank of New England-West, N.A. (*In re Daylight Dairy Prods.*, Inc., 125 B.R. 1, 4 (Bankr. D. Mass. 1991) (Queenan, J.) (holding that under Massachusetts law a bona fide purchaser need not inquire into oddities or discrepancies in the record that are "logically consistent with facts supporting an absence of any defect").
that the debtor has transferred. In the leading case of McCannon v. Marston, a buyer of a condominium in the Drake Hotel paid a deposit of $500 toward the purchase price of $17,988 and immediately took possession. She never recorded the deed from the hotel, however. When the hotel filed for Chapter 11, it sought to evict the buyer and turn her into a general creditor for her down payment.

The debtor in possession argued that, under the strong arm power, it was a bona fide purchaser of real estate "without regard to any knowledge of the trustee or of any creditor." Among the things of which the hotel could claim to be ignorant was the buyer's possession of her condominium apartment. Although this theory won the adherence of the bankruptcy and the district courts, Judge John Gibbons disagreed. He wrote that in Pennsylvania:

> clear and open possession of real property generally constitutes constructive notice to subsequent purchasers of the rights of the party in possession. Such possession, even in the absence of recording, obliges any prospective subsequent purchaser to inquire into the possessor's claimed interests, equitable or legal, in that property. Thus in Pennsylvania the rights of a subsequent purchaser do not take priority over those of one in clear and open possession of real property.

The debtor in possession, deemed to have made inquiries of the buyer in possession, could not claim to have been ignorant of the buyer's possession. Hence, McCannon did not lose her home to the very debtor that sold her the condominium.

Judge Gibbon's reason for overriding the "without knowledge" stipulation in section 544(a) was that Congress could not have meant anything so revolutionary in enacting the strong arm power. "According to the bankruptcy and district courts," he wrote, "nothing can be done to protect against the claims of a future trustee in bankruptcy who assumes the role of a hypothetical bona fide purchaser without

245. But see Clark v. Kahn (In re Dlott), 43 B.R. 789, 794 (Bankr. D. Mass. 1983) (Lawless, J.) (holding that under Massachusetts law a bona fide purchaser is not on inquiry notice of the rights of possessors of real estate). In Dlott the possessor claimed to be an owner of an encumbered fee simple absolute, but the record showed the possessor to be the owner of only a cotenancy. Hence, the possession in question was inconsistent with the record, and a purchaser probably had no duty to inquire, even outside of Massachusetts.


247. Id. at 14.


249. McCannon, 679 F.2d at 16 (citation omitted).

250. Id. at 17.
actual knowledge."251 This is, of course, an exaggeration: buyers of real estate can record their conveyances, which is what the strong arm power is designed to encourage. But other sentiments of Judge Gibbons seem undoubtedly correct:

The trustee under . . . Section 544, has been clothed not only with the rights of a bona fide purchaser, but has been granted as well a substantial additional mantle of power not available to any actual subsequent purchaser in Pennsylvania. Such a conclusion is not to be lightly inferred.252

After McCannon, courts have uniformly agreed that possession of real estate by a purchaser constitutes perfection of the conveyance, even if the conveyance is not recorded.253 In this regard, real estate recordation in bankruptcy dovetails nicely with the law pertaining to Article 9 security interests: either creditor possession or filing the proper documents suffices to perfect a transfer against the trustee's strong arm power.254

The presumption that the trustee hypothetically visits property seems to be limited to real property. If a trustee were to visit personal property which, for example, had a secured party's name stamped on it, the trustee's knowledge would not matter, at least under the UCC as it is usually interpreted.255 But some nonuniform legislation may exist that would make such visits significant. In California as of 1983, if cat-

251. Id. at 16.
252. Id. Judge Gibbons also pointed out that the buyer was specifically authorized to stay in possession under § 365(i), if the buyer's interest was an executory contract. Id. at 17-18. This may have helped the buyer in McCannon, but it is little help when the buyer or the seller has fully performed, so that there is no executory contract in the picture. See McAlister v. Aldridge (In re Anderson), 30 B.R. 995, 1011 (M.D. Tenn. 1983) (Nixon, J.) (adopting report of Judge George Paine, as special master).
254. In Ellsworth v. Fitzpatrick (In re Fitzpatrick), 29 B.R. 701 (Bankr. W.D. Wis. 1983) (Martin, J.), the debtor sold the reversion in a leasehold to a transferee, who did not record. Even though the old tenants had been there during the debtor's tenure (and hence were not inconsistent with the debtor's record ownership), Judge Robert Martin deduced that a hypothetical bona fide purchaser would have asked the tenants to describe their rights. These tenants would explain that the new buyer was now their landlord. Hence, the strong arm power was not good against the buyer's unrecorded conveyance. Id. at 704-05.
255. For a discussion of whether Article 9 contains an implicit good faith requirement in its priority provisions, see supra note 56.
tule were placed by their owner in a feed lot for fattening, then purchasers, creditors, or encumbrancers, if they were without knowledge, were entitled to assume that the cows belonged to the lot owner unless the true owner filed notice in the public records within ten days of check-in.\footnote{255}{The California statute requiring notice filing had long been forgotten by most ranchers. Perceiving this, the feed lot owner, in \textit{Black & White Cattle Co. v. Shamrock Farms Co. (In re Black & White Cattle Co.)},\footnote{256}{\textit{Id.} at 513-15.} \textit{induced ranchers to matriculate their cattle with the feed lot and then filed for Chapter 11 reorganization. Purporting to be a hypothetical judicial lien creditor without knowledge, the debtor in possession claimed the cattle for the general creditors at the expense of the ranchers.}}

An appellate panel of the bankruptcy court thought this a straightforward application of the strong arm power. That the cattle were branded made no difference. Perhaps bankruptcy trustees pay hypothetical visits to the filing office, but they do not visit the cattle and observe the brands.\footnote{257}{\textit{Id.} at 513-15.} The trustee was, in short, the ideal cattle rustler. And when the ranchers cited \textit{McCannon v. Marston} in their defense, it was distinguished on the following grounds:

\begin{quote}
First of all, we are not dealing here with a person in possession of real property, but most importantly, California state law provides that an unrecorded feeding agreement \textit{voids} \ldots all terms reserving title in the bailed cattle as against any purchaser, creditor or encumbrancer. Hence, possession, without a recorded instrument, does not require inquiry as to the ownership interest in the cattle.\footnote{258}{\textit{Id.} at 515.}
\end{quote}

This distinction is unpersuasive. Why should the propensity to visit property differ between real and personal property? Furthermore, nearly \textit{every} recording act is described in terms of partial voidance of an unperfected property interest.\footnote{259}{\textit{Id.} at 515.} Partial avoidance language in real property recording statutes is no impediment to hypothetical visitations and neither should the presence of such language in personal property recording statutes bar bankruptcy trustees from making hypothetical inspections of personal property.\footnote{260}{\textit{See supra} text accompanying notes 81-88.} \footnote{261}{Earlier, I suggested that subordination and partial avoidance and even total bankruptcy avoidance are all synonymous terms. \textit{See id.} Hence, the wording of any recording statute is irrelevant in determining what hypothetical visits the trustee makes.}

257. 30 B.R. 508 (Bankr. 9th Cir. 1983) (Katz, J.), \textit{rev'd} per \textit{curiam}, 746 F.2d 1484 (9th Cir. 1984).
259. \textit{Id.} at 515.
260. \textit{See supra} text accompanying notes 81-88.
261. Earlier, I suggested that subordination and partial avoidance and even total bankruptcy avoidance are all synonymous terms. \textit{See id.} Hence, the wording of any recording statute is irrelevant in determining what hypothetical visits the trustee makes.
As a result of the Black & White Cattle case, the California legislature immediately repealed the forgotten recording system for feed lots, and cattle rustling in feed lot bankruptcies has become impossible. Also, the Ninth Circuit, in an unpublished opinion, reversed.262 The Ninth Circuit ruled that a trustee would have paid the cows a visit after all, would have observed the brands, and would have concluded that the feed lot owner did not own the branded cows in its lot.

This opinion is not without UCC significance, if you think the UCC contains a good faith duty with regard to Article 9 priorities.263 For example, if a secured party were to brand its collateral somehow, and if this requires a hypothetical judicial lien creditor to make a good faith inquiry, then a great many unperfected security interests might survive bankruptcy. This flies in the face of the 1972 amendments to the UCC, however, which were quite deliberately designed to give a subsequent bad faith judicial lien creditor priority over an earlier unperfected secured party264—though, even after 1972, secured parties who file a correct financing statement in the wrong UCC office still take priority over any subsequent transferee with knowledge of the security interest.265 Black & White Cattle should be of assistance to those secured parties who have made an erroneous filing, so long as they can claim to have branded the collateral somehow. In particular, the appearance of the security interest on the debtor's financial reports ought to serve as the equivalent of a brand.

In any case, the bona fide purchaser in section 544(a)(3) is deemed to have visited any property the debtor may have transferred. What about other visits? We said earlier that a bona fide purchaser is deemed to have read the documents that have been properly recorded, as that word has been technically defined. Does the hypothetical bona fide purchaser also read other documents that happen to be lying around as well—documents that are in the record but are not necessarily recorded?266

Apparently, this visit oversteps the laws of hypothesization in the First Circuit, though at least one bankruptcy judge thought otherwise. In Stern v. Continental Assurance Co. (In re Ryan)267 Judge James

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263. For the argument that the UCC should be read this way, see supra note 56.
264. See supra notes 55-56 and accompanying text.
266. See Probasco v. Eads (In re Probasco), 839 F.2d 1352, 1355 (9th Cir. 1988) (Boochever, J.) (holding that what constitutes inquiry notice is a finding of fact for purposes of appellate review).
Queenan tried to save a secured party from an inconsequential mistake, but was reversed on appeal. The secured party's predecessor in interest had obtained only one witness to a mortgage deed, instead of two, as Vermont law sternly requires.268

Citing Day v. Adams,269 an old Vermont case that held a deed witnessed by only one person cannot be properly recorded,270 Judge Queenan predicted that the modern Supreme Court of Vermont was too enlightened to follow that precedent today—though he conceded that the old case represented "a majority view" in other, slower footed parts of the United States.271 Queenan went on, however, to denounce the entire majority view as one founded on "turn-of-the-century cases in which courts slavishly observed rigorous technical requirements. Courts in the present day are more willing to disregard a minor error in form if ignoring the error will not prejudice other parties' rights."272

Instead, Judge Queenan thought that the modern attitude was expressed in UCC section 9-402(8), which says, "A financing statement substantially complying with the requirements of this section is effective even though it contains minor errors which are not seriously misleading."273 Hence, Queenan predicted that a Vermont court would hold that the mortgage was sufficiently recorded to give a purchaser constructive notice of the secured party's rights.274


269. 42 Vt. 510 (1869) (Peck, J.).

270. In Day an owner of land conveyed certain water rights to A, but only one witness had signed the deed. The former owner then died. His administrator sold the land to B. B then tried to sue the administrator for breach of a title warranty, but the court held for the administrator because B took the land free and clear of A. Id. at 513-15. But cf. Tindale v. Bove, 124 A. 586 (Vt. 1924) (Watson, C.J.) (holding that an unwitnessed mortgage is good against subsequent transferees with knowledge of it).


272. Id. at 512-13 (citations omitted). Of course, the mere failure to avoid a mortgage prejudices the general creditors. Judge Queenan must have had something else in mind—such as a creditor making an advance based upon a false impression of the financial facts.

273. U.C.C. § 9-402(8) (1972). Judge Queenan also cited Benjamin Franklin Savings & Loan Ass'n v. New Concept Realty & Development, Inc. (In re New Concept Realty & Development, Inc.), 763 F.2d 804 (9th Cir. 1985) (per curiam). In New Concept the mortgage was notarized without a required statement to the effect that the grantor was known to the notary. The Ninth Circuit certified the case to the Supreme Court of the state of Idaho, which assured the Ninth Circuit that such a mortgage was recordable, in spite of the defect in notarization. Benjamin Franklin Sav. & Loan v. New Concept Realty & Dev., Inc. (In re New Concept Realty & Dev., Inc.), 692 P.2d 355 (Idaho 1984) (Donaldson, C.J.).

But just in case he had failed to predict what Vermont judges would do, Queenan went a good deal further and held that even if the mortgage was not properly recorded, it was still good in bankruptcy because the attempted recordation put the bankruptcy trustee on inquiry notice of the unperfected mortgage, the same way a mortgagee's actual possession of the real property might put a trustee on inquiry notice.\(^275\) Noting that the UCC occasionally adopts an "objective" standard of knowledge—what a reasonable person \textit{should} have known—Judge Queenan hypothesized that the bankruptcy trustee would have gone down to the record office to see what documents were actually there.\(^276\) After all, the bankruptcy trustee is presumed to have visited real property, observed persons in possession, and inquired as to their rights. Because this hypothetical visit is charged to the trustee, why not one more stop at the recording office? The second visit is no great inconvenience, especially when the whole exercise is imaginary. "There would be a logical inconsistency," Queenan thought, "if such vague indications of another's property interest created a duty to inquire, and the unmistakable claim arising from a mortgage on record lacking just one of two witnesses did not raise such a duty."\(^277\)

Furthermore:

Treated the trustee as subject to inquiry notice . . . is consistent with the good faith ascribed to him by § 544(a)(3). He would be acting in subjective bad faith only if he purchased the property with the intention of taking advantage of any priority over the Bank by reason of the missing witness in the Bank's mortgage. We hypothesize a buyer who has no such intention, but rather who accepts the Bank's priority, as indeed he must under Vermont law.\(^278\)

In Vermont creditors are apparently unprotected from unrecorded real estate transactions.\(^279\) Nevertheless, Judge Queenan took the trouble to rule that the trustee as judicial lien creditor has the same duty to examine exactly what is on file.\(^280\) If they had survived on appeal, these holdings would have meant that unperfected security interests would

\(^{275}\) Ryan, 70 B.R. at 514-19.

\(^{276}\) Id. at 517-18.

\(^{277}\) Id. at 518.

\(^{278}\) Id.

\(^{279}\) Reynolds v. Haskins, 35 A. 349, 350 (Vt. 1896) (Ross, J.) (holding that only "purchasers" are protected, not creditors).

\(^{280}\) Ryan, 70 B.R. at 518-19.
be valid in bankruptcy if the secured parties had filed anything with their names on it,281 or even if they had spray painted their rights on the courthouse walls.282

In reversing Judge Queenan, Judge Frank Freedman ruled that Vermont law does indeed prohibit recordation of underwitnessed mortgages.283 As to Queenan’s theory that a trustee is deemed to have visited the recording office and read the documents actually found there, Judge Freedman thought that “[s]ince the mortgage was invalid, the trustee’s notice obligations are irrelevant to deciding the issue.”284 Such a holding is surprising because Freedman cited cases clearly indicating that an underwitnessed mortgage in Vermont is valid between the parties,—i.e., it was still an unperfected security interest.285 Hence, Judge Queenan’s theory would seem to be very relevant.

Higher up in the judicial food chain, Judge Levin Campbell agreed that inquiry notice could not save an under-witnessed mortgage.286 Although he treated Judge Queenan’s attempt to anticipate Vermont legal reform with far less scorn than did Judge Freedman,287 he also felt


282. This was tried unsuccessfully in Carlyle v. City of Phila. Water Revenue Bureau (In re Carlyle), 100 B.R. 217 (Bankr. E.D. Pa. 1989), in which the city of Philadelphia placed a sign in the real estate recording office warning title searchers that water and sewer liens were indexed in the next room. Judge Scholl ruled, however, that the trustee does not hypothetically visit the recording office for any purpose other than that of reading the documents properly recorded there. Id. at 220-21; see also McLean v. City of Phila., 891 F.2d 474, 476, 478 (3d Cir. 1989) (Gibbons, C.J.) (ruling that, in a bankruptcy filed before the signs were posted, Philadelphia had not properly docketed sewer liens by maintaining a separate nonalphabetical, chronological file but emphasizing the lack of a sign to warn title searchers of the different system).


