Revisiting Professor Elizabeth Warren's Carve-Out Proposal: A Comparative Analysis of the United Kingdom's Prescribed Part

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Article 9 security interests were expanded under the revision of 1998 to cover more assets, causing a coordinating contraction to the assets available for unsecured creditors such as trade creditors, employees, pension funds, and personal injury claimants. As a result, the Revised Article 9 often transfers the risk of a debtor's insolvency from those who are highly capable of assessing risk and spreading it, like financial institutions, to those who are unable to adjust to it. Former Harvard Law professor, Massachusetts Senator, and 2020 presidential candidate Elizabeth Warren argues that the expansion of Article 9 allows "the debtor and one lender to get together and agree that, in the event of complete collapse, a third party will bear the biggest share of the losses."

To remedy the apparent unfairness of Revised Article 9, Elizabeth Warren submitted a draft proposal to the American Law Institute (ALI) in 1996. However, her carve-out proposal was unanimously rejected by the ALI and met with "a storm" of criticism. In the decades following the great carve-out proposal controversy, the American system has remained "one in which the priority of secured creditors over unsecured creditors remains absolute," and thus, the concerns voiced by proponents of the carve-out proposal persist. Meanwhile, the Parliament of the United Kingdom did adopt a carve-out provision, referred to over the pond as a "prescribed part," in 2002.

The dismal state of returns for unsecured creditors in U.S. liquidation bankruptcy proceedings, therefore, prompts the question: would Elizabeth Warren's carve-out proposal have provided greater returns for unsecured creditors? Would adopting the carve-out proposal now be worth it? Warren herself advised that "comparative studies of other economies that do not use full priority rules" provide a "promising approach to the study of commercial law questions." Hence, this Note seeks to evaluate whether the strongest arguments against Warren's carve-out proposal still hold water by examining how the prescribed part has fared in the U.K. This Note will then reconsider the merits of adopting Warren's carve-out proposal in the United States.

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Introduction

Article 9 has shifted from a device that simply enables commercial creditors to reliably encumber some of a debtor's assets to one that permits secured creditors to take a lien on virtually all of a debtor's assets.[1] As the scope of Article 9 security interests was expanded under the revision of 1998 to cover more assets, there was a simultaneous contraction on the remaining assets available for unsecured creditors such as trade creditors, employees, pension funds, and personal injury claimants.[2] The Revised Article 9 thus often transfers the risk of a debtor's insolvency from those who are highly capable of assessing risk and spreading it, like financial institutions, to those who are unable to adjust to it.[3] Elizabeth Warren argues the expansion of Article 9 allows "the debtor and one lender to get together and agree that, in the event of complete collapse, a third party will bear the biggest share of the losses."[4]

Returns for unsecured creditors in liquidation bankruptcy proceedings are indeed quite low. A case study conducted in Richmond, Virginia, found that in Chapter 7 bankruptcy proceedings, unsecured creditors were generally paid little or nothing upon their unsecured claims.[5] In these proceedings, only 5% of the property available to the trustee was utilized to repay unsecured creditors.[6] It seems that unsecured creditors do not fare much better in Chapter 11 liquidation proceedings: in analyzing a sample of 449 bankruptcy cases filed in 1994, it was determined that:

> Chapter 11 liquidating plans . . . return a more respectable 20% to unsecured creditors - although the standard error is rather large, and the proper number could be as low as 6.9% or as high as 34.7%. Of note is that the median return to unsecured creditors in all liquidation cases, including [C]hapter 11 liquidation plans, is zero.[7]

To remedy the apparent unfairness of Revised Article 9, Elizabeth Warren, at the request of Institute Director Geoffrey Hazard, submitted a

1. LYNN M. LOPUCKI & ELIZABETH WARREN, SECURED CREDIT: A SYSTEMS APPROACH 806 (2d ed. 1998).

2. William J. Woodward, Jr., *The Carve-Out Proposal and Its Critics: A Response*, 30 UCC L.J. 32, 33 (1997).

3. *Id.* at 33–34; *see also* Elizabeth Warren, *Making Policy with Imperfect Information: The Article 9 Full Priority Debates*, 82 CORNELL L. REV. 1373, 1374 (1997) (stating that the Article 9 revision "ensur[es] that secured creditors sweep in more of the debtors' assets and leave less for the unsecured creditors").

4. Warren, *supra* note 3, at 1375.

5. Michael J. Herbert & Domenic E. Pacitti, *Down and Out in Richmond, Virginia: The Distribution of Assets in Chapter 7 Bankruptcy Proceedings Closed During 1984-1987*, 22 U. RICHMOND L. REV. 303, 315–16 (1988).

6. *Id.* at 316.

