TRUST MORTGAGES: AN UNDER-APPRECIATED TOOL

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INTRODUCTION

The trust mortgage is the most under-appreciated, and thus under-utilized, tool in out-of-court restructurings today. In the pantheon of restructuring devices, the trust mortgage can best be described as an out-of-court chapter 11. Like chapter 11, it can be employed for the purpose of either reorganization or liquidation. For reorganization, the trust mortgage is used to provide security to creditors and enhance their control in the context of what would otherwise be an unsecured composition.[1] For liquidation, the trust mortgage is used to assure close supervision by creditors of a going-concern sale or liquidation undertaken by management.[2]

I. WHAT IS A TRUST MORTGAGE?[3]

A trust mortgage is a mortgage on and/or a security interest in all assets of a debtor granted to a trustee[4] to be administered for the benefit of unsecured creditors.

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[1] *See* United States v. Gargill, 218 F.2d 556, 558 (1st Cir. 1955) (noting terms of recorded trust mortgage permitted mortgagor to continue business operations on condition that mortgagor remained indebted to creditors and required mortgagor to provide creditors with financial statements and accounting books on demand); S. Samuels & Co. v. Charles E. Fogg Co., 155 N.E. 429, 429–30 (Mass. 1927) (describing trust mortgage terms that granted corporation right to operate mortgaged property on various conditions including payment of notes at maturity while preserving right of trustee to "upon breach of condition . . . take possession of the property and run the business and receive income and profits for the benefit of" creditors).

[2] *See, e.g.*, *In re* Mich. Mach. Tool Control Corp., 381 B.R. 657, 665 (Bankr. E.D. Mich. 2008) (observing corporate decision to execute trust mortgage "providing for the liquidation of all of its assets for the benefit of its creditors"); *see* McKnight v. Troderman, No. 03-P-1391, 2005 WL 36155, at *2 (Mass. Jan. 7, 2005) (observing "trust mortgage agreement was planned and implemented as a liquidation and termination of the company and not as a conventional mortgage, pledge, or grant of a security interest"); Gilmore v. Century Bank and Trust Co., 477 N.E.2d 1069, 1071 (Mass. 1985) (explaining workout agreement where claims of forty-two subcontractors claiming payment for work done were to be consolidated into trust mortgage and liquidated).

[3] The term "trust mortgage" is also used in situations other than corporate reorganizations or liquidations, including where a mortgage is granted to a trustee as security for bonds or syndicated loans. Trust mortgages of that variety are not the subject of this article.

[4] *See* Williams v. Banana Distrib. Co., 59 F.2d 645, 645 (6th Cir. 1932) (describing trust mortgage as instrument "which conveys all of the assets of a debtor to a trustee for the benefit of his creditors without preference"); Lake States Ins. Co. v. Consumer Ins. Servs. of Am., No. CIV.A.00-5501C, 2001 WL 476526, at *1 n.2 (Mass. Super. Ct. May 2, 2001) (explaining arrangement where company transfers all assets to trustee is "known as a 'trust mortgage' arrangement and is modeled after chapter 7 of the United States Bankruptcy Code"). The Honorable Robert Somma has described a trust mortgage as:

> [A] grant by a debtor of a lien on its assets to secure an agreement with creditors for the payment of their claims. The debtor grants to a trustee a security interest in, or a mortgage on, its assets and property for the benefit of its creditors. The creditors agree

The trust mortgage secures payment of unsecured claims, which will typically be entitled to a *pro rata* distribution of net proceeds from disposition of the collateral (in a liquidation) or an agreed percentage of allowed claims (in a reorganization). The arrangement has two fundamental components: (i) the debtor's grant of a lien on all of its assets to the trustee, and (ii) establishment of a trust arrangement between the debtor (in this capacity, functioning as settlor) and the trustee.[5] Although the two components can be combined in a single document, more commonly there will be a separate trust mortgage/security agreement and a creditors' trust agreement.

The mortgage and/or security agreement generally resembles a garden variety real estate mortgage and/or Article 9 security agreement, except that it secures the trust agreement instead of a more traditional debt instrument. Since first-in-time filing rules under state real property law and the Uniform Commercial Code do not readily adapt to *pro rata* security interests, this result is achieved through the mechanism of a trust. In this regard, the structure resembles use of a collateral trustee in a lending transaction involving multiple debtholders.