284. Id. at 265-66.

285. See id. at 266-67 (citing Tindale v. Bove, 124 A. 585 (Vt. 1924) (Watson, J.) (holding that an unrecorded mortgage is good against subsequent transferees with knowledge of it)).


287. In reversing, Judge Freedman was sharply critical of Judge Queenan’s predictions, calling them “a unique and erroneous interpretation of the role of precedent in judicial decision making. State supreme court decisions do not lose precedential value as they age.” Ryan, 80 B.R. at 267. Freedman also found a modern bankruptcy case that applied an Ohio two-witness rule statute and held that the strong arm power could defeat an improperly witnessed mortgage, id. at 267-68 (citing In re Hofacker, 34 B.R. 604 (Bankr. S.D. Ohio 1983) (Anderson, J).), and a modern Vermont bankruptcy judge who had at least cited Day v. Adams with a lack of disapproval, id. at 267 (citing In re Gorman, 68 B.R. 541, 543 n.1 (Bankr. D. Vt. 1986) (Conrad, J.) (wondering whether Day meant an unrecorded conveyance was completely void or merely voidable by subsequent
obliged to rule that, under modern Vermont law, the mortgage was unperfected.288

Meanwhile, on the important issue of whether a trustee hypothetically would pay a visit to look at the records, Judge Campbell also disagreed with Judge Queenan. He saw Queenan's new hypothetical visit for what it was—a vast relaxation of Vermont's definition of what it means to record a mortgage. Because a bankruptcy court must apparently take state law as is, not as it ought to be, Judge Campbell reversed and held that the trustee's strong arm power overcame the unperfected mortgage.289

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In comparison, Judge Campbell thought that Judge Queenan's predictions were "well-stated" and "tempting." Ryan, 851 F.2d at 508.

288. Campbell cited a Supreme Court case on diversity jurisdiction in which a 1910 Vermont case was held to establish the law of Vermont, even though the 1910 opinion seemed antiquated: "'[T]here appears to be no confusion in the Vermont decisions, no developing line of authorities that casts a shadow over the established ones, no dicta, doubts or ambiguities in the opinions of Vermont judges on the question, no legislative development that promises to undermine the judicial rule.'" Ryan, 851 F.2d at 509 (quoting Bernhardt v. Polygraphic Co. of America, Inc., 350 U.S. 198, 205 (1956) (Douglas, J.). But see Angeles Real Estate Co. v. Kerxton (In re Construction Gen., Inc.), 737 F.2d 416, 419 (4th Cir. 1984) (Winter, C.J.) (rejecting nineteenth century case about equitable assignments as unlikely to be followed in Maryland today).

289. Judge Campbell wrote:

This reasoning of the bankruptcy court, if adopted by a state court or legislature, might result in an improved land recording system. We do not believe, however, that the bankruptcy court was free to write on a clean slate. To accept the suggested expansion of inquiry notice would be to disregard the clear Day v. Adams rule that defectively recorded mortgages do not provide constructive notice.

.......

We think the bankruptcy court . . . bypassed the source of the preliminary facts that serve to put a purchaser upon inquiry, and instead simply created, as a matter of policy, a new legal duty to search the town lands records. . . . Thus the question posed by the bankruptcy court amounted to nothing more than asking whether a purchaser should not henceforth be deemed as having constructive notice of all records placed with the town clerk. This question is conclusively answered by Day v. Adams: purchasers are only charged with constructive notice of properly recorded deeds, and not of all deeds on file with the town clerk.

Ryan, 851 F.2d at 511 (citation omitted). Less successful is Campbell's argument that the purpose of the strong arm power is to increase the size of the bankrupt estate available to the general creditors: "Whether or not Congress specifically envisioned the result reached in this case, the result cannot be said to clash with the general policy of increasing the size of the estate." Id. at 512. Surely the goal of enriching the general creditors must be tempered by some limiting principle. Otherwise, it vindicates things like bank robbery. Enriching the general creditors is only one side of the equation; it must be balanced by some other limiting principle that Judge Campbell did not articulate.
Although the mortgage witnessed by one—not two—persons harmed no one, it was struck down for not meeting the fastidious requirements of Vermont recordability. Yet one thing might be said for Judge Campbell's reversal of this revolution in strong arm law. It is the slippery slope argument first presented in Day v. Adams. 290 If "one of the two witnesses may be dispensed with, both may, and on the same principle, all the statutory requirements may be disregarded." 291 Judge Queenan's technique of hypothesizing a visit to the recording office could likewise do away with recording requirements altogether, if hypothesization is expanded to include visits to the secured party's office or the file drawer where the security agreement is kept.

In contrast, the Ninth Circuit was willing to hypothesize a visit to the recording office to read unrecorded documents. In Probasco v. Eads (In re Probasco) 292 a debtor conveyed a cotenancy to a buyer with regard to three plots. The buyer properly recorded with regard to the second and third plots, but not with regard to the first. Judge Robert Boochever nevertheless found that the debtor in possession had constructive notice of the buyer's cotenancy on the unrecorded first plot as well. 293 The premise was that the trustee (as hypothetical bona fide purchaser) would visit the recording office and read the documents recorded as to the other plots—that is to say documents that were unrecorded against the first plot. Having read these unrecorded documents, the trustee would then learn that the buyer was cotenant to plots two and three. Next, the trustee would hypothetically visit the disputed first plot. There, the trustee would have seen only one fence surrounding all three plots and construction activity occurring on all three plots. 294 From this, the trustee would deduce that, if the buyer was cotenant to the second and third plots, he must be cotenant to the first plot as well. 295 This entire complicated hypothetical exercise was

290. 42 Vt. 510 (1869) (Peck, J.).
291. Id. at 515.
292. 839 F.2d 1352 (9th Cir. 1988) (Boochever, J.).
293. Id. at 1357.
294. Id. at 1355.
295. It is almost inconceivable that such a prudent person, knowing that Parcels 2 and 3 were jointly owned, and seeing a perimeter fence around all three parcels, no fence between the parcels, the staking of all three parcels, and roads traversing the entire property, would not inquire whether a one-half owner of Parcels 2 and 3 had an interest in Parcel 1.

Id. at 1356. The quoted passage indicates that the trustee has hypothetically visited the recording office to read documents not pertaining to Lot 1.

For another theoretical visit see Hunts Point Tomato Co. v. Roman Crest Fruit, Inc. (In re Roman Crest Fruit, Inc.), 35 B.R. 939 (Bankr. S.D.N.Y. 1983). Judge Buschman decided that, if a landlord has veto rights over assignments of a lease, a bona fide purchaser of the lease would inquire and find out that an earlier party with a contract to
founded upon the hypothetical reading of unrecorded documents on file with the real estate clerk.

Furthermore, Judge Boocheever specified that the existence of inquiry notice was a question of fact, for the purpose of appellate review. Hence, the trial court was given wide discretion in determining whether the trustee was on inquiry notice.296 This is rather odd because the trustee is only a hypothetical lien creditor or bona fide purchaser. How can the suspicions of a nonexistent person be a finding of fact?297 Nevertheless, the Ninth Circuit is in opposition to the First Circuit on this matter, where Judge Campbell seemed to give Judge Queenan little or no discretion to find the fact of inquiry notice.298

Finally, the Ninth Circuit has ruled, rather surprisingly, that the bankruptcy trustee is on inquiry notice of any facts arising from an involuntary petition in bankruptcy. In Briggs v. Kent (In re Professional Investment Properties of America)299 mortgagees who had not recorded filed an involuntary petition against the debtor. The petition referred to the mortgage because Bankruptcy Code section 303(b) requires that the petitioning creditors have claims aggregating "at least $5,000 more than the value of any lien on property of the debtor securing such claims held by the holders of such claims."300

The trustee301 claimed that the mortgage was dead by virtue of the lease already had requested approval. Id. at 947. Since the contract for a lease amounted to an equitable right in the land itself—the doctrine of equitable conversion—the earlier party's equitable interest survived the strong arm power.

296. Probasco, 839 F.2d at 1355.
297. Indeed, Judge Boocheever wrote:
We note, however, that there is no dispute over the historical facts in this case. Nor are there any findings based on credibility of witnesses. The decision of the bankruptcy court that there was no constructive notice is based on inferences from the undisputed facts. Although, unlike credibility determinations, an appellate court is equally capable of making those inferences, the dictates of judicial economy require application of the clearly erroneous standard.

Id. Judge Boocheever seems to be saying that, although the facts are not disputed, inquiry notice is still not a question of law—an absurdity.


299. 955 F.2d 623 (9th Cir. 1992) (Nelson, J.).
301. Or to be more precise, the trustee's assignee. The trustee had sold avoidance
strong arm power, but the mortgagees claimed that the bankruptcy petition itself put the trustee on inquiry notice of their rights. The bankruptcy court rejected this claim on timing grounds: "'[A]ny constructive notice of plaintiffs' interest achieved by filing the original bankruptcy pleadings comes too late to secure their interest in a position prior to that acquired by the trustee.'" 302 The district court reversed and held that "the filing would put the trustee, once appointed, on inquiry notice." 303

On appeal Judge T.G. Nelson found the district court's holding persuasive. "There is no practical reason why a trustee should not be put on inquiry notice by the very petition that created his position." 304

*Professional Investment*, however, is not faithful to the premises of inquiry notice. The imagery invoked by inquiry notice is that, when a prospective buyer is presented with some clue that the seller is not really the owner of the property being tendered, the buyer should take the time and make a reasonable investigation of the facts. Yet, in *Professional Investment*, the trustee, as a hypothetical judicial lien creditor or bona fide purchaser, obtained the clue and became a purchaser at *precisely the same time*. Now a buyer presented with a clue need only make a reasonable inquiry. But if there is no time at all in which to make that inquiry, it may be reasonable to defer the purchase or forego the inquiry. Because the Bankruptcy Code does not permit the former, it would appear that the bankruptcy trustee has not been unreasonable in (hypothetically) making no search. Hence, the trustee should still be a judicial lien creditor or bona fide purchaser without knowledge.

*Professional Investment* has great potential to reverse the single most irritating thing about the strong arm power—the spectacle of the debtor in possession, who conveyed a security interest to a creditor, turning around and avoiding the security interest with the strong arm power. Although *Professional Investment* involved an involuntary petition, there is no principle that would limit the holding to involuntary petitions. If hypothetical judicial lien creditors or bona fide purchasers are on notice of the contents of an involuntary petition, they ought to be equally notified by the contents of a voluntary petition.

A debtor is expected to file a list of creditors along with the petition. 305 If this list contains some indication of an unperfected security

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302. *Id.* at 625 (quoting bankruptcy court).
303. *Id.* at 628.
304. *Id.*
interest, the trustee would be on inquiry notice of it; this inquiry notice might preserve the security interest from the strong arm power.

Such a theory may avail the secured party nothing in the end. Even if the bankruptcy petition puts the trustee on inquiry notice of unperfected security interests, it still remains true that the unperfected security interest is probably a voidable preference.\(^{306}\) As such, the unperfected security interest may not survive avoidance after all, on the theory of Professional Investment. Fortunately for the mortgagees in Professional Investment, the bankruptcy trustee seems to have overlooked the voidable preference theory altogether, and so the mortgagees were able to prevail on the strength of their unrecorded mortgage.

**B. Fixtures**

Fixtures are, of course, real estate. They can be defined as real property that has a personal property past and might also have a personal property future. For the purpose of section 544(a)(3), however, Congress has denied the trustee the status of a bona fide purchaser of fixtures.\(^{307}\) This was accomplished by amendment in 1984 because the classification of fixtures as real property interfered with the smooth workings of Article 9.\(^{308}\)

Under Article 9 a secured party can protect herself from judicial lien creditors by filing an ordinary UCC-1,\(^{309}\) but to protect herself from a subsequent "encumbrancer" of real estate, the secured party must make a fixture filing,\(^{310}\) which differs in some respects from an ordinary Article 9 filing.\(^{311}\) Prior to 1984, the failure to make a fixture filing was fatal to the security interest in bankruptcy. Oddly, a fixture was treated as personal property for the purposes of voidable preference law,\(^{312}\) so that the failure to treat a fixture as personal property...

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306. Under § 547(e)(2)(C) the security interest would be deemed transferred just before bankruptcy and hence is a transfer on antecedent debt. 11 U.S.C. § 547(e)(2)(C) (1988).


308. For a description of the pre-1984 situation with regard to fixtures and the strong arm power, see Irving A. Breitowitz, Article 9 Security Interests as Voidable Preferences, 3 Cardozo L. Rev. 357, 384-87 (1982); Carlson, supra note 177, at 397-98.


310. Id. § 9-313(4)(b).

311. Id. § 9-402(5) (requiring that a fixture filing "must show that it covers this type of collateral, must recite that it is to be filed [for record] in the real estate records, and the financing statement must contain a description of the real estate.") (brackets supplied by statute).

under section 544(a)(3) was pretty clearly a drafting error.\textsuperscript{313} After 1984 this paradox ceased to exist.

\textbf{VII. Refusals to Allow the Strong Arm Power}

The strong arm power gratifies a hatred of secret liens. But in fact, unperfected security interests and secret liens are not necessarily the same thing. Often the existence of an unperfected security interest is universally known to all lenders who care enough to investigate their debtors. Often these security interests are described in detail in the debtor’s financial reports. In Chapter 11 the trustee may be a debtor in possession who helped perpetuate the very wrong that the trustee is now trying to undo.\textsuperscript{314} Yet if the secured party has made some technical mistake, the secured party loses her security interest. In most bankruptcies this loss is a disaster because few bankruptcies produce dividends for the general creditors. When a security interest is avoided, it usually means only that the trustee and her lawyers and accountants obtain a larger fee.\textsuperscript{315}

\textsuperscript{313} Spotting this error, Judge William Hill managed to avoid the consequence of the pre-1984 strong arm power with regard to fixtures in Minot Area Development Corp. v. Armstrong (\textit{In re Trestle Valley Recreation Area, Inc.}, 45 B.R. 458 (Bankr. D.N.D. 1984). In \textit{Trestle Valley} the debtor owned a ski lodge but not the ground beneath it. Although the lodge was a fixture, Judge Hill decided that the trustee was not a bona fide purchaser of fixtures if the debtor did not also own the ground beneath the fixture. This conclusion was more asserted than argued. \textit{Id.} at 462. Fortunately, because Congress amended the strong arm power in 1984, we need not speculate on what Judge Hill’s reasoning would have meant for condominiums in apartment buildings in which the owner may own nothing but fixtures hovering above the ground.

\textsuperscript{314} The classic statement of this irony is in Loup v. Great Plains Western Ranch Co. (\textit{In re Great Plains Western Ranch Co.}, 38 B.R. 899 (Bankr. C.D. Cal. 1984) (Ayer, J.), in which the debtor in possession had defrauded its partners out of real estate. Although this called for a constructive trust, the debtor in possession, as a bona fide purchaser of real estate, took free of this property interest. \textit{Id.} at 905-06. Judge John Ayer commented:  

There are many anomalies here. The strong-arm clause protects reliance, and protects against fraud, without any showing either of reliance or of fraud. The strong-arm clause permits an (assumed) fraud against the plaintiffs in this case to protect against a (hypothetical) fraud by the debtor in which the plaintiffs by definition might have no part. The strong-arm clause permits the alleged wrongdoer to assert the rights of innocent parties against his own supposed victim. All of this is, to say the least, a remarkable result. Nonetheless, as I have tried to show, I think it is consistent alike with the letter and with the spirit of the Bankruptcy Code.  

\textit{Id.} at 907.