7. Stephen J. Lubben, *Business Liquidation*, 81 AM. BANKR. L.J. 65, 81 (2007).

draft proposal to the ALI in 1996.[8] Warren's proposal (hereinafter carve-out proposal) provided that:

> (5) A person who becomes a lien creditor and levies while a security interest is perfected shall be entitled on account of such person's inferior judicial lien to receive from the proceeds of the collateral subject to such protected security interest an amount no greater than 20 percent of the value of the property subject to the levy which is also subject to the security interest, if and only if
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> (a) the lien creditor gives notice of the intent to satisfy the lien to the person holding the perfected security interest at least ten days prior to the disposition of the property;
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> (b) the property levied upon is not consumer goods; and
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> (c) the person holding the perfected security interest is unable to protect the property subject to the security interest by compelling the lien creditor to marshal.[9]

The carve-out proposal was unanimously rejected by the ALI and met with "a storm" of criticism.[10] The most salient arguments opposing the carve-out proposal are that: (1) the carve-out proposal would lead to a decline in the total amount of credit available in the economy, (2) borrowers and lenders would mitigate the effects of the carve-out by using substitute lending techniques, and (3) the carve-out proposal would not deliver unsecured creditors significantly better recoveries.[11]

In the decades following the great carve-out-proposal controversy, the American system has remained "one in which the priority of secured creditors over unsecured creditors remains absolute," and thus the concerns voiced by proponents of the carve-out proposal persist.[12] Meanwhile, driven by similar sentiments, the Parliament of the United Kingdom adopted a carve-out provision, referred to across the pond as the "prescribed part," in 2002.[13]

The continued sorry state of returns for unsecured creditors in U.S. liquidation bankruptcy proceedings thus prompts the question: would Elizabeth Warren's carve-out proposal have provided greater returns for

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8. LOPUCKI & WARREN, *supra* note 1, at 805.

9. *Id.* at 806.

10. *Id.*, at 808; Lynn M. LoPucki et al., *Optimizing English and American Security Interests*, 88 NOTRE DAME L. REV. 1785, 1858 (2013).

11. LOPUCKI & WARREN, *supra* note 1, at 808; Lisa M. Bossetti & Mette H. Kurth, *Professor Elizabeth Warren's Article 9 Carve-Out Proposal: A Strategic Analysis*, 30 UCC L.J. 3, 6–7 (1997).

12. LoPucki et al., *supra* note 10, at 1858; *see also* DOUGLAS J. WHALEY & STEPHEN M. MCJOHN, PROBLEMS AND MATERIALS ON SECURED TRANSACTIONS 275 (Wolters Kluwer, 10th ed. 2017) ("When a debtor enters bankruptcy court seeking financial relief, a creditor is likely to get nothing unless the court recognizes the validity of the security interest held by that creditor in an asset of the debtor.").

13. Enterprise Act 2002, c. 40, § 252, sch. 176A (UK).

unsecured creditors? Would adopting the carve-out proposal be worth it? Warren herself advised that "comparative studies of other economies that do not use full priority rules" provide a "promising approach to the study of commercial law questions."[14] Hence, this Note seeks to evaluate whether the strongest arguments against Warren's carve-out proposal still hold water by examining how the prescribed part has fared in the U.K. This Note will then reconsider the merits of adopting Warren's carve-out proposal in the United States.

I. The Prescribed Part

The Enterprise Act of 2002 abolished the Crown's preferential claim to recover unpaid taxes ahead of unsecured creditors and assigned a portion of floating-charge collateral, otherwise known as the prescribed part, to unsecured creditors in insolvency distributions.[15] Parliament was motivated to pass the Act by a belief that the previous regime was not sufficiently equitable and that the "unacceptably" low level of returns to unsecured creditors should be improved.[16] Proponents of the prescribed part hoped that it would come to represent "a real restitution of the prospects of those who have become inured to finding themselves at the bottom of the pile when it comes to insolvency distribution."[17] The Act reads in part:

> (1) This section applies where a floating charge relates to property of a company—
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> (a) which has gone into liquidation,
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> (b) which is in administration,
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> . . . .
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> (2) The liquidator, administrator or receiver—
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> (a) shall make a prescribed part of the company's net property available for the satisfaction of unsecured debts, and

14. Warren, *supra* note 3, at 1383.

15. Adrian J. Walters, *Statutory Erosion of Secured Creditors' Rights: Some Insights from the United Kingdom*, U. ILL. L. REV. 543, 557 (2015). In October of 2018, the British government announced plans to reintroduce the Crown preference in April 2020. *Changes to Protect Tax in Insolvency Cases*, HM REVENUE & CUSTOMS (July 11, 2019), https://www.gov.uk/government/publications/changes-to-protect-tax-in-insolvency-cases/changes-to-protect-tax-in-insolvency-cases [https://perma.cc/7DUE-5Q92]. The new Crown preference will be similar to the status that it enjoyed prior to 2003, but with a few differences. *Id.* This reinstated priority for the Crown will likely have a harmful impact on returns to unsecured creditors, but that is outside the scope of this Note.