The trust agreement will typically blend elements of an assignment for the benefit of creditors ("ABC") and a composition agreement.[6] As in an ABC, the agreement is made by the debtor and the trustee, but includes assent procedures by which creditors of the debtor will bind themselves to the terms of the agreement. However, the trust agreement more nearly resembles a composition agreement in that the debtor retains its assets provided that it complies with the terms of the agreement. As with an ABC or composition agreement, creditors through submission of their assents agree to accept the payments due under the trust agreement in full satisfaction of their claims, cease all collection activities, and

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> not to enforce their claims and to accept the payment schedule provided under the agreement. Because a trust mortgage provides security for the payment of claims, creditors may be willing to accept greater extensions of time or smaller payments than they would accept in a composition.

Robert Somma & Arthur L. Streeter, *Workout and Non-Bankruptcy Alternatives*, *in* 3 MASSACHUSETTS BUSINESS LAWYERING, at *10 (Massachusetts Continuing Legal Education 1998) (setting forth requirements and rights of creditors under trust mortgage), *available on* Westlaw *at* BLIII MA-CLE S-43-I. Frequently more than one trustee is appointed, often to deal with any issues of succession if one trustee dies or is incapacitated, or to provide representation for certain constituencies. For the sake of simplicity, this article refers to a single trustee/mortgagee.

[5] *See Banana Distrib.*, 59 F.2d at 645 (characterizing trust mortgage as conveyance of all of debtor's assets and establishing trust arrangement); Murray Bros. v. Mackinac Circuit Judge, 216 N.W. 914, 915 (Mich. 1928) (discussing features of particular trust mortgage involving conveyance and limitation on trustee's powers under indenture). *See generally* Somma & Streeter, *supra* note 4, at *10–11 (describing general characteristics of trust mortgage).

[6] *See generally In re* Me. State Raceways, 97 F. Supp. 1016, 1018 (D. Me. 1951) (describing trust mortgage as aiming to include elements of both "composition of the debts" and assignment for benefit of creditors); *Murray Bros*., 216 N.W. at 915 ("The rights of [parties to a trust mortgage] should be passed upon and tested by the same rules that apply to one who has made an assignment for the benefit of creditors."); *In re* Hersey, 171 F. 998, 999 (D. Iowa 1909) (elucidating that trust mortgage included elements of composition and assignment for benefit of creditors).

forgo other remedies including state court litigation or commencement of an involuntary bankruptcy proceeding.[7] The trust agreement will also provide procedures for resolving any dispute between the trustee and an assenting creditor concerning the allowance of its claim.

As with other out-of-court mechanisms for liquidation or reorganization, a trust mortgage involves trade-offs when compared to a bankruptcy proceeding. By obviating the need for bankruptcy court oversight and compliance with the Bankruptcy Code, the trust mortgage will often be cheaper, faster and more flexible than chapter 7 or chapter 11.[8] These advantages are purchased at the price of foregoing the protections and powers of the Bankruptcy Code—protections that include the automatic stay, transparency and due process, and powers that include selling free and clear of liens, assuming and assigning contracts over the objection of the non-debtor party thereto, avoiding preferential transfers, and disempowering holdout creditors.[9] As always, the salient issue is whether the benefits of bankruptcy are likely to increase *net* value to stakeholders after taking account of the costs.[10]

II. HOW TRUST MORTGAGES ARE USED

A trust mortgage may be utilized to effect either a reorganization or a liquidation.

A. Reorganization

When utilized to implement a reorganization, a trust mortgage will typically provide for the debtor to remit to the trustee a schedule of payments, which the trustee will then distribute to creditors in accordance with the priority scheme of the

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[7] *See* Somma & Streeter, *supra* note 4, at *10 (setting forth requirements and rights of creditors under trust mortgage). *See generally* Fed. Deposit Ins. Corp. v. Juron, 713 F. Supp. 1116, 1119–20 (N.D. Ill. 1989) (stating similarities and differences between ABC and composition agreements); Melanie Rovner Cohen & Joanna L. Challacombe, *Assignment for the Benefit of Creditors—A Contemporary Alternative for Corporations*, 2 DEPAUL BUS. L.J. 269, 269–70 (1990) (discussing process and benefits of ABC).