\textsuperscript{315} It is sometimes claimed that \textit{general creditors} benefit when security interests are avoided. \textit{E.g.}, Einoder v. Mount Greenwood Bank (\textit{In re Einoder}, 55 B.R. 319, 329 (Bankr. N.D. Ill. 1985) (Ginsberg, J.) ("Moreover, such [unperfected] liens, if allowed in
The reports are full of cruel cases in which secured parties have made inconsequential mistakes and are made to forfeit their security interests. Mortgagees who filed documents but who made notarization mistakes\textsuperscript{316} or other clerical errors\textsuperscript{317} have lost their mortgages. UCC filings are notoriously treacherous. If the UCC requires filings with the secretary of state and the local UCC office,\textsuperscript{318} secured parties will lose their security interests to the strong arm power if only one filing is made.\textsuperscript{319} Even if two filings are made, if the debtor moves her place of business just across the county line, one of the filings lapses after four months, and the security interest becomes unperfected.\textsuperscript{320} Secured parties can lose their security interests if they file under a trade name bankruptcy, could leave unsecured creditors with no dividends in a Chapter 7 case and thus no right to a significant distribution in a Chapter 13 case.”). I would like to state my undocumented suspicion, however, that many avoidance actions simply allow lawyers to supply more legal services to a bankrupt estate than would otherwise be possible if the strong arm power were ignored from time to time.

316. Stern v. Continental Assurance Co. (\textit{In re} Ryan), 851 F.2d 502 (1st Cir. 1988) (Campbell, C.J.) (avoiding mortgage because only one witness, not two, witnessed the signing of the mortgage); Baldin v. Calumet Nat'l Bank (\textit{In re} Baldin), 135 B.R. 586 (Bankr. N.D. Ind. 1991) (Lindquist, J.) (subordinating a mortgagee who forgot to fill in the blank on a notarization form with the name of the debtor, even though the debtor’s identity was abundantly apparent from the deed itself, which was filed in the appropriate county office); Bash v. Check (\textit{In re} Check), 129 B.R. 492 (Bankr. N.D. Ohio 1991) (O’Neill, J.) (holding that a mortgage was not recorded because the mortgagee served as the notary); Harkins v. Wheeling Nat’l Bank (\textit{In re} Morgan), 96 B.R. 615 (Bankr. N.D.W. Va. 1989) (Friend, J.) (subordinating a deed of trust because it lacked notarization even though the deed was visible on the record).

317. Newton v. Herskowitz (\textit{In re} Gatlinburg Motel Enters., Ltd.), 119 B.R. 955 (Bankr. E.D. Tenn. 1990) (Stair, J.) (avoiding a mortgage under the strong arm power because the description of real estate fell off the recorded document even though the mortgage was listed in the debtor’s financial statement and the recorded document referred to other mortgages with proper description); Funding Sys. Asset Management Corp. v. Chemical Business Credit Corp. (\textit{In re} Funding Sys. Asset Management Corp.), 111 B.R. 500, 515-22 (Bankr. W.D. Pa. 1990) (Markovitz, J.) (avoiding security interests filed with the recorder of deeds of Allegheny County rather than with the prothonotary of that county); Carlyle v. City of Phila. Water Revenue Bureau (\textit{In re} Carlyle), 100 B.R. 217 (Bankr. E.D. Pa. 1989) (Scholl, J.) (holding that the city’s water liens were improperly recorded and invalid in bankruptcy when city placed a sign in the real estate recording office warning title searchers that water and sewer liens were indexed in the next room).

318. There are three alternate versions of the UCC in this regard. The third version requires two filings whenever the debtor has a place of business in only one county. U.C.C. § 9-401(1)(c) (1972) (Third Alternative Subsection (1)).


320. \textit{E.g.}, RCA Corp. v. Video East, Inc. (\textit{In re} Video East, Inc.), 41 B.R. 176 (Bankr. E.D. Pa. 1984) (Goldhaber, J.) (avoiding a security interest under the strong arm power because the debtor moved its place of business and the secured party failed to file in the UCC office of the debtor’s new place of business).
instead of an individual name.321 Sometimes it is hard to tell whether collateral is real or personal property,322 or whether a thing does or does not fall under vehicle certificate statutes323; the wrong guess can subject the lender to the strong arm power.324

321. U.C.C. § 9-402(7) (1972) ("A financing statement sufficiently shows the name of the debtor if it gives the individual, partnership or corporate name of the debtor, whether or not it adds other trade names or names of partners."); see Greenbelt Coop., Inc. v. Werres Corp. (In re Greenbelt Coop., Inc.), 124 B.R. 465 (Bankr. D. Md. 1991) (Derby, J.) (allowing postconfirmation use of the strong arm power because equity owners of the debtor were the only ones to benefit and avoiding lease held to be a security interest because filing under trade name instead of corporate name made the security interest unperfected).

322. See Bullock v. Roost (In re Gold Key Properties, Inc.), 119 B.R. 787 (Bankr. D. Or. 1990) (Radcliffe, J.) (holding that a lender who filed an assignment of debtor's rights as vendor in land sale contract in the real estate records but not in the UCC records took debtor's interest in real estate subject to a prior contract of sale and was perfected as to real property interest but not as to stream of payments that the vendee might pay); Southwest Nat'l Bank v. Southworth (In re Southworth), 22 B.R. 376 (Bankr. D. Kan. 1982) (Pusateri, J.) (same).

323. See United Nat'l Bank v. Corsica Enters., Inc. (In re Corsica Enters., Inc.), 40 B.R. 769 (Bankr. D.S.D. 1984) (Ecker, J.) (avoiding a security interest in trailer fertilizer spreaders because the secured party filed a financing statement on farm equipment but should have obtained a notation on the equipment's certificate of title).

324. Perhaps the cruelest of all recent strong arm cases is Judge Arthur Votolato's short but devastating opinion in In re Glenwood Associates, 134 B.R. 1012 (Bankr. D.R.I. 1991). In this case a buyer at a mortgage foreclosure sale purchased a foreclosure deed on June 11, 1991. The buyer recorded the deed at 2 p.m., on June 13. The debtor, however, beat him to the punch. The debtor filed a Chapter 11 bankruptcy petition on June 13, 1991, at 10:30 a.m. Id. at 1012. When the buyer moved for relief from the automatic stay, so that he could take possession of his property, Judge Votolato denied the motion and implied that the buyer was now a general creditor in the debtor's Chapter 11 proceeding. Id.

While it is true enough that the buyer held an unrecorded conveyance from the debtor, by virtue of the foreclosure sale, this opinion not only applies the strong arm power in a cruel way, but it also radically overapplies it. Surely the buyer should be a secured creditor in the bankruptcy, not an unsecured creditor, as Judge Votolato implied. As it stands, the buyer paid good cash for present title and probably lost everything because of a maliciously timed bankruptcy petition.

When a lien is foreclosed, the mortgagee sells at least two things to the buyer: the mortgage and the debtor's equity. See Carlson, Death and Subordination, supra note 94, at 558-63 (describing this as a minimal theory of foreclosure). Hence, it should follow that the most the debtor in possession could avoid is the buyer's unrecorded interest in the debtor's equity. The perfected mortgage, which is merged into the buyer's title, should still survive. On this reasoning, the buyer is a perfected secured creditor in the bankruptcy. Any other analysis—based on the absolute disappearance of the mortgage—gives a debtor in possession one of the least justifiable windfalls on record.

In Hegel's philosophy, when a concept is negated, it does not disappear. Rather, it is "sublated"—soaked up into the new concept that has replaced the old, inadequate concept. As Hegel put it:

[W]hat is sublated is not . . . reduced to nothing . . . it is a non-being . . .
As a result of the strong arm power (and its close relative, voidable preference law), bankruptcy lawyers love to comb the UCC and real estate files for tiny errors. If they find them, a no-asset case can suddenly become a case in which the lawyers might be paid. Bankruptcy then becomes economically viable and professionally profitable.\(^{328}\)

Whether this is a good state of affairs must be severely questioned. Traditional justifications for the strong arm power include such claims as this: (1) secret liens mislead general creditors, which is unfair or economically inefficient; (2) the strong arm power encourages secured parties to perfect their security interests, thereby providing the market with better information about the debtor’s state of title; or (3) an unperfected secured party is really the same as a general creditor and, therefore, ought to be treated equally in bankruptcy. An additional argument one sometimes hears is that the strong arm power is fair because it compensates for the unfair fact that state law—particularly the UCC—allows secured parties to soak up too many assets before bankruptcy—in exchange for dribbling out loans that never should have been extended. As a result, improvident general creditors—such as employees or the Internal Revenue Service—are left with nothing from the bankruptcy estate.

All of these statements certainly contain a grain of truth, but like all generalizations, they fail to do justice in individual cases. Must a court do a clear injustice, just because the Bankruptcy Code requires it?

Before a court engages in something so drastic as ignoring the clear dictates of the Bankruptcy Code, various other maneuvers should be investigated. For example, by manipulating state law—or even by changing its content—a court might proclaim a security interest perfected. This maneuver avoids the need to flout the will of Congress. We have seen in \textit{Stern v. Continental Assurance Co.} (\textit{In re Ryan})\(^{328}\) that Judge Queenan tried to do just this, but was blocked by appellate judges who insisted on taking state law precisely as it is found. Other

\hspace{1em} which had its origin in a being. It still has, therefore, \textit{in itself}, the determinateness from which it originates. \textit{To sublate} has a twofold meaning in the language: on the one hand it means to preserve, to maintain, and equally it also means to cause to cease, to put an end to.

\textsc{George W.F. Hegel, The Science of Logic} 107 (A. Miller trans. 1969). Accordingly, the buyer’s title contains within it not only the debtor’s equity interest—which the buyer has failed to record—but the mortgagee’s perfected security interest as well. The foreclosure of the mortgage is not the same as its disappearance.

\(^{325}\) Professor MacLachlan refers to bankruptcy practitioners as “accustomed to subsist on a diet foraged from secured creditors.” MacLachlan, \textit{supra} note 47, at 671.

bankruptcy courts, however, have succeeded in proclaiming changes in state law. For example, in Matos v. Gwinnett Bank & Trust Co. (In re Matos)\textsuperscript{327} a probate judge had attempted to record a mortgage without identifying who typed out the forms. Alabama law seemed to render such mortgages unrecordable. But Judge Robert Propst simply interpreted Alabama law to make such mortgages recordable, from his federal position on the bankruptcy court.\textsuperscript{328}

But sometimes state law is not conducive to this kind of manipulation. Hence, courts are often faced with the choice of following the Bankruptcy Code literally and imposing a loss on a secured party who made a harmless mistake or simply refusing to employ the statute. Not surprisingly, some judges have simply refused to enforce the strong arm power.

Sometimes, courts claim that the strong arm power should not be enforced because of congressional intent. Most notable is participation in mortgages—\textit{i.e.}, the secondary mortgage market. This market is specifically mentioned in Bankruptcy Code section 541(d):

\begin{quote}
Property in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest, such as a mortgage secured by real property, or an interest in such a mortgage, sold by the debtor but as to which the debtor retains legal title to service or supervise the servicing of such mortgage or interest, becomes property of the estate under subsection (a)(1) or (2) of this section only to the extent of the debtor's legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold.\textsuperscript{329}
\end{quote}

This section does show special solicitude for the secondary mortgage market, but, it fails to repeal the strong arm power. Indeed, in 1984 Congress increased the analytical barriers for disposing of the strong arm power by substituting "under subsection (a)(1) or (2)" for "under

\textsuperscript{327} 50 B.R. 742 (N.D. Ala. 1985) (Propst, J.), appeal dismissed, 790 F.2d 864 (11th Cir. 1986) (Tjoflat, J).

\textsuperscript{328} Id. at 745-48. For a less aggressive approach, see Sandy Ridge Oil Co. v. Centerre Bank National Ass'n (\textit{In re Sandy Ridge Oil Co.}, 807 F.2d 1332, 1337-38 (7th Cir. 1986), in which Judge Joel Flaum certified to the Indiana courts the question of whether a mortgage that did not disclose who physically prepared it, as required by Indiana law, would still put a subsequent purchaser on constructive notice. The Indiana Supreme Court later determined that documents containing such an error are nevertheless recordable, Sandy Ridge Oil Co. v. Centerre Bank Nat'l Ass'n (\textit{In re Sandy Ridge Oil Co.}, 510 N.E.2d 667 (Ind. 1987) (Dickson, J.), and the Seventh Circuit held that the trustee could not avoid the mortgage, Sandy Ridge Oil Co. v. Centerre Bank Nat'l Ass'n (\textit{In re Sandy Ridge Oil Co.}, 832 F.2d 75 (7th Cir. 1987) (per curiam).  

section (a).” 330 Since the strong arm power is referred to in section 541(a)(3), it is a fair reading of the 1984 amendments that Congress intended to subject the secondary mortgage market to the strong arm power. 331

Nevertheless, courts have simply declared that unperfected participations in mortgages are not subject to the strong arm power. For example, in 1986 Judge Robert Clive Jones wrote that “the trustee cannot use § 544(a) against the assignees of interests in mortgages. To allow otherwise would completely frustrate the protection Congress intended to give to the secondary mortgage market.” 332 Some pre-1984 cases, with considerably less statutory difficulty, declared the same. 333

The secondary mortgage market benefits from a specific reference in section 541(d), though courts still must ignore the vast weight of authority that privileges the strong arm power against the language of section 541(d). 334 Other courts, however, have ignored the strong arm


331. See infra text accompanying note 334.


Still other courts use some constructive trust maneuvers to preserve participations in mortgages. In Starr v. Bruce Farley Corp. (In re Bruce Farley Corp.), 612 F.2d 1197 (9th Cir. 1980), an assignee of a mortgage filed in the real estate records, but should have taken possession of the “instruments” under the UCC. Id. at 1199-1200. Judge Byrne ruled that if the debtor “wrongfully detained” the instruments in spite of the secured party’s demands to surrender possession, then the documents were held in constructive trust for the secured party. Id. at 1201. The case was remanded to determine whether such a demand had occurred prior to the debtor’s petition in bankruptcy. Thus, if the secured party was ignorant of the UCC’s jurisdiction and made an honest legal mistake, the secured party would have lost. Accord McTevia v. Adamo (In re Atlantic Mortgage Corp.), 69 B.R. 321 (Bankr. E.D. Mich. 1987) (Rhodes, J.) (holding that a constructive trust might be imposed on the assignor of mortgages if the res of the trust could still be traced).


334. See, e.g., National Bank v. Erickson (In re Seaway Express Corp.), 912 F.2d 1125, 1128 (9th Cir. 1990) (Beazer, J.); Belisle v. Plunkett, 877 F.2d 512, 516 (7th Cir.) (Easterbrook, J.), cert. denied, 493 U.S. 893 (1989). For a case holding that the strong arm power overrides a constructive trust even before the 1984 amendments to § 541(d),
power without the slightest bow toward congressional intent. Here are some examples.

In Pyne v. Hartman Paving, Inc. (In re Hartman Paving, Inc.) 335 a seller of real estate and mobile homes took back a purchase money mortgage. The form of the mortgage required the debtor Hartman to convey title to a third party. This third party was also a notary, and so he notarized the deed of trust. Apparently, under West Virginia law this notarization by the grantee made the deed unrecordable. 336 Judge Sam Ervin refused to invalidate the mortgage because Hartman had actual knowledge of the unperfected mortgage:

Because Hartman had actual notice, he cannot now claim that the improper acknowledgement caused him injury. To read West Virginia law as the district court did, therefore, permits Hartman to turn a legal "fiction" found in § 544(a) to unfair personal gain. In short, the lower court's interpretation of [West Virginia law] turns West Virginia law on its head. 337

Although Judge Ervin claims that the district court misread West Virginia law, it is clearly Judge Ervin who has misread federal law, which dictates that the trustee, as a bona fide purchaser of real estate, has that status "without regard to any knowledge of the trustee." 338 This was explained lucidly by Judge Harrison Winter in dissent, 339 but the majority of the panel elected not to take any instruction on this matter. 340 Because the majority's "mistake" was so entirely disingenuous, Hartman Paving must pass as a case in which the court simply refused to enforce the strong arm power.