16. Sandra Frisby, *In Search of a Rescue Regime: The Enterprise Act 2002*, 67 MOD. L. REV. 247, 247, 270 (2004).

17. *Id.* at 271.

> (b) shall not distribute that part to the proprietor of a floating charge except in so far as it exceeds the amount required for the satisfaction of unsecured debts.[18]

There are several rules and restrictions for calculating the prescribed part. They basically stipulate that the prescribed part consists of 50% of the first £10,000 of the company's net property and 20% of any amount over that subject to a cap of £600,000.[19]

At this point, it would be helpful to define some essential foreign terms within the provision. Principally, a "charge" is the main form of a consensual, nonpossessory security interest in British law.[20] A "fixed charge" is a type of security interest in which lenders can collateralize specific assets, as well as replacement assets, without the need for further security instruments or perfection.[21] However, with a fixed charge, the debtor must obtain the lender's consent prior to disposing of fixed-charge assets.[22] A "floating charge" is a lending device that allows creditors to take security over all of a debtor's assets without interfering with the operation of a company by classifying present and future property as security without further action.[23] Importantly, the floating charge allows the "chargor" to dispose of charged assets without obtaining consent from the "chargee," much like a blanket lien under Article 9.[24]

When "crystallized," the floating charge becomes a fixed charge and the debtor may no longer dispose of assets without the chargor's permission.[25] The floating charge may be crystallized when the debtor's business ends or the lender initiates an enforcement action in response to default.[26] For the purposes of the prescribed part, the Enterprise Act defines a "floating charge" as "a charge which is a floating charge on its creation."[27] Thus, the crystallization of a floating charge does not protect a creditor from the prescribed part.

Furthermore, "liquidation" in the U.K. is an insolvency process in which a company sells all of its assets and then dissolves completely, like Chapter 7 bankruptcy in the United States.[28] "Administration," on the other hand, is an

18. Enterprise Act 2002, c. 40, § 252, sch. 176A (UK).

19. Frisby, *supra* note 16, at 270.

20. Walters, *supra* note 15, at 548.

21. *Id.* at 549.

22. *Id.*

23. Louise Gullifer, *The Reforms of the Enterprise Act 2002 and the Floating Charge as a Security Device*, 46 CAN. BUS. L.J. 399, 399 (2008).

24. *Id.*

25. Gullifer, *supra* note 23, at 399–400.

26. Walters, *supra* note 15, at 550.

27. Enterprise Act 2002, c. 40, § 252, sch. 176A (UK).

28. *Liquidation*, PRACTICAL LAW UK GLOSSARY (2018), Westlaw 5-107-6770.

insolvency process whereby the first objective is to rescue the company, like reorganization under Chapter 11 bankruptcy in the United States.[29]

The prescribed part's "statutory carve-out has powerfully influenced English jurisprudence on the fixed and floating charge and, in turn, shaped the standard form transactional structures and legal technologies that lenders use."[30] Accordingly, to determine how the prescribed part's operation in the U.K. lends perspective to the carve-out proposal's utility in the United States, this Note examines its influence on U.K. lending in the context of the three most robust arguments against Warren's proposal: (1) whether the prescribed part has led to a decrease in the total amount of credit available in the economy by increasing the cost of borrowing, (2) whether borrowers and lenders have managed to mitigate the effects of the prescribed part by adopting substitute lending techniques, and (3) whether the prescribed part has delivered better recoveries to unsecured creditors.[31] The Note then discusses key differences between the prescribed part and the carve-out proposal. Finally, the Note highlights some important takeaways from examining the prescribed part's tenure in the U.K.

A. Total Amount of Credit Available in the Economy

As Warren elucidates, "there may be no way of testing the credit-constriction assertion directly or measuring the magnitude or direction of the changes that would occur with partial priority."[32] Accordingly, research in this area is a bit sparse. Nevertheless, some light has been shed on the influence of the prescribed part on the price of borrowing and the amount of credit available in the economy.

The reviews have been mixed: cross-sectional studies of secured lending in the U.K., France, and Germany have found that the statutory re-ordering of priorities has led to creditors demanding a higher ratio of collateral-to-loan value.[33] However, statutory redistribution has also been associated with a decrease in the use of secured lending that is subject to statutory subordination.[34] In fact, in the U.K., "lenders have managed to circumnavigate the carve-out, and reduce their costs of providing short-term

29. PRACTICAL LAW RESTRUCTURING & INSOLVENCY, PRACTICAL LAW UK, ADMINISTRATION: A QUICK GUIDE (2017), Westlaw 7-385-3012.