[8] *See* Somma & Streeter, *supra* note 4, at *6 (discussing non-bankruptcy alternatives, such as establishing trust mortgage, as "cheaper, quicker, [and] less labor-intensive" than reorganization under chapter 11). *See generally* James A. Chatz & Joy E. Levy, *Alternatives to Bankruptcy*, 17 NORTON J. BANKR. L. & PRAC. 1, Art. 5 (Feb. 2008) (stating drawbacks of filing for bankruptcy and how non-bankruptcy alternatives can eliminate such disadvantages); Conrad B. Duberstein, *Out-of-Court Workouts*, 1 AM. BANKR. INST. L. REV. 347, 347, 350–51 (1993) (discussing benefits of out-of-court workout as alternative to filing for bankruptcy, including avoidance of costs and delays).

[9] A trust mortgagee can, however, avoid fraudulent transfers, including preferential transfers to insiders made within one year before suit is brought. UNIF. FRAUDULENT TRANSFER ACT § 5(b), 7A U.L.A. 129 (2006). A well-drafted trust mortgage will provide that assenting creditors assign to the trustee their right to recover fraudulent transfers, which the trustee can then pursue under state fraudulent transfer laws.

[10] *See* Somma & Streeter, *supra* note 4, at *6 (remarking on availability of automatic stay as means to reign in hostile creditors). *See generally* Chatz & Levy, *supra* note 8 (noting advantages of filing for bankruptcy and protections gained by process); Duberstein, *supra* note 8, at 351 (discussing protections lost as result of not filing for bankruptcy).

Bankruptcy Code.[11] The required payments may be fixed in amount, computed on the basis of a formula (for example, a percentage of cash flow) or tied to particular events, such as asset dispositions.[12] The trust mortgage will provide for financial reporting to the trustee, often in great detail. In addition to the usual covenants contained in a loan and security agreement, a trust mortgage will typically provide benchmarks that the debtor must achieve in implementing its turnaround plan. What if a default occurs? As between the creditors and the trustee who serves as their fiduciary, the trustee may be required to liquidate immediately, but more often will have the power to forbear for a period of time, at the trustee's discretion, and perhaps to waive defaults altogether and reset covenants with the approval of the creditors' committee or trust advisory committee (if there is one), or a majority or super-majority of creditors.

From the debtor's perspective, a key benefit to employing a trust mortgage is that the debtor grants only a security interest in its property. As a result, the debtor retains the mortgaged property and can continue operations. For this very reason, a trust mortgage might also prove attractive to trade creditors interested in doing business with the debtor on an ongoing basis as well as realizing some return on their past-due receivables; but even viewed solely from the perspective of maximizing payment on account of their existing claims, creditors will benefit from a trust mortgage in cases where liquidation would likely yield a lower recovery than the present value of the payment stream to be provided under the trust mortgage.[13] Of course, in any situation where creditors agree to accept a payment stream rather than immediate liquidation, they face the risk that the payments will not be made—potentially resulting in a future liquidation at a time when the debtor's liquidation value has declined. However, the trustee's security interest in the debtor's assets mitigates this risk to some extent by providing the means, in the event of a default, for liquidation to be quickly commenced and conducted by a creditor-oriented professional, the trustee.

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[11] An important exception is the need for a trust mortgage to accord priority to all claims of the United States. *See infra* Part IV.D.

[12] *See* How to Restructure Debt Outside Chapter 11, http://www.cwg11.com/pgs/resources/chap11.html (last visited Jan. 28, 2009) (discussing how lien created by trust mortgage secures debtor's obligations to creditors "which might include payments to creditors"). *See generally* Kavanagh v. Kayes (*In re* Fair Creamery Co.), 193 F.2d 5, 6 (6th Cir. 1951) (discussing consequences of failing to meet requirements in payment schedule under trust mortgage agreement); Michael S. Lurey, *Participation in a Pre-Bankruptcy Workout*, PRACTISING LAW INSTITUTE CORPORATE LAW AND PRACTICE COURSE HANDBOOK SERIES NO. B4-6761 427, 438–39 (1986) (discussing sources of payment debtor can offer creditor in pre-bankruptcy workout).