335. 745 F.2d 307 (4th Cir. 1984).
336. Id. at 309 (citing Tavenner v. Barrett, 21 W. Va. 656 (1883) (Green, J.).
337. Id. at 310 n.5.
340. The majority opinion in Hartman Paving has been roundly criticized for its mistake. See Probasco v. Eads (In re Probasco), 839 F.2d 1352, 1354 n.2 (9th Cir. 1988) (Boochever, J.); Sandy Ridge Oil Co. v. Centerre Bank Nat'l Ass'n (In re Sandy Ridge Oil Co.), 807 F.2d 1322, 1325 (7th Cir. 1986) (Flaum, J.) (refusing to follow Hartman Paving and avoiding a mortgage that did not indicate who physically prepared the document); Bandell Invs., Ltd. v. Capitol Fed. Savs. & Loan Ass'n (In re Bandell Invs., Ltd.), 80 B.R. 210, 212 (D. Colo. 1987) (Kane, J.); Matos v. Gwinnett Bank & Trust (In re Matos), 50 B.R. 742 (N.D. Ala. 1985) (Propst, J), appeal dismissed, 790 F.2d 864 (11th Cir. 1986) (Tjoflat, J.).

In Hampton v. Hampton (In re Hampton)\textsuperscript{341} a divorcing spouse had a "special equity" in real property under Florida law, a property right akin to a resulting trust.\textsuperscript{342} As such, the beneficial interest of the spouse was voidable by a bona fide purchaser of the real estate in question.\textsuperscript{343} Judge Alexander Paskay simply refused to allow the Chapter 11 debtor to avoid his former spouse's property right in real estate:

There is no doubt that an unrecorded interest in real property is . . . voidable in bankruptcy under the special voiding power accorded the trustee pursuant to § 544(a) of the Bankruptcy Code. However, due to the particular factual situation of this case, as well as the sequence of events leading up to the sale of the subject property and ultimate resolution of this controversy, a mechanical application of these statutes would result in an unfair and patently unjust outcome.

This Court is satisfied that to permit any other result would be both inequitable and a misuse of the bankruptcy laws.\textsuperscript{344}

In Steinberg v. Morton (In re Buchanan)\textsuperscript{345} Judge Clive Bare also

\begin{itemize}
\item \textsuperscript{341} 43 B.R. 633 (Bankr. M.D. Fla. 1984).
\item \textsuperscript{342} Id. at 635. Resulting trusts arise by operation of law when property is conveyed to a stranger who pays no consideration, but who nevertheless takes title. In such a case, if no gift was intended, it is presumed that the stranger is the resulting trustee of the person who paid for the property. Torrez v. Torrez (In re Torrez), 63 B.R. 751, 754 (Bankr. 9th Cir. 1986) (Meyers, J.), aff'd, 827 F.2d 1299 (9th Cir. 1987) (Tang, J.).
\item Resulting trusts are usually thought to be no good against bona fide purchasers.
\item "A judgment creditor cannot have his debt satisfied out of the property held in the name of his judgment debtor under a resulting trust for another, unless it is made to appear that it was on the faith of the judgment debtor's apparent ownership that the credit was given which resulted in the judgment sought to be satisfied."
\item Estey v. Sharp Elecs. Corp., 409 So. 2d 217, 217 (Fla. Dist. Ct. App. 1982) (Dell, J.) (quoting Laganke v. Sutter, 187 So. 536, 589 (Fla. 1939) (Buford, J.)); see Torrez, 63 B.R. at 754. But see McAllester v. Aldridge (In re Anderson), 30 B.R. 995, 1006-07 (M.D. Tenn. 1983) (Paine, J., as special master for District Court Judge Nixon) ("[T]he courts of Tennessee have been very hesitant to infer the existence of a resulting trust where such a trust would defeat the rights of a subsequent bona fide purchaser under Tennessee's registration statutes.").
\item \textsuperscript{343} Hampton, 43 B.R. at 636.
\item \textsuperscript{344} Id. In Federal Deposit Insurance Corp. v. Whitaker (In re Whitaker), 18 B.R. 314 (Bankr. D. Kan. 1982), Judge Benjamin Franklin found that shares acquired by the debtor pursuant to a stock split were encumbered by an equitable lien that survived the trustee's strong arm power. Id. at 317. But he went on to remark:
\item Although § 544 allows the trustee to defeat unperfected security interests, this Court is accorded broad equitable powers under 11 U.S.C. § 105 to see that justice is done. The Court further finds that it would be inequitable to strip FDIC of half of its collateral [i.e., the stock split]. Had bankruptcy not occurred, FDIC would have been entitled to the additional shares.
\item Whitaker, 18 B.R. at 317.
\item \textsuperscript{345} 35 B.R. 849 (Bankr. E.D. Tenn. 1983).
\end{itemize}
refused to enforce the strong arm power under the following conditions: the debtors were straw men in the middle of a transaction in which A wished to convey land to B. That is, A conveyed to the debtors, and the debtors simultaneously conveyed the land to B. Hence, the debtors were both grantees and grantors of deeds. Nothing was recorded. Given that the debtors' interest in the land was so tenuous, Judge Bare decided to ignore the strong arm power and simply decided that B's land was out of the bankrupt estate.\textsuperscript{346}

Another convenient way to get rid of the strong arm power in a Chapter 11 case is for a debtor in possession to refrain from using it against insiders. Thus, in \textit{Boyd v. Martin Exploration Co.}\textsuperscript{347} Judge Morey Sear ruled that the creditors' committee could not raise the debtor in possession's obvious claim, as a bona fide purchaser of oil leases, to take free of the insiders' constructive trust.\textsuperscript{348} Hence, the insiders successfully wrested these leases from the debtor in possession, which they themselves controlled. To be sure, these creditors might have had a trustee appointed. But the grounds for such a move are basically limited to fraud, incompetence, or the best interest of the creditors.\textsuperscript{349} If a court thinks that enforcing the strong arm power is unjust, it is unlikely to find that the debtor in possession's refusal to pursue a strong arm action is grounds for removal.

\textsuperscript{346} \textit{Id.} at 853-54. \textit{Compare} Gerling v. Cirasuolo (\textit{In re} Cirasuolo), 48 B.R. 447 (Bankr. N.D.N.Y. 1985) (Marketos, J.). In this case an amateur mortgagee took deeds in fee simple absolute from the debtor. These overgenerous deeds were properly recorded. Apparently, wishing to redo the transaction, the mortgagee later reconveyed the property back to the debtor in fee simple. This reconveyance was never recorded. The debtor then executed a proper mortgage on behalf of the mortgagee. This mortgage also was never recorded. \textit{Id.} at 448-49. Nevertheless, the mortgage survived the strong arm power. \textit{Id.} at 451.

Properly speaking, the recorded deeds should not have put a subsequent bona fide purchaser from the debtor on notice of the unrecorded mortgage. The recorded deeds were undone by the later unrecorded conveyance back by the mortgagee to the debtor. These earlier deeds, though once properly recorded, were not recorded for the purpose of the later mortgage. Nor could a reader of the superseded recorded deeds, knowing that the mortgagee had conveyed the land back to the debtor, deduce that the debtor must have reconveyed the properties back to the mortgagee yet again. Nevertheless, Judge Leon Marketos not only attributed the trustee with knowledge of improperly recorded deeds, but with facts that could not possibly have been deduced from those deeds. \textit{Id.}

\textsuperscript{347} 56 B.R. 776 (E.D. La. 1986).

\textsuperscript{348} \textit{Id.} at 779-81.

\textsuperscript{349} Bankruptcy Code § 1104(a) provides that a trustee might displace the debtor in possession "(1) for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management, either before or after the commencement of the case, or similar cause, . . . ; or (2) if such appointment is in the interests of creditors." 11 U.S.C. § 1104(a)(1)-(2) (1988).
A. Constructive Trusts

1. Personal Property

If a court thinks the strong arm power is unfair, one way to defeat it without being seen as flouting the intent of Congress is to declare that the debtor in possession holds collateral for an unperfected secured party in constructive trust. As such, the collateral is expelled from the bankrupt estate under section 541(d).

Now this idea may not work if the collateral is real property because a bankruptcy trustee is a bona fide purchaser of real property and would take free and clear of the rights of any beneficiary of a constructive trust. But if the collateral is personal property, a constructive trust theory can save an unperfected security interest.

One real property case in which a constructive trust theory came in handy is McAllester v. Aldridge (In re Anderson). In Anderson Judge George Paine, as special master for Judge John Nixon, faced a situation in which buyers of real estate from Anderson took unrecordable Tennessee deeds. It appears that the notary forgot to aver that he knew Anderson personally. Hence, recordation of these deeds was ineffective.

Nevertheless, the buyers were in possession of the real property that they bought. In most states bona fide purchasers are on inquiry notice of the rights of persons in possession. While this also is true in Tennessee, judicial lien creditors take free and clear of all unrecorded deeds regardless of buyer possession. Hence, technically, the buyers stood to lose their homes because some notary forgot to allege his personal acquaintance with the debtor.

Here indeed was a test of the maxim that bankruptcy judges cannot do equity when clear statutory language commands otherwise. Judge Paine elected to ignore the statute and do the right thing:

This court, sitting as a court of equity, cannot ignore the blatant and manifest injustice which would occur if the trustee were given possession of these properties on behalf of the bankruptcy estate. Nor does this court feel that the courts of Tennessee would tolerate such an inequitable result if a creditor of the debtor attacked the validity of these conveyances under Tennessee's registration statutes. Under both federal and Tennessee law, a court may create a constructive

351. 30 B.R. 995, 1003 (M.D. Tenn. 1993).
352. Id. at 1002.
353. See supra note 251.
trust on behalf of a party if the court determines that “property has been acquired in such circumstances that the holder of the legal title may not in good conscience retain the beneficial interest.”

Thus, although Judge Paine did condition the constructive trust on payment by these homeowners of the trustee’s attorney fees, the buyers were able to keep their homes. The constructive trust survived the bona fide purchaser power because the buyers were actually in possession, which put the trustee on inquiry notice of the buyers’ rights. Meanwhile, the trustee as a judicial lien creditor was defeated because only bona fide purchasers—not creditors—take free of constructive trusts.

To declare Article 9 collateral the subject of a constructive trust completely defeats Article 9’s persecution of the unperfected security interest. The leading case in this vein is Sanyo Electric, Inc. v. Howard’s Appliance Corp. (In re Howard’s Appliance Corp.). In Howard’s Appliance Sanyo took a security interest in inventory. Sanyo filed a financing statement in New York, but the inventory, in contradiction of the security agreement, was stored in New Jersey, where Sanyo had never filed anything.

Although Sanyo clearly had an unperfected security interest, Judge Roger Miner imposed a constructive trust on the inventory in Sanyo’s favor. Constructive trusts, however, usually require some showing of wrongdoing on the part of the debtor. For example, a New Jersey judge had declared, “[A]ll that is required to impose a constructive trust is a finding that there was some wrongful act, usually, though not limited to, fraud, mistake, undue influence, or breach of a confidential relationship, which has resulted in a transfer of property.” Now the debtor in Howard’s Appliance had no sinister motive in storing the goods in New Jersey. Nevertheless, Judge Miner reckoned the debtor “must have known that, under the terms of the security agree-

355. Id. at 1013 (quoting Akers v. Gillentine, 231 S.W.2d 369, 371 (Tenn. 1948) (Burnett, J.)).
356. Id. at 1014. Judge Paine did invite the homeowners to sue the attorneys who prepared the deeds for malpractice. Id. at 1015.
357. Id. at 1007.
358. Id. at 1014. Cf. Lancaster v. Hurst (In re Hurst), 27 B.R. 740, 746 (Bankr. E.D. Tenn. 1983) (Bare, J.) (dispossessing equitable owner in possession, but relieving her of the obligation to pay rent “on the basis of equitable considerations”); see also supra text accompanying notes 202-22 (discussing Tennessee law on creditors and inquiry notice).
359. 874 F.2d 88 (2d Cir. 1989) (Miner, J.).
360. Id. at 94.
361. D’Ippolito v. Castoro, 242 A.2d 617, 619 (N.J. 1968) (Haneman, J); see also Sharp v Kosmalski, 351 N.E.2d 721, 723 (N.Y. 1976) (Gabrielli, J.) (describing the four traditional elements of a constructive trust as: “(1) a confidential or fiduciary relation, (2) a promise, (3) a transfer in reliance thereon and (4) unjust enrichment”).
ment, it was obligated to keep its Sanyo merchandise at its Nassau County location, and that by storing its inventory in New Jersey, it would frustrate Sanyo's interest in those goods.\textsuperscript{362} Hence, something resembling wrongful conduct on the part of the debtor was found. But it is also clear that Sanyo could have protected itself. Its shipping office knew that the debtor was storing the inventory in New Jersey, but neglected to tell the financial personnel.\textsuperscript{363} One must conclude that the wrongdoing by the debtor was pretty much fabricated from nothing.\textsuperscript{364}

Generally, courts do seem to condition constructive trusts on debtor wrongdoing. In \textit{Starr v. Bruce Farley Corp. (In re Bruce Farley Corp.)}\textsuperscript{365} an assignee of a mortgage filed in the real estate records, but should have taken possession of the "instruments" under the UCC.\textsuperscript{366} Judge William Matthew Byrne ruled that if the debtor "wrongfully detained" the instruments in spite of the secured party's demands to surrender possession, then the documents were held in constructive trust for the secured party.\textsuperscript{367} The case was remanded to determine whether a demand had occurred prior to the debtor's petition in bankruptcy. If the secured party was merely ignorant of the UCC's requirements and made no such demand, the secured party would lose its security interest.\textsuperscript{368}

There are, or ought to be, some limitations on the use of constructive trust theory to defeat the strong arm power. For example, in Lieb

\textsuperscript{362} Howard's Appliance, 874 F.2d at 94.

\textsuperscript{363} \textit{Id.} at 94-95.

\textsuperscript{364} Cf. Torres v. Eastlick (\textit{In re North Am. Coin & Currency, Ltd.}, 767 F.2d 1573, 1575-76 (9th Cir.) (Canby, J.) (emphasizing reluctance to find a constructive trust unless the debtor has engaged in actual fraud), \textit{modified}, 774 F.2d 1390 (9th Cir. 1985), \textit{cert. denied}, 475 U.S. 1083 (1986); Greenbelt Corp., Inc. v. Werres Corp. (\textit{In re Greenbelt Corp.}, Inc.), 124 B.R. 465, 467 (Bankr. D. Md. 1991) (Derby, J.) (reading \textit{Howard's Appliance} to mean that a debtor in possession might be estopped from asserting the strong arm power).

\textsuperscript{365} 612 F.2d 1197 (9th Cir. 1980).

\textsuperscript{366} \textit{Id.} at 1199-1200.

\textsuperscript{367} \textit{Id.} at 1201.

\textsuperscript{368} \textit{Accord} McTevia v. Adamo (\textit{In re Atlantic Mortgage Corp.}, 69 B.R. 321 (Bankr. E.D. Mich. 1987) (Rhodes, J.) (holding that a constructive trust might be imposed on an assignor of mortgages if the res of the trust could still be traced).

In Chemical Bank v. United States Lines (S.A.), Inc. (\textit{In re McLean Industries, Inc.}, 132 B.R. 271 (Bankr. S.D.N.Y. 1991), Judge Cornelius Blackshear held that insurance proceeds from a damaged mortgaged ship went to the secured party who perfected under the Ship Mortgage Act of 1920. \textit{Id.} at 282. But he also indicated that the proceeds would have been held for the secured party in constructive trust. \textit{Id.} at 285. In \textit{McLean} the secured parties and the debtor were held to be in a fiduciary relationship. The debtor had promised to have the secured parties named as insurance payees and did not do it. \textit{Id.} at 286. "Thus the imposition of a constructive trust on the insurance proceeds will prevent unjust enrichment by the Debtor, its estate, and the unsecured creditors, who were never the intended beneficiaries of the insurance." \textit{Id.} at 287.
v. Aronson (In re Mishkin)\(^{369}\) a debtor had defrauded some investors out of their funds and had given the funds away. Judge Howard Schwartzberg ruled that the debtor’s bankruptcy trustee could retrieve these funds for the benefit of their equitable owners. The strong arm power was cited as authority for this proposition.\(^{370}\) Yet section 541(d) makes clear that the equitable interest in a constructive trust is excluded from the bankrupt estate. Judge Schwartzberg did not explain how a judicial lien creditor of the debtor might reach funds that do not even belong, beneficially or otherwise, to the debtor after the debtor has given the funds away. One suspects that Judge Schwartzberg’s zeal in preventing the transferees of these funds from profiting led to a bending of the rules. If Judge Schwartzberg had ruled otherwise, the demobilized and disorganized investors would have had to pursue their own remedies under state law.