30. Walters, *supra* note 15, at 558.

31. LOPUCKI & WARREN, *supra* note 1, at 808; Bossetti & Kurth, *supra* note 11, at 7. Translated into British English as: "the suitability of the prescribed part fund as a realisation tonic for unsecured creditors in contemporary English insolvency proceedings." Kayode Akintola, The Prescribed Part for Unsecured Creditors: A Pithy Review 1 (May 13, 2017) (unpublished manuscript), https://eprints.lancs.ac.uk/id/eprint/86275/ [https://perma.cc/D5SX-BLEP].

32. Warren, *supra* note 3, at 1386.

33. John Armour, *The Law and Economics Debate About Secured Lending: Lessons for European Lawmaking?* 16 (Ctr. for Bus. Research, Univ. of Cambridge, Working Paper No. 362, 2008).

34. *Id.*

cash-flow finance to small- and medium-sized enterprises."[35] Therefore, it seems that a crucial factor in determining whether the amount of credit in the economy decreases is the ease and frequency at which lenders can avoid the statutory carve-out.

B. Lender Avoidance

Since the enactment of the Enterprise Act, sophisticated lenders have effectively altered their behavior to reduce their exposure to statutory redistribution.[36] In fact, sophisticated creditors have been "remarkably successful" in avoiding participation in the prescribed part.[37] Secured creditors have aptly avoided the prescribed part by, somewhat adopting alternative lending techniques, such as "invoice discounting" and "factoring."[38]

Invoice discounting occurs when the debtor assigns its receivables to the creditor in exchange for immediate funds—thus, the transaction has the character of an outright sale and is not subject to the prescribed part.[39] The creditor pays the face value of the receivables (minus a finance charge) to the debtor in multiple stages: first upon assignment and the remainder when the receivables are collected.[40] The debtor collects the receivables acting as an "agent" for the creditor and pays the proceeds into an account for the creditor's benefit.[41] The debtor may then withdraw the remainder of its "price" from this same account.[42] The creditor may make ongoing decisions about whether the debtor may withdraw from this account based on assessments of the value of the receivables.[43] Invoice discounting operates in a manner quite similar to possessing a floating charge over the debtor's receivables, and this similarity helps to explain why the use of invoice discounting grew dramatically between 1999 and 2005.[44]

There seems to have been a shift toward the technique of factoring in U.K. lending as well.[45] Factoring occurs when a specialist financier who lends funds in exchange for security, in other words a factor, takes control

35. Walters, *supra* note 15, at 558.

36. John Armour, *Should We Redistribute in Insolvency?* 14 (Ctr. for Bus. Research, Univ. of Cambridge, Working Paper No. 319, 2006).

37. *Id.* at 28.

38. Walters, *supra* note 15, at 558; Armour, *supra* note 36, at 12.

39. Armour, *supra* note 36, at 12.

40. *Id.*

41. *Id.*

42. *Id.*

43. *Id.*

44. *Id.* at 13; *see id.* at 13 fig.2 (indicating a spike in the use of invoice discounting after the Enterprise Act came into force in 2002).

45. Kayode Akintola, *What Is Left of the Floating Charge? An Empirical Outlook*, 30 BUTTERWORTHS J. INT'L BANKING & FIN. L. 404, 405 (2015).

over a company's credit-assessment and debt-collection functions.[46] Hence, unlike taking a floating charge or invoice discounting, the debtor does not retain control of its sales ledger in factoring.[47] Within a study that collected data from 2,129 companies that entered into administration or liquidation in the U.K. between 2006 and 2011, a total of 528 factoring agreements were observed.[48] The growth in factoring can be attributed in part to the emergence of the prescribed part.[49]

Floating charges are still a widely utilized lending device. In the same study of 2,129 companies, 1,160 companies gave floating-charge security to their creditors and 704 of these charges were created after the Enterprise Act came into force.[50] Nevertheless, around 90% of these floating charges were taken along with fixed charges.[51] Floating charges in the context of this arrangement have been dubbed "lightweight" floating charges.[52] In this capacity, the floating charge acts as a "mop-up" debt-realization device that is simply added onto other security or factoring arrangements.[53] Thus, the floating charge's value has largely shifted from being a priority device.[54] It appears that in response to the Enterprise Act, even when a floating charge is taken over a debtor's assets, new methods of lending have largely restricted the prescribed part's utility as a redistribution tool.[55]

Given the rise of these alternative lending strategies, it is evident that "[l]enders have persistently, and for the most part, successfully restructured and recharacterized their lending transactions to avoid the ambit of . . . [the prescribed part]."[56] Lender avoidance has thus largely diminished the potency of the prescribed part as an equity-producing instrument.[57]

C. Recoveries for Unsecured Lenders

Despite Parliament's intention of creating a redistribution device that improves outcomes for unsecured creditors, the prescribed-part fund has

46. Armour, *supra* note 36, at 13.

47. *Id.* at 13–14.