[13] *Cf.* Ralph Brubaker, *Bankruptcy Injunctions and Complex Litigation: A Critical Reappraisal of Non-Debtor Releases in Chapter 11 Reorganizations*, 1997 U. ILL. L. REV. 959, 1011 (1997) (providing hypothetical where creditors would be better off if debtor continues business operations instead of pursuing liquidation); Alan Schwartz, *Contracting About Bankruptcy*, 13 J.L. ECON. & ORG. 127, 142–43 (1997) (examining conflict arising from trade creditors who prefer to continue business dealings with debtor as going concern); Steven L. Schwarcz, *Rethinking Freedom of Contract: A Bankruptcy Paradigm*, 77 TEX. L. REV. 515, 530 (1999) ("Senior creditors may prefer liquidation in order to be paid, but trade creditors may prefer that the debtor's business continue to operate . . . .").

B. Liquidation

As with a reorganizational trust mortgage, a liquidating trust mortgage allows the debtor to retain the assets. However, this state of affairs is decidedly temporary since the purpose of the arrangement is for the debtor to liquidate those assets on an orderly basis. Liquidating trust mortgages is particularly useful when the debtor is seeking to sell its business as a going concern or needs to complete certain operations (for example, completion of work in process, or sale of seasonal goods) in order to maximize value. While this process takes place, the trust mortgage serves to establish the priority of, and equality of treatment among, existing unsecured creditors. Given its limited purpose and short lifespan, a liquidating trust mortgage will typically keep the debtor on a tighter leash than a reorganizational trust mortgage. Since the debtor is running operations purely for the benefit of creditors (and is probably burning through cash), the trust mortgage will likely require the debtor to provide the trustee with regular budgets and financial reports—perhaps as often as weekly. The trustee will often have the power under the trust mortgage to approve or disapprove the debtor's proposed budgets. Often the liquidating trust mortgage will permit the trustee, as a matter of discretion, to take possession of the collateral and commence foreclosure if dissatisfied with the progress of the liquidation.

Using a trust mortgage rather than an ABC as the vehicle for a liquidation will typically reflect one or a combination of three factors. First, creditors may believe that the debtor will conduct a better wind-down of the business and disposition of assets, yielding greater proceeds. In a rare case, this belief may reflect confidence in the debtor's management; more often, it will result from the debtor's retention of a competent and credible liquidation professional. Second, creditors may believe that putting an assignee for the benefit of creditors in charge of the liquidation process would not be cost effective, lowering the net return to creditors. Third, a trust mortgage may avoid legal and practical difficulties that an ABC would cause. Entailing as it does an outright transfer of the debtor's assets, an ABC might trigger defaults under contracts and leases that a trust mortgage, which takes the form of merely granting a security interest, may not. Even a party who has the legal right to terminate its relationship with the debtor may be more easily persuaded to cooperate with the liquidation process if the debtor's managers remain in charge.

III. LEGAL ISSUES ARISING UNDER TRUST MORTGAGES

A. Applicability of Laws Pertaining to Assignments for the Benefit of Creditors

Trust mortgages are not expressly regulated by state law.[14] However, because trust mortgages bear a certain similarity to ABCs—both are mechanisms for a debtor to transfer an interest in its property to a third party acting on behalf of creditors for the purpose of facilitating a *pro rata* distribution to general unsecured creditors—the question arises whether statutes and common law governing ABCs also apply to trust mortgages.[15] This will be of particular concern in those states where statutes establish procedural requirements for the validity of an ABC.[16]

In *Williams v. Banana Distributing Co.*,[17] the Sixth Circuit, applying Michigan law, held that "any instrument, including a trust mortgage, which conveys all of the assets of a debtor to a trustee for the benefit of his creditors without preference, is construed as an assignment for the benefit of creditors."[18] The Michigan statute governing assignments for the benefit of creditors provided that such assignments would be void unless the instrument of assignment, an inventory of assigned property, a list of creditors, and a sufficient bond by the assignee were filed with the local court within ten days.[19] A trust mortgage was granted and recorded, but the

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[14] *See generally* Vivian Luo, Comment, *A Preference for States? The Woes of Preempting State Preference Statutes*, 24 EMORY BANKR. DEV. J. 513, 521 (2008) (outlining two types of creditor collective action proceedings generally provided by state law: assignments for benefit of creditors and receiverships).

[15] *See* Williams v. Banana Distrib. Co., 59 F.2d 645, 645 (6th Cir. 1932) (stating Michigan law viewed trust mortgages as assignments for benefit of creditors) (citations omitted); *see also In re* Mackin, 208 F. Supp. 45, 49 (D. Mass. 1962) ("An assignment for the benefit of creditors may take the form of a 'trust mortgage' and yet be ruled an assignment.") (citation omitted). *But see In re* Me. State Raceways, 97 F. Supp. 1016, 1019 (D. Me. 1951) (holding trust mortgage was not general assignment for benefit of creditors).