2. Unperfected Security Interests on Constructive Trusts

Vineyard v. McKenzie (In re Quality Holstein Leasing)\(^{371}\) raises the intriguing issue of what happens to an unperfected secured party whose debtor is defrauded out of the collateral by a third person who then files for bankruptcy. That is, A conveys an unperfected security interest to C; A is then fraudulently induced to transfer the equity to D, a bad faith purchaser who files for bankruptcy. At least with regard to personal property, the victim of fraud will obtain the property back because the trustee holds it for the victim in constructive trust. But can the unperfected secured party piggy-back on this victim’s right and avoid the strong arm power that belongs to the bankruptcy trustee of the perpetrator of the fraud?

In Quality Holstein Leasing, Borg-Warner Leasing claimed a security interest on an airplane (Plane One) owned by McKenzie. McKenzie wished to swap planes with another plane owner. This other plane (Plane Two) was encumbered by another security interest. Each lender agreed to the swap and, to facilitate the deal, each released its security interest on the plane to be swapped. Both security interests continued to be recorded in the FAA records. When McKenzie received Plane Two, Borg-Warner failed to perfect a security interest on it. Instead, it relied on the recordation of the other lender still on the books.

Soon thereafter, somebody filed a release in the FAA records with regard to the other lender’s security interest in Plane Two. Plane Two

\(^{370}\) Id. at 882.
\(^{371}\) 752 F.2d 1009 (5th Cir. 1985) (Williams, J.).
continued to be encumbered by Borg-Warner's unperfected security interest, but Borg-Warner had no theory by which to argue that its security interest was perfected. Thereafter, McKenzie transferred Plane Two to his corporate subsidiary. McKenzie and his spouse were 100% shareholders of the subsidiary. The subsidiary then filed bankruptcy.372

Borg-Warner tried to claim that McKenzie was the beneficial owner of a constructive trust in Plane Two, and thus, Borg-Warner reasoned, Plane Two was not part of the bankrupt estate of the corporate subsidiary. Instead, it was the property of McKenzie.373

Of course, McKenzie was not the victim but was the perpetrator of the fraud.374 Hence, McKenzie could hardly claim the plane back on a constructive trust theory.

Because the trustee for the bankrupt subsidiary was moving for summary judgment, Judge Jerre Williams was compelled to treat as true Borg-Warner's absurd allegation that McKenzie had been defrauded out of his plane by his own subsidiary.375 Nevertheless, Judge Williams held that Borg-Warner's unperfected security interest still fell to the trustee's strong arm power, even if McKenzie had a valid constructive trust claim. His grounds seem to be that the constructive trust should give way to the trustee's avoiding power:

[T]he trustee's strong-arm powers . . . serve essentially to marshal all of the debtor's assets, including some that the debtor itself could not recover, in order to enhance the resources available to the pool of creditors. Exercise of the powers allows the estate to avoid, among other interests, secret or otherwise unperfected liens on property that the debtor appears to own on the petition date.376

372. Id. at 1010-11.

373. Id. at 1014.

374. Id. at 1011 n.5 ("That his own company fooled him appears most doubtful."). McKenzie was a debtor who had transferred collateral to a buyer (his subsidiary) out of the ordinary course of business and with full knowledge of the unperfected security interest. Such a buyer takes subject to unperfected security interests. See U.C.C. § 9-301(1)(c) (1972) ("[A]n unperfected security interest is subordinate to the rights of . . . (c) in the case of goods . . . a person who is [a] buyer not in ordinary course of business, to the extent that he gives value and receives delivery of the collateral without knowledge of the security interest and before it is perfected . . . ."). Because the buyer, McKenzie's wholly owned corporation, had knowledge and could not claim priority under this provision, § 9-201 applied, and it assured priority to Borg-Warner. Section 9-201 provides: "Except as otherwise provided by this Act a security agreement is effective according to its terms between the parties, against purchasers of the collateral and against creditors." Id. § 9-201.

375. Quality Holstein Leasing, 752 F.2d at 1011 n.5.

376. Id. at 1014 (citing Jackson, supra note 54, at 732) ("The basis of those avoiding powers is to protect the advantages of bankruptcy's collective proceeding."). In fact, this thesis of Jackson—that the avoidance of an unperfected security interest enhances the value of the bankrupt estate—has been defeated. It enhances the recovery of the general
This argument is in fact an argument for avoiding all liens—even the perfected ones. Or for bank robbery by debtors—for that too would enhance the estate for the general creditors. Surely there is some limit on the principle that general creditors ought to be enriched, though Judge Williams was unable to articulate what this limiting principle might be.

Williams goes on to argue in a different vein:

A contrary holding would lead to untoward results. . . . It seems likely that creditors of third parties from whom a debtor fraudulently procured property would unduly burden the bankruptcy courts with claims similar to Borg-Warner's. Such claims would prove no less insidious to the orderly workings of the bankruptcy structure than the hidden interests and unperfected liens that section 544 in the main authorizes the trustee to avoid. The policy consists in doing equity among creditors. Remote creditors such as Borg-Warner should do no better than direct but unperfected security holders.\(^{377}\)

This too is inadequate reasoning. It is true that, if Borg-Warner loses, claimants in the position of Borg-Warner cannot clog the courts with law suits.\(^{378}\) But, in the abstract, this constitutes an argument against any cause of action, no matter how meritorious. If clearing court calendars is an unmodified good in the world, then all lawsuits ought to be banned, court personnel should be laid off, the law schools should be closed, and this law review should go out of business. Surely some limiting principle is at work to modify the assertion that law suits should not be filed. Law suits may have their bad features, but they undoubtedly have their good features as well—features for which Judge Williams does not account.

It is interesting to contemplate what would have happened if McKenzie did have a valid constructive trust claim—a fact Judge Williams assumed to be true for summary judgment purposes. In such a case the plane would be returned to McKenzie, but the trustee would have encumbered Borg-Warner’s unperfected security interest with its superior judicial lien—a lien on a lien.\(^{378}\) This implies that, if McKenzie

creditors, but the estate itself is not affected one way or the other if an unperfected security interest is valid in bankruptcy. All that is required to maximize the bankrupt estate—in cases in which going concern value exceeds liquidation value—is to hold the estate together. If that is achieved, how the enhanced pool is divided up is irrelevant. See David Gray Carlson, Philosophy in Bankruptcy, 85 Mich. L. Rev. 1341, 1350-52 (1987).

377. Quality Holstein Leasing, 752 F.2d at 1015.

378. In this regard, consider how rarified Borg-Warner’s argument was: it claimed an unperfected security interest on a constructive trust. This problem is not likely to recur very often.

379. Earlier, it was suggested that § 551—lien preservation—implies precisely this,
zie is not in default under his agreement with Borg-Warner, McKenzie can retain the plane. If McKenzie defaults, the bankruptcy trustee, but not Borg-Warner, can repossess the plane and hold a foreclosure sale. If the sale produces a surplus, the surplus would be returned to McKenzie, not to Borg-Warner (although Borg-Warner has a claim that the surplus money constitutes proceeds under UCC section 9-306(2)). Or, to say the same thing in different words, when McKenzie was (hypothetically) defrauded out of his airplane, he gave voidable title to the bankrupt subsidiary. This title was voidable only by McKenzie, not by Borg-Warner. As to the latter, the transfer was rightful. Therefore, the only part of the plane that is subject to the constructive trust is McKenzie’s equity in the plane. As to this equity, the subsidiary’s bankruptcy trustee has no claim under the strong arm power. But as to the nonvoidable title—that part of the title to which Borg-Warner’s unperfected security interest attached—the trustee is a judicial lien creditor who takes free of Borg-Warner’s unperfected security interest.

and that § 551 is simply the natural consequence of the strong arm power’s effect on an unperfected security interest. See supra text accompanying notes 90-93.

The susceptibility of Borg-Warner’s unperfected security interest to the trustee’s hypothetical judicial lien also depends on a certain construction of the following emphasized words of § 551: “Any transfer avoided under section . . . 544 . . . is preserved for the benefit of the estate but only with respect to property of the estate.” 11 U.S.C. § 551 (1988) (emphasis added). It is possible to argue that a lien preservation theory cannot work in Quality Holstein Leasing because the preserved lien attaches to property outside of the bankruptcy estate. See Waldschmidt v. Edgcomb Metals (In re Ward), 42 B.R. 946, 950-53 (Bankr. M.D. Tenn. 1984) (Lundin, J.) (holding that § 551 cannot preserve a lien on property that is not part of the bankruptcy estate). But this position would not be sensible. If the trustee’s hypothetical judicial lien attaches itself to the unperfected security interest, the avoided security interest is property of the estate in its own right. Also, the legislative history indicates that the emphasized language in § 551 is designed to prevent a trustee from asserting avoided tax liens against property that the debtor acquires after filing for bankruptcy. 124 Cong. Rec. 32,400 (1978); see Tracy Springer, Note, An Individual Debtor’s Right to Avoid Liens Under Section 506(d) of the Bankruptcy Code, 12 Cardozo L. Rev. 263, 281 (1990). Hence, it should be possible for the trustee to take over Borg-Warner’s unperfected security interest in this case.

380. See U.C.C. § 9-311 (1972) (preserving a debtor’s right to transfer its equity in collateral to a buyer over the opposition of a secured party).

381. Professor Jeffrey Davis calls Judge Williams’s opinion “both insightful and confusing, owing in part to the poor work of Borg-Warner’s lawyers.” Davis, supra note 224, at 39; see also id. at 45 (describing Quality Holstein Leasing as “a recent opinion that eschews strict application of the statute”). In Davis’s view, what is insightful is the destruction of the constructive trust. What is confusing is everything Judge Williams says.

But what I have argued in the text is that Judge Williams did not destroy the constructive trust. Rather, Williams only targeted the unperfected security interest on the constructive trust, which if existent might still exist for McKenzie’s benefit only, not for Borg-Warner’s benefit.
This principle, of course, could not be limited to constructive trusts. It would have to be extended to ordinary trusts as well. Suppose B owns the beneficial interest of a trust administered by T. B encumbers this beneficial interest to a secured party who never perfects. Suppose that T then files for bankruptcy. Section 541(d) makes clear that the beneficial interest of this trust is not part of T's bankruptcy estate, but, on Judge Williams's reasoning, the bankruptcy trustee of T can avoid the unperfected security interest on the beneficial trust interest, thereby enriching the general creditors of T. Yet one would think that the general creditors of T should not receive any bonuses from the beneficial interest of the trust.\footnote{382. In Quality Holstein Leasing, Borg-Warner also referred to fraudulent conveyance law, thought in a manner so incomplete that Judge Williams felt free to dismiss the argument without comment. 752 F.2d at 1012 n.5 ("We do not, therefore, consider a fraudulent conveyance claim except to observe that it would not affect our decision in this case."). Nevertheless, the claim might have had more merit than Williams gave it credit for.}

Another case in which constructive trusts mingled with unperfected security interests is \textit{Anderson v. South Carolina National Bank (In re McWhorter)}.\footnote{383. In this case a bank held a perfected security interest on the debtor's car. The debtor then went through a divorce and was ordered to convey the car to his spouse. The debtor transferred possession but never transferred title. When the debtor defaulted to the bank, the bank froze the debtor's checking account. Three days later the debtor was bankrupt. In spite of the bankruptcy, the state family court threatened the debtor with jail unless he completed the transfer of the car to his wife. The debtor finally did so. Meanwhile, the bank set off the debtor's checking account against the} In this case a bank held a perfected security interest on the debtor's car. The debtor then went through a divorce and was ordered to convey the car to his spouse. The debtor transferred possession but never transferred title. When the debtor defaulted to the bank, the bank froze the debtor's checking account. Three days later the debtor was bankrupt. In spite of the bankruptcy, the state family court threatened the debtor with jail unless he completed the transfer of the car to his wife. The debtor finally did so. Meanwhile, the bank set off the debtor's checking account against the...
debtor's obligation on the car—in violation of the automatic stay. Thinking it was paid, the bank released its lien on the car by delivering the certificate back to the spouse.

Faced with these facts, Judge Bratton Davis first declared the bank's postpetition setoff invalid. He gave the bank the option of "proceeding against the Buick automobile," or setting up an account in the name of the trustee and requesting setoff at a later time. 384 Thus, the bank was fully secured, to the extent of the potential setoff.

Second, Judge Davis erroneously suggested that the spouse's interest in the car at the time of bankruptcy was an equitable lien. If the spouse claimed an equitable lien, the spouse's right to possession would be only for the purpose of holding a sale to satisfy some debt. In fact, the spouse claimed an absolute interest in the car—as encumbered by the bank's perfected security interest. The spouse had no lien at all; rather she had equitable title. The debtor held legal title in constructive trust for the wife, which resulted in the legal conveyance of title from the debtor to the spouse.

Having declared that the spouse had an equitable lien in the car, Davis then ruled that the trustee's strong arm power voided the wife's equitable lien. This may have been erroneous because, under South Carolina law, equitable liens take priority over subsequent judicial lien creditors. 385 Hence, any equitable lien should have survived the strong arm power. 386 Furthermore, the court, in dictum, suggested that the bank should have its security interest reinstated in the car—because of the erroneous release. 387 This is the opposite of what the court should have done. The bank was fully secured by virtue of its setoff right. The security interest on the car was extra collateral. Under the doctrine of marshaling assets, 388 the court should have declared that the spouse owned the car free and clear of the bank, who could look to its cash collateral in the debtor's bankruptcy. Although, strictly speaking, marshaling requires a court to have common jurisdiction over both pools of collateral—the car should have been excluded from the estate on a constructive trust theory—marshaling in McWhorter was appropriately applied because the bank was seeking an equitable reinstatement of its security interest on the spouse's car. Given that this remedy was unnecessary in light of the cash collateral, the court should have re-

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384. Id. at 745.
386. See infra text accompanying notes 424-25.
387. McWhorter, 37 B.R. at 745 (giving the bank the option of "proceeding against the Buick automobile").
388. See supra text accompanying notes 192-98.
fused to reinstate the lien.389

3. Real Property

Although the status of a bona fide purchaser for value has homogenized the treatment of unperfected mortgages in bankruptcy, section 544(a)(3) also creates a few new disparities. For example, section 544(a)(3) destroys constructive trusts in real estate.

This allegation is the subject of some controversy. Judge Williams, in Vineyard v. McKenzie (In re Quality Holstein Leasing),390 suggested that the strong arm power cannot destroy constructive trusts because the debtor does not own any equity in the trust property and the property is therefore excluded altogether from the bankrupt estate under section 541(d) of the Bankruptcy Code.391 Under this theory the strong arm power cannot destroy constructive trusts in real estate.392

This argument was more plausible prior to 1984, when section 541(d) stated that trust property becomes property of the bankruptcy estate "under subsection (a)" only to the extent of legal title. After 1984, Congress changed these words to "under subsection (a)(1) or (2)."393 By implication, trust property can still become part of the bankruptcy estate under subsection (a)(3), which refers to the strong arm power. Hence, Judge Williams's argument that all constructive trusts are valid in bankruptcy has been weakened.