48. Akintola, *supra* note 45, at 404–05.

49. *Id.* at 405.

50. *Id.* at 404.

51. *Id.*

52. RIZWAAN JAMEEL MOKAL, CORPORATE INSOLVENCY LAW: THEORY AND APPLICATION 190 (2005).

53. Akintola, *supra* note 45, at 404.

54. *See* MOKAL, *supra* note 52, at 191–93 (arguing that the floating charge inherently does not act as a priority-based device).

55. *See id.* at 404–06 (discussing when a floating charge is usually taken over other debtor assets, other lending methods, and the distribution of monies among creditors).

56. Walters, *supra* note 15, at 548.

57. *See* Armour, *supra* note 36, at 28 (discussing why floating charges are no longer attractive to certain classes of lenders).

produced marginal returns for this group within insolvency proceedings.[58] As evidenced in the previous subpart, "sophisticated creditors seeking to adjust their affairs so as to fall outside the ambit of the statutory scheme. . . . were remarkably successful,"[59] leading to companies holding insufficient floating-charge assets to which the prescribed part may be applied.[60] Furthermore, empirical data reveals that the prescribed-part fund is set aside in only a fraction of eligible insolvencies, and when it is set aside, it provides "borderline irrelevant" returns to unsecured creditors.[61]

The cost of administering insolvency proceedings and applying the prescribed-part fund likely contribute to these low returns as well.[62] Expenses for administering insolvency proceedings, such as the costs of litigation and conducting sales, are deducted from the debtor's floating-charge assets with priority over the prescribed part.[63] The debtor's property available to satisfy unsecured creditors' claims via the prescribed part is thus largely dependent on the cost of the insolvency proceedings.[64] Preparing and distributing the prescribed part is also costly: if an officeholder is preparing a prescribed part, she must give notice of her intention to declare a dividend, organize the claims of eligible unsecured creditors, and make distributions.[65] A high number of unsecured creditors with small claims, therefore, puts an additional strain on the cost of preparing and distributing the prescribed part.[66]

Accordingly, officeholders often disapply the prescribed part, believing that the cost of setting the fund aside and distributing it would be disproportionate to the benefits for unsecured creditors.[67] In a survey of 704 floating charges within administration and liquidation proceedings after the enactment of the Enterprise Act, prescribed-part funds were set aside in only ninety-five cases.[68] Disapplication likely accounts for a substantial number

58. Akintola, *supra* note 45, at 404 (translated in British English as "the prescribed part fund seems to be yielding marginal fruits for this class of insolvency claimants").

59. Armour, *supra* note 36, at 28.

60. *See* Akintola, *supra* note 45, at 406 (discussing how a reason that the prescribed part provision is underutilized is that some corporations hold insufficient floating charge assets).

61. Akintola, *supra* note 31, at 6.

62. *Id.* at 8.

63. *Id.* at 7–8.

64. *Id.*

65. *Id.* at 8.

66. *Id.* at 9.

67. *Id.* at 8. If the prescribed part is less than £10,000 and the officeholder believes that the cost of making the distribution would be disproportionate to the benefits, the officeholder has the discretion to not apply the prescribed part. However, if the prescribed part is over £10,000, the officeholder must ask the court to make an order allowing disapplication. *The Prescribed Part - Some Useful Guidance from the Court*, BRODIES LLP: LEGAL UPDATES (Jan. 1, 2009), https://brodies.com/binformed/legal-updates/the-prescribed-part [https://perma.cc/M5M6-MHGB].

68. Akintola, *supra* note 31, at 9.

of the cases where the prescribed-part fund was not set aside.[69] This is significant given U.K. courts' case law on the subject: even where judges have agreed with officeholders' opinions that the cost of distribution would be disproportionate to the benefits for unsecured creditors, they have been reluctant to disapply the prescribed part.[70]

In *Castlebridge Plant Ltd.*,[71] the court held that minuscule returns to individual creditors are a relevant factor in determining whether to accept applications to disapply the prescribed part.[72] However, within that very opinion, the court stated that the fact that many creditors would not receive a dividend in excess of £100 did not persuade it to grant the application.[73] This approach is illustrated within a publication of Brodies LLP, a U.K. law firm, that disclosed the results of an application to the Court of Session to disapply the prescribed part for a company within administration proceedings.[74] The company had sixty-three unsecured creditors, the prescribed part fund contained £18,197, and it was estimated that after deducting the costs of distribution, there would only be £9,777 available for the unsecured creditors.[75] There were three companies whose claims made up the majority of the claims, leaving £978 available for the remaining sixty creditors, of whom only four would receive more than £25.[76] The court refused to grant the application to disapply the prescribed part.[77]