[16] In general, states regulate ABCs either through statutes or common law and, in common-law jurisdictions, the regulation may be quite minimal. This topic will be not covered in this article, as it has been thoroughly covered elsewhere. *See* GEOFFREY L. BERMAN, GENERAL ASSIGNMENTS FOR THE BENEFIT OF CREDITORS: THE ABCS OF ABCS (2d ed. 2006); *see also* Chatz & Levy, *supra* note 8 (discussing how many states have adopted statutes dictating procedure for making valid ABCs); Jeffrey Davis, *Florida's Beefed-Up Assignment for the Benefit of Creditors as an Alternative to Bankruptcy*, 19 U. FLA. J.L. & PUB. POL'Y 17, 18–19 (2008) (detailing 1987 amendments to Florida statutes laying out specific notices and procedures for valid assignments for benefit of creditors).

[17] 59 F.2d 645.

[18] *See id.* at 645 (collecting Michigan cases).

[19] *See id.* (interpreting trust mortgage requirements under 1929 version of statute). The current Michigan statute governing common law assignments for the benefit of creditors contains similar requirements for a valid assignment for the benefit of creditors:

> (1) [*Requirements for validity.*] All assignments commonly called common law assignments for the benefit of creditors are void unless the same are without preferences as between such creditors and are of all the property of the assignor not exempt from execution, and the instrument of assignment (or a duplicate thereof), a list of creditors of the assignor, and a bond for the faithful performance of the trust by the assignee are filed in the office of the clerk of the circuit court where said assignor resides, or if he is not a resident of the state, then of the county where the assigned

trust mortgagee failed to satisfy the requirements of this statute.[20] After the trustee took possession, a creditor obtained a judgment against the debtors and levied on the mortgaged real estate.[21] The levying creditor, once the period to avoid its lien under bankruptcy law had lapsed, brought an action in the federal court seeking to vacate the trust mortgage and to direct the sheriff to sell the property pursuant to the execution.[22] The trust mortgagee answered by requesting enforcement of the trust mortgage and offering to file a bond to comply with the assignment statute.[23] But it was too late. After construing the trust mortgage as an ABC for purposes of the statute, the court applied Michigan Supreme Court precedent that failure by an assignee to file a bond within ten days of an ABC rendered the assignment invalid.[24] Further, the court held that state law precedent provided only two options when the assignee failed to satisfy the statutory requirements: (i) creditors could ask for the appointment of a receiver (i.e. proceed in equity), or (ii) creditors could enforce their claims by levy (i.e. proceed at law).[25] Since the levying creditor had opted for the latter, and all other creditors had slept on their right to seek appointment of a

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> property is principally located, within 10 days after the making thereof.
> (2) [*Bond of assignee, filing, approval.*] No such assignment is effectual to convey the title to the property to the assignee until such bond is filed with and approved by said clerk.
> (3) [*Subsequent attachment or execution on assigned property.*] No attachment or execution levied upon any assigned property of such assignor after such assignment and before the expiration of the time provided herein for filing such bond, is valid, and does not create any lien upon such property.
> (4) [*Acknowledgment; inventory, contents; list of creditors, contents.*] Such assignment shall be acknowledged before some officer authorized to take acknowledgments. Such inventory shall be a detailed statement as near as may be of the general description, value and location of all the property and rights assigned, and in cases of persons engaged in business, specifying the original cost of any goods, wares, merchandise, fixtures and furniture. Such list of creditors shall, as far as the assignor can state the same, contain the name and post office address of each creditor, the amount due as near as may be over and above all defenses, the actual consideration for the debt, when contracted, and all securities and the value thereof held by each creditor. Such inventory and list of creditors shall be sworn by the assignor to be full, true and correct to the best of his knowledge, information and belief.
> (5) [*Bond of assignee, sureties.*] Such bond shall be to the assignor for the joint and several use and benefit of himself and each, any and all of the creditors of such assignor in a penal sum at least double the value of the assigned property as shown by such inventory, and conditioned for the prompt and faithful administration of the trust by the assignee and shall be signed by the assignee and sufficient surety or sureties, who shall, under oath endorsed on said bond, testify that they are worth in the aggregate over and above all exemptions, encumbrances and debts, the penal sum of said bond.