There is a second impediment in 'using the strong arm power to defeat a constructive trust in real estate: A trustee is a bona fide purchaser only of real estate "from the debtor, against whom applicable law permits such transfer to be perfected."394 In other words, the trustee is a bona fide purchaser of real estate who takes free of a constructive trust only if you think a constructive trust is perfectible under state law.395 "Perfection" is not a defined term in section 544(a)(3).396

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389. The result suggested would be consistent with the doctrine of exoneration, whereby, if property is to be given under a will, it must be given free and clear of lien. 3 American Law of Property § 11.17, at 75-78 (A. James Casner ed., 1952).
390. 752 F.2d 1009 (5th Cir. 1985).
391. Id. at 1013-14.
395. Emily L. Sherwin, Constructive Trusts in Bankruptcy, 1989 U. ILL. L. REV. 297, 325 n.114. In the original 1898 Act, § 67(a) provided, "claims which for want of record . . . would not have been valid liens as against the claims of the creditors of the bankrupt shall not be liens against his estate." An Act to Establish a Uniform System of Bankruptcy Throughout the United States, ch. 541, § 67(a), 30 Stat. 544, 564 (1898).
A constructive trust in real estate is probably perfectible. A lis pendens might be filed with regard to it,\textsuperscript{397} or the trust itself could be executed by court decree.\textsuperscript{398} Also, if the claimant is in possession of the trust property, the trust interest is good against any bona fide purchaser for value.\textsuperscript{399} Anyone of these events could "perfect" a constructive trust. Hence, it is probably the case that constructive trusts in real estate are avoided by the trustee's strong arm power.\textsuperscript{400}

If so, then constructive trusts on real property are void, but constructive trusts in personal property are quite valid.\textsuperscript{401} Hence, one anomaly—that some unperfected mortgages escape avoidance—is re-

\(\text{\textsuperscript{397} See National Bank v. Erickson (In re Seaway Express Corp.), 912 F.2d 1125, 1129 (9th Cir. 1990) (Bezeer, J.); Saghi v. Walsh (In re Gurs), 27 B.R. 163 (Bankr. 9th Cir. 1983) (Elliott, J.) (denying creditors' motion for summary judgment because constructive trust on real estate might survive strong arm power because lis pendens was filed); Omni Dev. & Servs., Inc. v. Servicios Solsan, S.A. (In re Omni Dev. & Servs., Inc.), 31 B.R. 482, 485 (Bankr. S.D. Fla. 1983) (Weaver, J.).\)

\(\text{\textsuperscript{398} Sherwin, supra note 395, at 301.}\)

\(\text{\textsuperscript{399} See supra text accompanying notes 245-54. But see Eads v. Probasco (In re Eads), 69 B.R. 730, 734-35 (Bankr. 9th Cir. 1986) (Elliott, J.) (finding no constructive notice), rev'd sub nom. on other grounds, Probasco v. Eads (In re Probasco), 839 F.2d 1352, 1356 (9th Cir. 1988) (Elliott, J.).}\)

\(\text{\textsuperscript{400} Professor Emily Sherwin points out the policy against secret liens is in part aimed at collusion between the debtor and some cooperative creditor. Constructive trusts, however, are not collusive in this way. Hence, at least from this perspective, the strong arm policy against secret liens should not be aimed at constructive trusts at all. Sherwin, supra note 395, at 322-23.}\)

\(\text{\textsuperscript{401} This is ironic because, prior to the Bankruptcy Code's enactment, Congress spent considerable time trying to knock out the use of equitable liens as a means of beating the trustee's strong arm and voidable preference powers. It would appear that the failure of Congress to revive these provisions has led to a renaissance of the equitable lien. See Davis, supra note 224, at 2. Perhaps Congress was under the misimpression that Article 9 clearly displaces the equitable lien. See Morris, supra note 19, at 753 ("The equitable lien problem has finally been put to rest—not by any reform of bankruptcy law, but by the expunging of such liens from the local law through the adoption of the Uniform Commercial Code.").}\)
placed by another—that constructive trusts on personal property escape avoidance.402

One judge has devised a brilliant device whereby constructive trusts on real estate might be protected. According to this interpretation of the strong arm power, transfers of real property by someone other than the debtor cannot be subjected to the strong arm power. In In re Mill Concepts Corp.403 a third party had transferred land fraudulently to the debtor. The debtor allegedly held this land in constructive trust for the transferor’s defrauded creditor. The debtor then filed for bankruptcy and, as debtor in possession, claimed the land free and clear of constructive trust or fraudulent conveyance liability.

Because bona fide purchasers of real estate usually take free of constructive trusts and fraudulent conveyance liability,404 this claim at first glance would seem to have been meritorious. Judge James Queenan thought otherwise. By a ruthless parsing of section 544(a), he reasoned that section 544(a)(3) avoids only transfers by the debtor.

His reasoning works as follows. The opening words of section 544(a) refer to transfers by the debtor, but only in the conjunctive tense: “The trustee shall have . . . the rights and powers of, or may avoid any transfer of property of the debtor . . . that is voidable by” lien creditors or bona fide purchasers of real property.405 But section 544(a)(3) specifically negates the possibility that a trustee has the broad “rights and powers” of a bona fide purchaser because it refers to “such transfer.”406

Unlike subparagraphs (1) and (2), subparagraph (3) speaks in terms of a transfer. It describes the hypothetical bona fide purchaser only in reference to a transfer made by the debtor, in these words: “a bona fide purchaser of real property, other than fixtures, from the debtor, against whom applicable law permits such transfer to be perfected . . . .” The words “such transfer” necessarily have reference to the transfer previously described in the body of § 544(a) in the phrase “may avoid any transfer of property of the debtor . . . that is voidable by.” Nowhere in subparagraph (3) is there any indication of a grant of

402. Sherwin, supra note 395, at 324-25. Professor Sherwin takes the position that constructive trusts are purely remedial. As such, a bankruptcy court should always reassess the equities of each case and determine whether the general creditors of the debtor have been unjustly enriched by the debtor’s dealings with the trust claimant. See id. at 317, 324-25, 339-61. For a case that simply refuses to preserve from the strong arm power a constructive trust established by Ohio law with regard to pension funds, see Ironworkers Combined Fund v. Society Bank, N.A. (In re Gibbons-Grable Co.), 100 B.R. 901 (Bankr. N.D. Ohio 1989) (Williams, C.J.).


406. Id.
power beyond the ability to avoid transfers of property made by the debtor.407

In other words, "such transfer" in section 544(a)(3) eliminates "rights and powers" in real estate cases, so that the strong arm power for real estate can be reduced to these words:

    The trustee . . . may avoid any transfer of property of the debtor . . . that is voidable by . . . (3) a bona fide purchaser of real property, other than fixtures, from the debtor, against whom applicable law permits such transfer to be perfected, that obtains the status of a bona fide purchaser and has perfected such transfer at the time of the commencement of the case, whether or not such a purchaser exists.408

On Judge Queenan's reading, the "rights and powers" clause falls out of the statute because of the emphasized words in section 544(a)(3).409

Judge Queenan's reading of section 544(a)(3) probably preserves (and is certainly intended to preserve) constructive trusts in real estate from the strong arm power. If $D$ fraudulently induces $X$ to convey real estate to $D$, $D$ probably has not transferred the beneficial interest in a constructive trust to $X$. Rather, $X$ retained the beneficial interest and conveyed only the remaining legal title to $D$. Retained interests of this sort are not transfers by the debtor. The Bankruptcy Code's definition of transfer is "every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or with an interest in property, including retention of title as a security interest and foreclosure of the debtor's equity of redemption."410

Hence, title retained by $X$ as a security interest is a transfer by the debtor, but property retained as the beneficial interest in a trust might not be.411 Nor can it be said that the beneficiary of a constructive trust retains title to the property, if title equates with a legal interest. Rather, the debtor has the legal title, $X$ has retained a nontitular beneficial interest, and no transfer by the debtor has occurred.412

One good side effect of Judge Queenan's reading of section

409. In contrast, the trustee's hypothetical judicial lien encumbers property that the debtor has not transferred. *In re Digaudio*, 127 B.R. 713 (Bankr. D. Mass. 1991) (Queenan, J.) (holding that because judicial lien encumbers debtor's tenancy by the entirety, the tenancy is part of the bankrupt estate and is not exempt).
411. Though, to be sure, the fact that retained security interests are included in the definition suggests that other retained interests not mentioned might be included as well.
412. *Accord Saghi v. Walsh (In re Gurs)*, 34 B.R. 755, 757 (Bankr. 9th Cir. 1983) (Elliot, J. & Volinn, J.) (holding that filing of a lis pendens perfects a claim of ownership and is not a voidable transfer).
544(a)(3) is that it would prevent a bankruptcy trustee from avoiding a beneficial interest in an ordinary trust (at least when the trustee is not the grantor). One of the embarrassments of section 544(a)(3)'s wide sweep is that the creditors of a trustee take priority over the beneficiary if the trustee files for bankruptcy.413

Another good side effect is that the law of constructive trusts in bankruptcy is rendered uniform between personal and real property. Constructive trusts on personal property survive a bankruptcy trustee's power as a hypothetical judicial lien creditor.414 Under Queenan's reading of section 544(a)(3), they survive on real property as well, but only because the bona fide purchaser status of the trustee pertains to transfers made by the debtor.

There are bad effects as well. If Judge Queenan is right, unrecorded mortgages survive in bankruptcy if they were created by someone other than the debtor. Suppose X owns Blackacre and conveys a mortgage to A, who never records. X conveys the remaining equity interest in Blackacre to D, who, because of knowledge, takes subject to A's mortgage. Under Judge Queenan's theory, A's unrecorded mortgage survives the strong arm power because D did not transfer the mortgage to A. Furthermore, because section 547(b) uses the identical "transfer of the debtor" language that is used in section 544(a)(3), neither is A's mortgage a voidable preference.415

Other courts have specifically linked "rights and powers" with section 544(a)(3). In National Bank v. Erickson (In re Seaway Express Corp.)416 a secured party had the right to proceeds from accounts receivable. One account debtor paid the debtor by conveying real estate, so that the real estate became Article 9 proceeds of an account receivable. The secured party had not perfected its security interest in this real estate, and so the secured party was reduced to arguing that the real estate was held for it by the debtor in a constructive trust. Judge Robert Beezer, ignoring or overlooking the grammatical move proffered by Judge Queenan, wrote:

413. See In re Mill Concepts Corp., 123 B.R. 938, 945-46 (Bankr. D. Mass. 1991) (Queenan, J.), Here I assume that section 544(a)(3) overrides section 541(d) for reasons already explained. See supra text accompanying notes 392-98.
414. See supra text accompanying notes 350-70.
415. Possibly, in a title state, A "[retained] title as a security interest" when X conveyed to D, and hence A's mortgage is deemed a transfer by the debtor. 11 U.S.C. § 101(64) (Supp. II 1990). But this trick would not work in a lien theory state where A does not retain title.

Of course, in a state where judicial lien creditors are protected by the recording act, the trustee can still avoid unrecorded mortgages created by someone other than the debtor because, even under Judge Queenan's reading, "rights and powers" belong fully to the trustee as hypothetical judicial lien creditor.

416. 912 F.2d 1125 (9th Cir. 1990) (Beezer, J.).
Congress granted the bankruptcy trustee enhanced powers over real property owned by the debtor at the commencement of the case and not transferred. Under 11 U.S.C. § 544(a)(3), the trustee is granted, in addition to the avoidance powers, "the rights and powers of . . . a bona fide purchaser of real property . . . from the debtor."  

Judge Beezer therefore used the strong arm power to avoid any constructive trust claim to the real estate.

Similarly, in Belisle v. Plunkett a general partner used partnership assets to buy a leasehold interest in land located in the Virgin Islands. Judge Frank Easterbrook wrote:

Nothing in the text or function of § 544(a)(3) makes the force of this claim turn on whether [the debtor] once owned the leasehold and then sold it to the partnerships . . . or whether, instead, [the debtor] acquired the leasehold through the partnerships . . . Section 544(a)(3) allows the trustee to have a bona fide purchaser's rights or avoid a transfer, so a "transfer" by the debtor cannot be a necessary condition of the exercise of the strong-arm power. The statute mentions "transfer" only in the sense of the hypothetical transfer that measures the trustee's rights: if a hypothetical bona fide transferee from the debtor would come ahead of the "true" owner's rights, then the trustee takes ahead of the true owner.

B. Equitable Liens

Equitable liens are another means by which courts might defeat the strong arm power if justice so requires. The adjective "equita-

417. Id. at 1128 (footnote omitted).
419. In the Virgin Islands, leasehold interests are deemed to be real property. V.I. Code Ann. tit. 27, § 421 (1970 & Supp. 1991). Under the ancient common law, they were personal property. For the case in which the bona fide purchaser test could not be applied to a leasehold held in constructive trust (because leaseholds are personal property under California law), see Placer Savings & Loan Ass’n v. Walsh (In re Marino), 813 F.2d 1562, 1566 (9th Cir. 1987) (Pregerson, J.).


420. Belisle, 877 F.2d at 515.
421. Defeating the strong arm power is not the only utility an equitable lien might have. If a trustee wrongfully diverts assets of the bankrupt estate into his own house, the bankrupt estate might have an equitable lien on the house to recover the defalcations. McMerty v. Herzog, 661 F.2d 1184 (8th Cir. 1981) (per curiam) (imposing a constructive trust on proceeds of funds that the trustee wrongfully diverted from the bankruptcy estate), cert. denied, 455 U.S. 943 (1982). Or if a debtor diverts the bankruptcy estate's
ble," of course, implies the lien is good against everybody except bona fide purchasers for value. That is to say, equitable liens are sometimes thought to take priority over subsequent judicial lien creditors, and hence, insofar as the collateral is personal property, equitable liens

money into exempt property, a court might give the bankrupt trustee an equitable lien on the homestead. In contrast, an ordinary right to a judicial lien could not reach this homestead. Friedman v. Luengo (In re South Florida Title, Inc.), 104 B.R. 489, 491 (Bankr. S.D. Fla. 1989) (Britton, J.). One court used an equitable lien theory to get around the fact that a postpetition lender had failed to obtain court approval for its postpetition loan, which enriched the bankrupt estate. In re Smith, 72 B.R. 344, 351-52 (Bankr. S.D. Ohio 1987) (Clark, J.), aff'd, 119 B.R. 558 (S.D. Ohio 1989) (Rice, J.).

422. Justice Oliver Wendell Holmes expressed the early legal realist suspicion that "the phrase equitable lien may not carry the reasoning further or do much more than express the opinion of the court that the facts give a priority to the party said to have it." Sexton v. Kessler & Co., 225 U.S. 90, 98-99 (1912).

423. Judge Thomas Small remarked: "There are circumstances in which an equitable lien will defeat the rights of a bona fide purchaser, but those circumstances are rare." In re Price, 97 B.R. 264, 265 (Bankr. E.D.N.C. 1989) (Small, J.) (citing Angeles Real Estate Co. v. Kerxton (In re Construction Gen., Inc.), 737 F.2d 416 (4th Cir. 1984) (Winter, J.).) Judge Small does not delineate what these circumstances are, but Construction General was a personal property case, and therefore the bankruptcy trustee was not a bona fide purchaser. See infra text accompanying notes 450-60.

424. See McKee-Berger-Mansueto, Inc. v. Board of Educ., 691 F.2d 828, 837 (7th Cir. 1982) (Cudahy, J.) ("[U]nder Illinois law an equitable assignment has priority over a subsequently served garnishment summons . . . ."); Henry v. First Nat'l Bank, 595 F.2d 291, 309 (5th Cir. 1979) (Ainsworth, J.) ("The equitable as well as the legal property interests of the United States enjoy immunity from unconsented judicial process."); cert. denied, 444 U.S. 1074 (1980); Storage Technology Corp. v. Storage Technology Fin. Corp. (In re Storage Technology Corp.), 55 B.R. 479, 484 (Bankr. D. Colo. 1985) (Brumbaugh, J.) ("The law is clear in Colorado that, with regard to personalty, a beneficiary of an equitable lien prevails over a judicial lien creditor.").