Given U.K. courts' reluctance to disapply the prescribed part, the fact that the prescribed part is evidently disapplied so often demonstrates the disproportionate costs of preparing and distributing the fund compared to the potential returns for unsecured creditors. Within the ninety-five cases where the prescribed part was set aside, the average unsecured claims totaled £2,935,230, the average prescribed part fund consisted of £63,152, and there was an average of seventy-one unsecured creditors.[78] The average return ratio to unsecured creditors was thus 7.3 pence (pence is the equivalent to the U.S. penny) on the pound.[79] There was, of course, a range of outcomes within this sample. On the low end of the spectrum, one case had an unsecured debt of £3.9 million, a prescribed-part dividend of £41,500, and a return of less than 1 pence on the pound, mostly due to the cost of distributing the fund to 252

69. *Id.*

70. *Misapplying the Prescribed Part*, GATELEY PLC: TALKING RECOVERY (Apr. 15, 2014), https://talkingrecovery.gateleyplc.com/2014/04/15/misapplying-the-prescribed-part [https://perma.cc/99G3-AQEJ].

71. Castlebridge Plant Ltd. [2015] CSOH 165 (Scot.).

72. Akintola, *supra* note 31, at 9.

73. *Id.*

74. BRODIES LLP, *supra* note 67.

75. *Id.*

76. *Id.*

77. *Id.*

78. Akintola, *supra* note 31, at 9.

79. *Id.*

creditors.[80] On the other end of the spectrum, there was a case documented that had an unsecured debt of £504,973, a prescribed-part dividend of £154,628, and an average return ratio of 42 pence on the pound to unsecured creditors.[81]

Evidently, creditors' utilization of alternative-lending methods and the costs of administering insolvency proceedings, as well as the cost of preparing the fund itself, have not resulted in substantially better returns for unsecured creditors. That being said, evidence has suggested that the fund is often the only source of recovery for unsecured creditors in those few cases where the fund is actually set aside and distributed.[82] And as previously elucidated, returns to unsecured creditors have been substantial in some cases.

II. Comparison

A. Considerable Distinctions

In considering the performance of the prescribed part within the United Kingdom to predict the utility of Warren's carve-out proposal in the United States, it is important to highlight some of the key differences between the redistribution devices.

First, as opposed to the carve-out proposal's application to all collateral subject to security interests, the prescribed part only applies to collateral under a floating charge. While the narrowness of the prescribed part's application makes sense in light of historical criticism towards the floating charge,[83] it has made the U.K. carve-out highly susceptible to transactional innovation.[84] Because the prescribed-part fund is derived solely from floating-charge collateral, the statute has merely encouraged debtors to take different kinds of security.[85]

Second, the prescribed part emphasizes the global sum to be carved out for the body of unsecured creditors as a whole and does not allow for selective disapplication of the fund, making the device egalitarian, rather than focusing on what would be granted to unsecured creditors individually.[86] The carve-out proposal, on the other hand, rewards those unsecured creditors that obtain judicial liens from the court.[87] By requiring a court order to participate, the carve-out proposal could perhaps lessen some of the costs associated with

80. *Id.*
81. *Id.*
82. *Id.* at 2.
83. Frisby, *supra* note 16, at 250–51.
84. Walters, *supra* note 15, at 570.
85. Armour, *supra* note 36, at 27.
86. Akintola, *supra* note 31, at 8, 10.
87. LOPUCKI & WARREN, *supra* note 1, at 806.

preparing the prescribed part, such as organizing eligible claims and distributing the fund to a large number of creditors.

Third, while the prescribed part is awarded solely in administration and liquidation proceedings,[88] the carve-out proposal may operate outside of bankruptcy.[89] This difference could have many effects on lending in the United States that are not foreshadowed in the U.K., but it is also true that this variance could potentially lessen some of the costs associated with preparing the fund within British proceedings.

Finally, despite the prescribed part's lauded policy purposes, the legislation was perhaps unambitious to begin with. Even in maximizing the expected additional benefit to unsecured creditors to resolve any doubts, the prescribed part was never expected to yield high returns to unsecured creditors.[90] The British government estimated that the abolishment of the Crown preference would yield up to £100 million more in recoveries for unsecured creditors.[91] Given this estimate, recoveries for unsecured creditors were only expected to go up 7.4% at most once the Enterprise Act was implemented.[92] This means that Parliament could likely have expected that unsecured creditors would receive an increase of less than one-half of one pence after enacting the Enterprise Act.[93]

This is not to say that Parliament was disingenuous in implementing the prescribed part. However, it seems misguided to make assumptions on the fate of the carve-out proposal that was specifically drafted to improve the position of unsecured creditors without highlighting this difference in the magnitude of ambition.