MICH. COMP. LAWS SERV. § 600.5201 (LexisNexis 2004).

[20] *Banana Distrib.*, 59 F.2d at 645–46. *See* McCuaig v. City Sav. Bank, 69 N.W. 500, 501 (Mich. 1896) (noting one must file inventory, list of creditors, and bond within 10 days after filing with clerk).

[21] *Banana Distrib.*, 59 F.2d at 646.

[22] *Id.*

[23] *Id.*

[24] *Id.* at 647 (citations omitted).

[25] *Id.* at 646 (citation omitted).

receiver, the court invalidated the trust mortgage and permitted the levying creditor to proceed with its sheriff's sale.[26]

The lesson from *Banana Distributing* is that parties to a trust mortgage must analyze applicable laws governing ABCs, including the consequences of noncompliance. In general, the statutory requirements should be followed when the detriment from noncompliance would exceed the burden and cost of compliance. However, the parties may face a genuine dilemma if there are aspects of state law governing ABCs that the parties to a trust mortgage affirmatively wish to avoid. In that situation, in a jurisdiction (just about all of them, apparently) where the law is unclear whether trust mortgages are to be construed as ABCs, the parties might wish to include in the trust mortgage a statement of their intent that the document not be construed as an ABC.[27] Whatever decision the parties make, it should be the result of informed consideration of the *Banana Distributing* issue.

B. Rights of an Attaching or Levying Creditor Versus a Trust Mortgage

In addition to providing security for the payment stream, a trust mortgage also serves the function of establishing the assenting creditors' priority on the mortgaged assets. Absent being declared invalid as discussed in the previous section, the trust mortgage will be effective as to subsequently attaching creditors,[28] but to what extent? The mortgage itself secures "obligations" to the trustee. What is the amount of those obligations? Is it the total liabilities shown on the debtor's books as of the date of the trust mortgage? The aggregate amount claimed by unsecured creditors? The aggregate amount of claims filed by *assenting creditors*? The aggregate amount of claims ultimately allowed by the trustee? The aggregate amount of claims filed by assenting creditors, or allowed by the trustee, *as of the date of the attachment*? If any of these answers would yield an amount less than the value of the mortgaged assets, the attaching creditor has an incentive to contest the trustee's priority. Moreover, regardless of whether the lien of the attaching or levying creditor has any economic value, this creditor has the potential to disrupt the debtor's operations, for example, by causing the assets to be sold on execution and perhaps bidding its claim to acquire the assets.

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[26] *Id.* at 647 (agreeing with lower court's reliance on "the familiar principle that equity favors the diligent, and not those who slumber on their rights").

[27] *Cf. In re* Me. State Raceways, 97 F. Supp. 1016, 1018–19 (D. Me. 1951) (examining "real and primary purpose" of trust mortgage and debtor's intent in executing it in determining whether it was assignment for benefit of creditors). *But cf.* Am. Mortgage Co. v. Merrick Constr. Co., 104 N.Y.S. 900, 901 (N.Y. App. Div. 1907) (positing court "must look to the substance of what has been done" in determining whether trust mortgage was in effect an assignment for benefit of creditors).

[28] *Cf.* United States v. Gargill, 218 F.2d 556, 560 (1st Cir. 1955) (noting trust mortgage resulting in preference for particular creditor was previously upheld); McKnight v. Paul D. Osborne Desk Co., No. 00-1191, 2001 WL 1540583 at *2 (Mass. Super. Ct. Oct. 9, 2001) (discussing purpose of trust mortgages created for benefit of all creditors); Geoffrey L. Berman & Robert J. Hoder, *Use of the "Blanket" Security Interest for Trade Creditors in Out-of-Court Workouts*, 23 CAL. BANKR. J. 297, 298 (1997) (stating trust mortgages routinely upheld against state court challenges by attaching creditors).

Since the terms of the trust mortgage establish that at the end of the day, the debtor's liability to the trustee will consist of the aggregate allowed amount of assenting creditors' claims, this should be the correct answer as to the amount of the trust mortgagee's claim that is senior to the attaching creditor. There are, however, two strains of law that might lead courts to an incorrect conclusion in situations where an attachment is recorded after the trust mortgage but before the process of creditor assent and allowance of claims has concluded.