Henry has been criticized by those judges who believe that equitable liens are per se invalid in bankruptcy. Thus, in In re Joliet-Will County Community Action Agency, 847 F.2d 430 (7th Cir. 1988), Judge Richard Posner concluded that the use of the term "equitable lien" in bankruptcy was "unfortunate" and that the Henry court used the term "equitable lien" in a "special sense, equivalent to beneficial ownership." Id. at 433; see United States v. Marchand (In re Southwest Citizens' Org. for Poverty Elimination), 91 B.R. 278, 287 (Bankr. D.N.J. 1988) (Gambardella, J.) (taking similar facts to those of Henry and renaming the creditor's interest a "reversionary interest" rather than an equitable lien). All these cases dealt with the status of government grants when the debtor filed for bankruptcy without having spent all the money.

Meanwhile, McKee has been misinterpreted to mean that equitable liens in Illinois must be perfected to survive the trustee's strong arm power. Olsen v. Russell (In re Kleckner), 81 B.R. 464, 467 (Bankr. N.D. Ill. 1988) (DeGunther, J.), rev'd, 93 B.R. 143 (N.D. Ill. 1988) (Roszkowski, J.). A close reading of McKee shows that the creditor in that case failed to perfect under an attorneys' lien statute, but was nevertheless saved by an equitable lien. On appeal, Judge Stanley Roszkowski ruled that because the creditor (an attorney) already had been paid a contingency fee from a judgment recovered from an insurance company, it made no sense to call the payment an equitable lien. He preferred to call it an "equitable assignment." Olsen, 93 B.R. at 150.

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survive the bankruptcy trustee's strong arm power. In this respect, they are like constructive trusts. There is this key difference, however. A debtor who holds constructive trust property holds it only for the purpose of returning it to its equitable owner. The equitable owner has no obligation to sell the property and return any surplus to the debtor. The holder of an equitable lien, however, is obliged to sell the property and return the surplus. Accordingly, Bankruptcy Code section 541(d) expels trust property from the bankruptcy estate, but it has no such effect with regard to equitable liens. Collateral encumbered by equitable liens, if the liens survive avoidance, remains property of the estate and is subject to use or sale, provided the bankruptcy trustee supplies adequate protection of the secured creditor's lien.

Equitable liens were notoriously used in the early part of the century to save unperfected security interests from avoidance in bankruptcy. Because they were good against nonpurchasers, the strong arm power was originally insufficient to dispense with equitable liens. In response, Congress enacted detailed and difficult legislation to make sure that unperfected security interests were voidable in spite of equitable lien theory.


427. See Breitowitz, supra note 308, at 378-84.

428. According to § 60(a)(6) of the Bankruptcy Act:

The recognition of equitable liens where available means of perfecting legal liens have not been employed is hereby declared to be contrary to the policy of this section. If a transfer is for security and if (A) applicable law requires a signed and delivered writing, or a delivery of possession, or a filing or recording, or other like overt action as a condition to its full validity against third persons other than a buyer in the ordinary course of trade claiming through or under the transferor and (B) such overt action has not been taken, and (C) such transfer results in the acquisition of only an equitable lien, then such transfer is not perfected within the meaning of paragraph (2). Notwithstanding the first sentence of paragraph (2), it shall not suffice to perfect a transfer which creates an equitable lien such as is described in the first sentence of paragraph (6), that it is made for a valuable consideration and that both parties intend to perfect it and that they take action sufficient to effect a transfer as against liens by legal or equitable proceedings on a simple contract: Provided, however, That where the debtor's own interest is only equitable, he can perfect a transfer thereof by any means appropriate fully to transfer an interest of that character: And provided further, That nothing in paragraph (6)
With the advent of the UCC, there apparently grew up the impression that Article 9 repealed old jurisprudence with regard to equitable liens. There is some reason to believe it. The UCC defines a security interest as "an interest in personal property or fixtures which secures payment or performance of an obligation." Section 9-102 provides that "this Article applies (a) to any transaction (regardless of its form) which is intended to create a security interest in personal property or fixtures." It is hard to argue that an equitable lien is entirely separate from the intent of the parties to create a lien because the intent of the parties is often the origin of an equitable lien. Accordingly, several courts have stated that Article 9 now governs equitable liens.

The chief feature of this governance, of course, is that, unless the lienholder files an Article 9 financing statement or takes possession of the collateral, intervening judicial liens take priority over the equitable lien.

On the other hand, if one emphasizes the equitable lien's remedial—rather than its contractual—origin, then it could be said that

shall be construed to be contrary to the provisions of paragraph (7).
430. Id. § 9-102(1)(a) (1972).
431. See In re Hendleman, 91 B.R. 475, 476 (Bankr. N.D. Ill. 1988) (Barliant, J.) ("An equitable lien finds its basis in express or implied contract . . . ."); In re Jones, 37 B.R. 969, 976 (Bankr. N.D. Tex. 1984) (Bristor, J.) ("The fundamental element necessary to creation of an equitable lien is the existence of an express or implied contract, because an equitable lien does not arise except out of contract between the parties."); Omni Dev. & Servs., Inc. v. Servicios E. Inversiones Solsan, S.A., 31 B.R. 482, 484 (Bankr. S.D. Fla. 1983) (Weaver, J.) ("An equitable lien will only arise where the intention to create such a charge clearly appears in the language and attending circumstances of a transaction, and strict proof of such intention is required.").
Article 9 does not govern the equitable lien after all. That is, equitable liens come from the court, not from a contract. If equitable liens are not governed by Article 9, then Article 9's subordination of unperfected security interests to judicial liens does not apply. In its place, one might expect to find the usual equitable rule that the property interest is good against everyone but bona fide purchasers for value. Under this rule an equitable lien on personal property would survive the strong arm power, although an equitable lien on real property might succumb. That is, the equitable lien becomes similar to a constructive trust, with regard to the strong arm power.\textsuperscript{435}

\textsuperscript{435} (Bankr. W.D. Mo. 1986) (Stewart, J.) (holding that an equitable lien arises when the creditor is prevented from perfecting a security interest); Security State Bank v. Cap (\textit{In re} Van Winkle), 54 B.R. 466, 469 (Bankr. D.S.D. 1985) (Ecker, J.) (holding that an equitable lien should be reserved for cases in which the secured party did everything possible to perfect a security interest but failed because of the actions of another). Judge Letitia Clark, for example, described the Texas equitable lien as follows:

An equitable lien arises either from a written contract which shows an intention to charge some particular property with a debt or obligation, or is implied and declared by a court of equity out of general considerations of right and justice as applied to the relations of the parties and circumstances of their dealings.

Spring Serv. Texas, Inc. v. McConnell (\textit{In re} McConnell), 122 B.R. 41, 45 (Bankr. S.D. Tex. 1989) (Clark, J.) (citations omitted); \textit{see} Bob Cooper, 55 B.R. at 612 (same under Florida law). An emphasis on the latter formulation would lead to the view that Article 9 does not make equitable liens susceptible to judicial liens.

In McConnell the debtor purported to give a deed of trust on real estate he did not own. Rather, the debtor's corporate subsidiary owned the property. 122 B.R. at 42-43. Judge Clark held that the creditor could not claim an equitable lien on property belonging to a third party. Id. at 46. Judge Clark also ruled that the creditor had no standing to assert veil piercing, implying that this right belonged exclusively to the trustee, who had not yet pursued this theory. Id. at 43.

Judge Clark went on to rule that an equitable lien was not proper because the creditor had an adequate remedy at law:

\begin{quote}
(1) It could have obtained the Deed of Trust from the record title owner. This it failed to do. This court finds that, under the facts and circumstances of the present case, it would be highly inappropriate to recognize and establish that [the creditor] has an equitable lien on the Galveston property.
\textit{Id. at} 46. If an adequate remedy at law means that someone will voluntarily give you the property you seek, then equitable liens must go out of existence because it is always adequate for the other side to give you what you desire.
\end{quote}

A more defensible statement about adequate remedies at law is the rule that no equitable lien arises if the creditor has not used every orthodox means to perfect the lien. \textit{See} Associates Commercial Corp. v. Trim-Lean Meat Prods., Inc. (\textit{In re} Trim-Lean Meat Prods., Inc.), 10 B.R. 333 (D. Del. 1981) (Stapleton, J.) (refusing to find an equitable lien because the creditor did not take all possible reasonable steps to perfect its lien).

435. Thus, in Einoder v. Mount Greenwood Bank (\textit{In re} Einoder), 55 B.R. 319 (Bankr. N.D. Ill. 1985), Judge Robert Ginsberg ruled that the UCC makes equitable liens vulnerable to judicial liens, but he recognized that some bankruptcy courts will not subject equitable liens to the strong arm power if the equitable lien is a remedy for the
Nevertheless, even when Article 9 does not apply, some courts simply declare that judicial liens take priority over equitable liens. Article 9 does not apply to security interests in insurance policies, and so insurance cases become convenient testing medium for the equitable lien under laboratory conditions. In *In re Tyson Metal Products, Inc.* a secured party claimed a blanket lien on everything. The debtor had life insurance policies, which had a cash surrender value, on the lives of its key officers. After deciding that the parties did not intend to encumber the insurance policies in the first place, the court ruled that an equitable lien theory would not have availed because equitable liens are subordinate to judicial liens. According to Judge Joseph Cosetti:

[E]ven if an equitable lien were created, it would nevertheless be subordinate to the subsequent legal lien of a judgment creditor. Thus, such lien is invalid against the trustee who has the status of a hypothetical lien creditor. The legislative history of the Bankruptcy Code makes clear that Article IX of the U.C.C. treats equitable liens as "unperfected security interests which the trustee can in any case set

debtor's fraud. *Id.* at 328-29. That is, the UCC applies when a contractual origin is emphasized, and the UCC does not apply when the remedial origin is emphasized.

436. *E.g.*, Rosenbaum v. Century Indem. Co. (*In re Ultimite Corp.*), 168 F.2d 917, 919 (2d Cir.) (Augustus Hand, J.) ("[I]f any equitable lien were held to have arisen, it would be subordinate to the rights of judgment-creditors and trustees in bankruptcy . . . "). *cert. denied*, 335 U.S. 885 (1948); Ormond Wholesale Co. v. Moore (*In re Moore*), 54 B.R. 781, 783 (Bankr. E.D.N.C. 1985) (Small, J.) ("Nor are equitable liens recognized 'as to a receiver representing general creditors of a receivership estate,' unless the 'equities' take the case out of the general rule.") (quoting *Eno Inv. Co. v. Protective Chem. Lab., Inc.*, 63 S.E.2d 637 (N.C. 1951)).

437. U.C.C. § 9-104(f) (1972) ("This Article does not apply . . . to a transfer of an interest in or claim in or under any policy of insurance, except as provided with respect to proceeds . . . ").

438. Sometimes insurance claims are parasitic on real estate recordings. Judge Thomas Small upheld an equitable lien to insurance proceeds against the strong arm power in a case in which the collateral in question was insurance proceeds from the destruction of real estate. *Moore*, 54 B.R. at 784. These proceeds were held to be a real estate interest, not personal property. Because a deed of trust in the real estate had been recorded and referred to the insurance policy, it was held that a bona fide purchaser for value would take subject to the secured creditor's superior right to the insurance proceeds. *Id.*


440. Judge Cosetti's arguments in this vein were tendentious. The security agreement in question was very broad, but it referred to the grant of a security interest "under the UCC." *Id.* at 183. Judge Cosetti reasoned that, because security interests on insurance policies are not governed by Article 9, the parties must not have intended to encumber the insurance proceeds at all. *Id.* at 186. More likely, the parties simply overlooked the possibility that some of the collateral was not governed by Article 9 and intended instead a floating lien on all personal property.
Now the status of an equitable lien against a judicial lien should have been decided as a matter of nonuniform Pennsylvania law.442 Yet Judge Cosetti relied on a congressional statement about the content of the UCC443 and a case by a New York bankruptcy judge that arguably interpreted New York law.444 Hence, Judge Cosetti’s doctrinal justification for his ruling is weak indeed.446

A similar ipse dixit against equitable liens with no grounding in state law occurred in Weissing v. Gerring (In re G & R Builders, Inc.),446 in which Judge Alexander Paskay wrote:

[E]quitable liens have found a hostile environment in bankruptcy cases. The Act of 1898 expressly dealt with this subject and provided in § 60(a)(6), that “[t]he recognition of equitable liens where available

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444. Tyson Metal, 117 B.R. at 186 (citing Hassett v. Revlon, Inc. (In re O.P.M. Leasing Servs., Inc.), 23 B.R. 104 (Bankr. S.D.N.Y. 1982) (Lifland, J.)). Judge Lifland, like Judge Cosetti, thought the legislative history of the Bankruptcy Code indicates that the meaning of the UCC is to eliminate the equitable lien. O.P.M. Leasing, 23 B.R. at 120.

445. Perhaps, to be charitable, the Tyson Metal opinion can be viewed as an exercise of Professor Sherwin’s suggestion that bankruptcy judges independently decide whether the equities of a specific case warrant the imposition of a constructive trust or equitable lien. See Sherwin, supra note 395, at 340-61.

For a case upholding an equitable lien on insurance proceeds under Florida law, see In re Terra Villa Apartments, Ltd., 101 B.R. 755, 758-59 (Bankr. N.D. Fla. 1989) (Killian, J.).

means of perfecting legal liens have not been employed is hereby declared to be contrary to the policy of this section." This provision was consistent with one of the overall policies of the Bankruptcy Act, that is, to place the trustee in the position of an ideal nonexisting judgment lien creditor whether or not such creditor, in fact, existed.

While it is true that the Bankruptcy Code has no corresponding provision of § 60(a)(6) of the Bankruptcy Act, nevertheless this Court is satisfied that the special voiding powers accorded to the Trustee under § 544 of the Bankruptcy Code, the “strong arm” clause, impliedly includes the power of the Trustee to defeat unperfected liens such as the one in this instance . . . .447

This too changes some important parameters of the strong arm power. The strong arm power refers solely to state law; yet the trustee’s implied power to defeat equitable liens does not necessarily have its grounding in state law at all. Furthermore, the policy of making the trustee into an ideal judicial lien creditor does not defeat equitable liens because the whole idea of that doctrine is to place the equitable lien holder in a better position than that of subsequent judicial lien creditors.

In spite of the UCC and other sources of malice, equitable liens have sometimes survived the strong arm power448 even without the aid

447. Id. at 660.

Judge Merritt Deitz wrote:

With all deference to the bank’s plea that “equity regards as done that which ought to have been done”, [sic] we know of no reported case in which that hoary maxim of equity has come out anything but second best to the truly awesome statutory avoidance powers of the bankruptcy trustee in repelling claims of equitable liens.

In re Mosley, 55 B.R. 341, 343 (Bankr. W.D. Ky. 1985) (quoting Taylor v. Farmers Bank & Trust Co. (In re Schwartz), 56 B.R. 2, 3 (Bankr. W.D. Ky. 1985) (Deitz, J.) (finding that an equitable lien on real estate succumbs to the trustee’s power as a bona fide pur-

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of perfecting acts. In *Angeles Real Estate Co. v. Kerxton (In re Construction General, Inc.)* a debtor assigned one-half of a note to a creditor and agreed to collect it. Upon collecting on the note, however, the debtor paid a second creditor instead of turning this collection over to the assignee. This payment was a voidable preference, which the trustee recovered, and the assignee claimed a property right to one-half of the proceeds of the voidable preference action. Astonishingly, the assignee won.

Properly speaking, the debtor may have held the funds collected in a constructive trust for the assignee, but when these funds were transferred to a second creditor in satisfaction of antecedent debt, the second creditor became a bona fide purchaser of the funds. Accordingly, the second creditor took free of the constructive trust, and that should have terminated the assignee’s property claim. Meanwhile, because the money handed over was not debtor property (rather, it belonged to the assignee), the bankruptcy trustee should have had no voidable preference right against the second creditor. In spite of this the trustee did recover from the second creditor; hence, the question arises whether this dubious voidable preference award constitutes proceeds of the constructive trust payment. To be sure, when the debtor paid the second creditor, an inchoate general intangible right for the recovery of a voidable preference arguably arose, but this intangible right never belonged to the debtor; rather it belonged exclusively to the bankruptcy trustee. Hence, the preference recovery cannot be considered proceeds of the constructive trust. A proceeds theory requires that the debtor receive the proceeds in exchange for the trust property.