B. Valuable Lessons from the Prescribed Part

The plight of the prescribed part has demonstrated the importance of the role of courts in restricting alternative lending strategies as well as improving the fairness of the carve-out. In the U.K.'s notorious *Spectrum*[94] case, the Court made it clear that the only criteria when deciding whether a charge is fixed or floating, and therefore subject to the prescribed part, is the degree of control that the chargee exercises over the assets.[95] It further elucidated that this control means that a chargor cannot dispose of charged assets without the consent of the chargee, which must be provided in the charge agreement

88. Enterprise Act 2002, c. 40, § 252, sch. 176A (UK).

89. *See* LOPUCKI & WARREN, *supra* note 1, at 806 (declining to assert that the proposal's applicability is limited to the bankruptcy context).

90. MOKAL, *supra* note 52, at 129.

91. *Id.* at 130.

92. *Id.*

93. *Id.*

94. *In re* Spectrum Plus Ltd. [2005] UKHL 41 (appeal taken from Eng.).

95. Gullifer, *supra* note 23, at 424.

and carried out in practice.[96] *Spectrum* clarified that "charged assets" include the proceeds of debt as well as the debts themselves.[97]

The decision had numerous ramifications as it closed off a process by which bank lenders created "fixed" charges over receivables that were designed to "boost their priority by diverting receivables away from the statutory carve-out without excessively restricting the ability of borrowers to recycle their receivables into cash flow."[98] While the case has been criticized for creating uncertainty as to whether charges are fixed or floating,[99] it also successfully terminated the use of a practice "wholly inconsistent with the nature of a fixed charge" that was designed to avoid the prescribed-part carve-out.[100] The *Spectrum* decision demonstrates how concerted judicial action can proactively retain the usefulness of a carve-out provision as sophisticated lenders develop new workaround techniques.

In the decisions *Permacell Finesse*[101] and *Airbase Services*,[102] U.K. courts rejected the argument that secured creditors could participate in the prescribed part.[103] The secured creditors asserted that they should be treated as unsecured debtors entitled to participate in the prescribed part with respect to any shortfalls in security, which are treated as unsecured debt.[104] Nevertheless, the judges in both cases held that the correct interpretation of "unsecured creditor" is a creditor who does not hold security over the collateral of the debtor, thereby placing emphasis on the identity of the creditor rather than the nature of the debt.[105] The judges underscored the purpose of the prescribed part in excluding the secured creditors from participating in the carve-out.

Finally, as previously elaborated, the U.K. courts have adopted a policy of considering the global sum that would be carved out for the body of unsecured creditors as a whole, rather than what would be granted to unsecured creditors individually, when determining whether to disapply the prescribed part.[106] Consequently, British courts are reluctant to disapply the prescribed part.

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96. *Id.*

97. *Id.*

98. Walters, *supra* note 15, at 555.

99. *See* Gullifer, *supra* note 23, at 424–26 (detailing the various undecided points following the *Spectrum* decision).

100. Walters, *supra* note 15, at 557. For further discussion on the evolution of bank lenders' use of the "fixed charge" as a lending device, see *id.* at 554–57.

101. *In re* Permacell Finesse Ltd. [2007] EWHC 3233 (Ch).

102. *In re* Airbase Services (UK) Ltd. [2008] EWHC 124 (Ch).

103. *Asset Based Lending, Banking and Business Recovery & Insolvency*, INSIGHT (Hammonds LLP), July 2008, at 9.

104. *Id.*

105. *Id.*

106. Akintola, *supra* note 31, at 8–9.

These decisions are relevant in considering the potential efficacy of the carve-out proposal because critics have speculated on the deleterious consequences of certain interpretations of Warren's carve-out proposal.[107] As these decisions demonstrate, if ambiguities were to arise in applying the proposal, the courts are quite capable of resolving them consistently and fairly with the intention of the provision.

C. Considering Warren's Carve-Out

The returns procured from the prescribed part have been described as "borderline irrelevant" due to the ease with which lenders have avoided participation and the cost of liquidation proceedings as well as operating the fund.[108] Because the costs of the fund often make the returns for unsecured creditors marginal, it could be argued that the procedure is more or less wasteful.[109] Furthermore, it has been asserted that "reducing the assets originally meant for the satisfaction of the debts owed under the floating charge undermines the fundamentals of the concept of security," leading to the conclusion that "insolvency law grants security through the door then throws it away through the window by allowing unsecured creditors to enter a bargain they should not be part of."[110]

Yet despite the prescribed part perhaps being an expensive and not particularly effective way of protecting its beneficiaries, the fund is usually the only source of realization for this class of creditors.[111] Thus, possibly because the prescribed part has led to developments that have gone a *little way* to easing the plight of unsecured creditors, it has achieved something that is worthwhile.[112] Perhaps "[t]he fact that some people may escape does not mean that policymakers should be indifferent between endorsing parties' ability to tie up all the assets of a business and indicating that the parties should count on some balanced distribution between secured and unsecured creditors."[113] Failing to make any efforts to improve the situation of unsecured creditors may signal an embrace of well-positioned creditors above all others, which could affect the ultimate development of other commercial laws.[114] If the sole purpose of commercial law was to promote expansion, then it would perhaps permit security interests in body parts—there clearly are, and should be, policy-related bounds to structuring

107. Bossetti & Kurth, *supra* note 11, at 26–29.

108. Akintola, *supra* note 31, at 6.

109. *See supra* subpart I(C).