Judge Winter, however, thought that the assignee’s right to specific funds attached to the trustee’s voidable preference recovery. But this conclusion required the disposal of the trustee’s strong arm powers, as applied to the assignee’s property claim.

Judge Winter had several theories. First, he held that “under Maryland law, a prior specific lien is superior to the general lien of a judg-
ment creditor." Although expressed in strange terms, all this means is that a prior equitable lien on specific property is superior to judicial liens in general.

The trustee responded, however, that Article 9 has transformed equitable liens into unperfected security interests, which are susceptible to the strong arm power. "This argument assumes," Winter wrote,

that [the assignee's] interest is a mere security interest . . . But this is not the case. [The assignee's] interest in the note and its proceeds represents payment of a debt, not simply security for the payment. . . . Accordingly, [the assignee's] failure to record or otherwise to perfect its interest does not affect its claim on the property."

This claim, if true, would indeed dispose of the strong arm power, but its truth is highly suspect. Judge Winter's analysis supposes that a preexisting creditor of the debtor took an assignment of an uncollected debt in satisfaction of its own debt. That is, if the debtor failed to collect, the assignee would have no recourse against the debtor. Somehow, it seems unlikely that a creditor would make such a generous concession to a debtor on the brink of bankruptcy. Admittedly, such a structure does give the assignee a leg up on beating a voidable preference attack, especially in light of subsequent developments in Construction General, in which the assignment and collection occurred prior to the ninety-day preference period. It is more likely the case, however, that if the debtor failed to collect, the assignee would have expected recourse against the debtor personally.

453. Construction General, 737 F.2d at 418 (citing Garner v. Union Trust Co., 45 A.2d 106 (Md. 1945) (Delaplaine, J.)).

454. Id. at 419. Article 9 still covers the sale of certain choses in action, such as accounts and chattel paper. U.C.C. § 9-102(1)(b) (1972). But it does not cover the sale of an "instrument." See id. § 9-106 (making clear that an "instrument" cannot be an "account"). If, however, the debtor had collateral for the note it collected, the note would have been "chattel paper." Id. § 9-105(b). If the debtor held chattel paper, the sale still would have been governed by Article 9.

455. But see Rechnitzer v. Boyd (In re Executive Growth Invs., Inc.), 40 B.R. 417, 420-21 (Bankr. C.D. Cal. 1984) (Ayer, J.) (finding that if partial assignment was not a security interest, it was a fraudulent conveyance under a nonuniform California law because the debtor retained possession of the instrument, and the trustee could invoke this fraudulent conveyance doctrine by means of the strong arm power).

456. See id. at 422 (finding partial assignment of a note to be a security interest because the agreement specifically used the words "with recourse").

457. The assignment in question covered only half of the proceeds—a partial assignment. In the old days, partial assignments of accounts receivable were not enforceable against the account debtor, who could simply ignore them. The partial assignee, however, retained an equitable interest in the underlying claim. See Brown Shoe Co. v. Carns, 65 F.2d 294, 296 (8th Cir.) (Sanborn, J.) (finding that under Ohio law partial assignments do not convey legal title and therefore are not preferential transfers), cert. denied, 290
Finally, Judge Winter declared that the assignee should win by virtue of an equitable lien. This lien survived the trustee’s status as a hypothetical judicial lien creditor.\(^4\) Now, as the operative law was the Bankruptcy Act of 1898, as amended in 1950, there was the problem of the language therein which destroys equitable liens that are attempts to preserve unperfected security interests.\(^5\) But this was no worry because Judge Winter already had found that the assignment was not governed by Article 9.\(^6\) Rather, it was governed by the common law of assignments, which has no perfection requirements against judicial lien creditors. Hence, even though an equitable lien survived the trustee’s strong arm power, it did so specifically because Judge Winter thought the lien was not a lien after all, but an outright assignment of a chose in action. Judge Winter’s reliance on equitable lien theory must therefore be termed paradoxical.

**VIII. The Strong Arm Power as a Defense**

Not only does the strong arm power establish the trustee’s right to recover the property of third persons, but it provides a defense against having to return the debtor’s property to third persons as well.\(^7\) Sup-

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\(^4\) 695 (1933); National Surety Co. v. County Bd. of Educ., 15 F.2d 993, 995 (4th Cir. 1926) (Parker, J.) (giving contractor equitable lien on property partially assigned to another creditor). The trustee in *Construction General* cited these outmoded doctrines, 737 F.2d at 419, but they would not have helped the trustee because the assignee’s equitable interest is still good against nonpurchasers, *id.* at 420. So the trustee had no means of avoiding the equitable assignment.

Though the last Maryland case reported on the question agreed with the above “partial assignment” doctrine, Judge Winter simply predicted that modern Maryland courts would not follow such an archaic doctrine and would instead follow the Restatement (Second) of Contracts, § 326, which smiles upon partial assignments in all respects. *Id.* at 419 (citing *Restatement (Second) of Contracts* § 326 (1979)).

458. *Construction General*, 737 F.2d at 420.


460. *Construction General*, 737 F.2d at 420 (stating that section 60(a)(6) “addresses equitable liens arising because the creditor failed to meet the perfection requirements for legal liens”).

461. One can find claims that the *only* function of the strong arm power is to avoid transfers made by the debtor. Thus, in Putnam Properties, Ltd. Partnership v. Manufacturers & Traders Trust Co. (*In re* Putnam Properties, Ltd. Partnership), 134 B.R. 477 (Bankr. D. Conn. 1991) (Shiff, J.), the debtor in possession tried to avoid a security interest that, in Judge Alan Shiff’s opinion, did not exist. *Id.* at 480-81. For this the debtor in possession was scolded: “The thrust of § 544 is to avoid, for the benefit of the estate, interests of the debtor in property that were transferred to third parties when the transferred interests are either invalid or inferior to the rights of the debtor under nonbankruptcy law or the Bankruptcy Code.” *Id.* at 479. In fact, the strong arm power itself refers to the rights and powers of a judicial lien creditor, and hence the strong arm power
pose for example that $P$, an insolvent corporation, is the sole shareholder of $S$, also an insolvent corporation. Suppose further that $S$ issues a dividend to $P$ that is clearly a fraudulent conveyance. $S$'s creditors now have a cause of action against $P$ for the return of the dividend under state law. If $P$ conveys away the fraudulently conveyed property to a third party, that third party might have a defense. For example, under the Uniform Fraudulent Conveyance Act (UFCA), a "purchaser for fair consideration without knowledge of the fraud at the time of the purchase" takes free of the rights of $S$'s creditors to the dividend. Under the newer Uniform Fraudulent Transfer Act (UFTA), a transfer or obligation is not voidable against a "good faith transferee who took for value." The concept of "transferee" is broader than that of a "purchaser." The UFTA definition of "transfer" includes "every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with an asset or an interest in an asset." A purchaser, on the other hand, implies the recipient of a voluntary conveyance. A "transferee" could include one who is not a purchaser—a judicial lien creditor, for example.

If $P$ then files bankruptcy, $P$'s trustee is a transferee of a transferee. This is so even in Chapter 11 because the debtor and the debtor in possession are considered different juridical persons.

The strong arm power describes the extent to which $P$'s trustee can take advantage of defenses under state fraudulent conveyance law. If the dividend is real property, the trustee has a defense both under the UFCA and the UFTA because the trustee would be considered a bona fide purchaser of real property. If the dividend is personal

can be used as a defense as well as a theory for avoiding unperfected security interests.


463. UNIF. FRAUDULENT TRANSFER ACT § 8(b)(2), 7A U.L.A. 662 (1985). The structure of this defense is complex. UFTA § 8(b)(2) constitutes a defense from § 7(a)(1) only. Section 7(a)(1) provides: "(a) In an action for relief against a transfer or obligation under this [Act], a creditor, subject to the limitations in Section 8, may obtain: (1) avoidance of the transfer or obligation to the extent necessary to satisfy the creditor's claim . . . ." Id. § 7(a)(1), 7A U.L.A. at 660. "[A] transfer or obligation under this [Act]" would include transfers without a reasonably equivalent value, such as the dividend discussed in the text. See id. § 4(a)(2), 7A U.L.A. at 653.

Inexplicably, § 8(b)(1) is not a defense against "attachment or other provisional remedy," injunctions, or receivers, which are mentioned in § 7(a)(2) and (3). This is probably just an oversight that courts are advised to ignore.

464. Id. § 1(12), 7A U.L.A. at 645.


466. Greenbelt Coop., Inc. v. Werres Corp. (In re Greenbelt Coop., Inc.), 124 B.R. 465, 471 (Bankr. D. Md. 1991) (Derby, J.) ("The trustee is an entity distinct from the debtor, even where the debtor, as debtor-in-possession, is acting as trustee and the debtor had actual knowledge of an unperfected security interest.").

467. Karchin & Kempner, supra note 186, at 863-68.
property, however, P's trustee is only a hypothetical judicial lien creditor. As such, P's trustee still has a defense against S's creditors under the UFTA, which protects good faith transferees for value. But P's trustee would not have a defense against S's creditors under the UFCA because P's trustee is not a purchaser, and the UFCA protects only purchasers.

If S also files bankruptcy, then the position of P's trustee improves. Even in a state that has enacted the UFCA, Bankruptcy Code section 550(b)(1) protects any "transferee that takes for value, including satisfaction or securing of a present or antecedent debt, in good faith, and without knowledge of the voidability of the transfer avoided." Under state law (as represented by the UFCA), P's trustee, as a judicial lien creditor, may have no defense, but the Bankruptcy Code now supplies one. This is so even if S's trustee is relying on section 544(b) of the Bankruptcy Code, which subrogates the trustee to the rights of a real creditor of S, who could have taken the dividend away from P's trustee.

We have already seen, however, that under Judge Queenan's aggressive reading of section 544(a)(3) in In re Mill Concepts Corp., P's trustee is not a bona fide purchaser for value with regard to a transfer made by someone other than P. If S has conveyed real estate to P and P has transferred the land to P's trustee, P's trustee cannot claim to be a bona fide purchaser of real property. Yet P's trustee can claim to have the rights and powers of a hypothetical judicial lien creditor as to real estate. Hence, Judge Queenan would establish a nonuniform result under state law. That is, under Queenan's interpretation of the strong arm power, P's trustee, under the UFCA, would be liable in fraudulent conveyance actions brought by the creditors of S because Judge Queenan would say that the trustee is not a bona fide purchaser of this real property, only a hypothetical judicial lien creditor.

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468. Unif. Fraudulent Transfer Act § 8(b)(2), 7A U.L.A. 662 (1985); see City of New York v. Johnson, 137 F.2d 163 (2d Cir. 1943) (Augustus Hand, J.). In this case New York had not yet enacted the UFCA, which protects only bona fide purchasers. Instead, it had a fraudulent conveyance law that provided for a broader defense that included transferees, just as the UFTA now does. See Karchin & Kempner, supra note 156, at 855 n.94.

470. 11 U.S.C. § 550(b)(1) (1988); c.f. In re Dee's, Inc., 311 F.2d 619 (3d Cir. 1962) (Biggs, J.). In Dee's, S transferred inventory to P in violation of Article 6 of the UCC. P's trustee was erroneously held to be "a transferee for value without notice," who took free of "any outstanding claim or equity" under the Pennsylvania Statute of Elizabeth. Id. at 622. Judge Biggs also hinted that the order in which P and S filed for bankruptcy is relevant, but it is not. The only issue is whether P's trustee is a protected transferee of a transferee under § 550(b)(1) of the Bankruptcy Code or under state law.
tor.\textsuperscript{472} Under the UFTA and the Bankruptcy Code, however, \(P\)'s trustee would have a defense as a good faith transferee (by virtue of its hypothetical judicial lien).\textsuperscript{473}

There remains the issue of whether \(S\)'s trustee, as purchaser or transferee, is in good faith and for value. Good faith seems quite clear, because section 544(a) indicates that the trustee has the rights and powers of a judicial lien creditor "without regard to any knowledge of the trustee or of any creditor."\textsuperscript{474} Also, the trustee is deemed to be a "bona fide purchaser" of real estate.\textsuperscript{475}

As to whether \(P\)'s trustee is a transferee or purchaser for value, this ought to be fairly clear under section 550(b)(1), which provides that \(S\)'s trustee cannot recover from a transferee of \(P\) if that transferee "takes for value, including satisfaction or securing of a present or antecedent debt, in good faith, and without knowledge of the voidability of the transfer avoided."\textsuperscript{476} One court inexplicably holds to the contrary. According to Judge Clevert:

Section 544(a)(1) places the trustee in the position of "a creditor that extends credit to the debtor at the time of the commencement of the case, and that obtains, at such time and with respect to such credit, a judicial lien [on the debtor's property]." Whether this hypothetical extension of credit to the debtor makes the trustee a purchaser for value is determined by Wisconsin law.

In Wisconsin, a judicial lien creditor is not deemed a purchaser for value because "[he has not parted] with any value in reliance on the misleading state of his debtor's title."\textsuperscript{477}

Now there is much wrong with this ruling. First, it is irrelevant for the purposes of section 550(b) whether \(P\)'s trustee is a "purchaser for value." What matters is whether \(P\)'s trustee is a transferee for value. Authorities explaining that lien creditors are not purchasers are therefore irrelevant. Second, this is surely not a matter for state law. Section 550(b)(1) makes clear that transferees on antecedent debt are transferees for value. Whether the hypothetical credit deemed extended on bankruptcy day by section 544(a)(1) is contemporaneously exchanged for the judicial lien or whether the judicial lien is deemed a transfer on

\textsuperscript{472} Id. at 944.

\textsuperscript{473} For a case holding that the trustee is a bona fide purchaser of real estate for defensive purposes (and hence disagreeing with Judge Queenan's parsing of \$ 544(a)(3) in \textit{Mill Concepts}), see \textit{In re Stuckey}, 126 B.R. 697, 701 (Bankr. E.D. Va. 1990) (Tice, J.).

\textsuperscript{474} 11 U.S.C. \$ 544(a) (1988).

\textsuperscript{475} Id.

\textsuperscript{476} Id. \$ 550(b)(1).

antecedent debt, P's bankruptcy trustee surely must be viewed as a transferee for value. How could we view a bankruptcy trustee as a judicial lien creditor unless some antecedent claim existed for which the lien is security?

IX. CONCLUSION

The meaning of the strong arm power is that it embodies the trustee's status as representative of all the creditors against property the debtor either owns or has power to convey. On the one hand, individual creditors may no longer obtain judicial liens by obtaining judgments because bankruptcy's automatic stay prevents it.\textsuperscript{478} On the other hand, the trustee has a judicial lien\textsuperscript{479} to compensate the creditors collectively for their loss of power. In addition, the trustee is also a bona fide purchaser of real estate—a status that fits less elegantly into the idea of bankruptcy as a collective creditors' action.

Because the hypothetical judicial lien of a bankruptcy trustee is an imaginary thing, there has been considerable trouble reining in the trustee's imagination. In this Article, I have tried to show the many boundaries that Congress and the courts have established to prevent over-indulgence by the trustee at the expense of secured creditors and other property claimants.

Most of all I have tried to stress the unfairness the strong arm power can sometimes impose on secured creditors who have made innocent mistakes that harmed nobody. Courts are surprisingly ready to use a series of subterfuges to help out secured creditors, in appropriate cases. These devices include such venerable ideas as the constructive trust, the equitable lien, or just plain refusals to institute the strong arm power when justice demands. As a result, though the strong arm power is worded in absolute terms, it is a more flexible principle than is sometimes believed.

\textsuperscript{479} Id. § 544(a)(1).