110. Chrispas Nyombi, *Unfairness and Confusion: Inherent Features of Floating Charge Security*, 46 L. TCHR. 197, 198 (2012).

111. Akintola, *supra* note 31, at 2; Armour, *supra* note 36, at 12.

112. Frisby, *supra* note 16, at 272.

113. Warren, *supra* note 3, at 1392.

114. *Id.*

commercial lending transactions.[115] Therefore, it is plausible that determining these bounds should not be entirely restricted by efficiency concerns.

In 2014, the City of London Law Society, one of the largest law societies in the U.K., published a discussion paper that identified certain areas of concern regarding secured transactions and proposed several methods to address these problems.[116] The paper identified the difficulty in distinguishing between fixed and floating charges as a major problem that manifests itself when structuring transactions and when a company gets into financial difficulties.[117] One of three solutions proposed to fix the problem was "to do away with the requirement to distinguish between fixed and floating charges in an insolvency, and simply to pay the levy as a small percentage of all charged assets up to a cap."[118] The paper highlighted the advantages to this solution as it being clear and simple, eliminating the need to draw artificial distinctions, doing so fairly with less scope for arbitrage, and making the amount of assets required to cover the borrowing easier to ascertain.[119] In considering the disadvantages of the approach, the Society emphasizes its difference from the current system and consequential reclassification of winners and losers.[120]

The proposition by the City of London Law Society would morph the prescribed part into something more similar to Warren's carve-out proposal. Further, the society essentially states that a statutory redistribution system more like the Warren carve-out proposal would alleviate some of the burdens imposed by the prescribed part. If one of the main disadvantages to this proposal would be the difference from the current system, perhaps that could be interpreted as a positive attribute in light of unsecured creditors' current position within insolvency proceedings.

While the City of London Law Society proposal is far from an intricate analysis of how Warren's carve-out provision would benefit outcomes for unsecured creditors in the U.K., it lends credence to the idea that the carve-out proposal could fare better in the United States than the prescribed part has in the U.K.

Conclusion

Under Article 9, unsecured creditors often have dismal returns in liquidation bankruptcies.[121] One of the principal drafters of the UCC, Grant

115. *Id.* at 1386.

116. THE CITY OF LONDON LAW SOC'Y, SECURED TRANSACTIONS REFORM: DISCUSSION PAPER 2: FIXED AND FLOATING CHARGES ON INSOLVENCY (2014).

117. *Id.* at 2–3.

118. *Id.* at 9.

119. *Id.*

120. *Id.*

121. *See supra* subpart I(C).

Gilmore, has questioned this phenomenon in such colorful language as "why on earth should the fruits of a known insolvent's labors feed the assignee while all the other creditors starve? . . . [D]oes it make any sense to award everything to a secured party who stands idly by while a doomed enterprise goes down . . . ?"[122] Since the proposal drafted by Warren to remedy this situation was rejected, the ALI has not adopted a means for redistributing returns to unsecured creditors more equitably. Given the ongoing unfortunate position of unsecured creditors, "[o]ther systems may have much to teach about laws that foster a thriving commercial system."[123]

While the prescribed part differs from the carve-out proposal in significant ways, the impact of the prescribed part on U.K. lending is illustrative in considering a carve-out proposal for the United States. The prescribed part did not necessarily cause the total amount of credit available in the British economy to decline, but that is possibly because it likely incentivized borrowers and lenders to mitigate the effects of the carve-out by using substitute lending techniques, and it appears that the prescribed part has not delivered unsecured creditors significantly better recoveries. Nevertheless, the U.K. courts have taken some steps towards curbing sophisticated creditors' avoidance of the prescribed part's application. Those courts have also sought to grant unsecured creditors maximum returns where possible, and the prescribed part often provides the only return for unsecured creditors in insolvency proceedings.

This Note does not take a position on whether the United States should adopt Warren's carve-out proposal, but it hopefully provides some considerations as to why doing so would or would not be beneficial for unsecured creditors and the economy as a whole.

122. Grant Gilmore, *The Good Faith Purchase Idea and the Uniform Commercial Code: Confessions of a Repentant Draftsman*, 15 GA. L. REV. 605, 627 (1981).

123. Warren, *supra* note 3, at 1385.