First, as to real estate collateral, certain jurisdictions provide that advances under a mortgage will have priority over a junior lien only if made prior to the date of the junior lien or pursuant to a non-discretionary obligation that antedates the junior lien.[29] How might this affect a trust mortgage? While it is true that all advances secured by the trust mortgage have already been made by the time of recording, the trust mortgage does not secure these advances until the creditor assents to the trust mortgage. Sometimes the trust mortgage, by its terms, might not become effective until a certain percentage of creditors or outstanding debt assent; or a better drafted version of the same provision might provide for the trust mortgage to be immediately effective, but to terminate if a certain percentage of assents were not to be obtained by a certain date.[30] If an attachment were recorded between the date of the mortgage and the date that a creditor assented to the trust mortgage, should the assenting creditor's claim be viewed as a subsequent "advance" by the trust mortgagee and, if so, as an obligatory or discretionary advance?

For purposes of measuring the trustee's priority in relation to junior liens, the trust mortgage should be deemed to secure immediately from the date of recordation all valid unsecured claims against the debtor.[31] A well-drafted trust mortgage will expressly so provide. Creditor assent is best viewed (and should be drafted) as a condition subsequent such that the claims of non-assenting creditors will be secured immediately when the trust mortgage is recorded but released from the security of the trust mortgage if the creditor elects not to assent. Yet even if a

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[29] *See* 59 C.J.S. *Mortgages* § 214 (1998) (providing list of some of cases reaching this result). Since future advances are covered under Article 9, this will only be an issue in connection with real estate. *See* discussion *infra* note 38. *See also* First State Bank, Belmond v. Kalkwarf, 495 N.W.2d 708, 713 (Iowa 1993) (noting under Iowa law, "loans and advances made under a prior recorded mortgage will have priority over subsequent recorded or filed liens"); First Nat. Bank in Wichita v. Fink, 736 P.2d 909, 913 (Kan. 1987) (recognizing general rule that if "making of future advances is obligatory" then "lien of the mortgagee receives priority from the date of the recording of the mortgage").

[30] *Cf. Gargill*, 218 F.2d at 558 ("The trustees promise to hold the mortgaged property in trust 'for the equal pro rata benefit and security of such . . . creditors . . . as shall have assented hereto within sixty (60) days of the date of this indenture . . . . '"); *In re* Fairlamb, 199 F. 278, 278 (E.D. Pa. 1912) (noting "all the creditors signed the agreement within the year, and all creditors and the trustee were advised in writing upon the agreement filed with the trustee of the claim by the Western National Bank and its amount" and "[t]he settlement under the agreement could not have been consummated unless the bank had signed the agreement").

[31] *See generally In re* Astell Eng'g & Iron Works, 278 F. 743, 744–45 (E.D.N.Y. 1921) (noting creditor assent "'makes the instrument, as of the time it was given, a valid mortgage'" (quoting Rochester Bank v. Averell, 96 N.Y. 467, 467 (1884))).

court were attracted by the analogy of a creditor assent to a future advance, such future advance clearly qualifies as obligatory—such that its priority relates back to the date of recording of the trust mortgage—rather than discretionary since the trust mortgage affords the trustee no discretion to reject assents received within the time period provided by the trust mortgage.[32] In this regard, the typical trust mortgage provides an absolute right for creditors to assent within a certain period, typically 60 or 90 days after the date of the trust mortgage, and permits, but does not require, the trustee to accept assents tendered after this period.[33] Because the trustee may in theory reject an untimely assent, it might appear at first glance that if creditor assents are analogized to future advances, an untimely assent should be viewed as a discretionary future advance. Not so. The trustee's option to reject an untimely assent is illusory. He acts as a fiduciary for creditors, and may not act inconsistently with such duty by rejecting an untimely assent. While it might be argued that once the initial deadline for assents has passed, the trustee should reject subsequent assents so as not to dilute the interests of timely-assenting creditors, accepted practice among trustees (and assignees under ABCs) is to accept late-filed assents from creditors who appear to have valid claims.[34] Both for this reason, and also to avoid the wrenching conflict that a trust mortgagee would face if he held liens at multiple levels of priority on behalf of various subsets of the debtor's creditors, courts should treat all claims of assenting creditors as nondiscretionary advances by the trustee regardless of the date or timeliness of any particular assent.

The second strain of law that might suggest less than complete priority for the trust mortgage over a subsequent attachment consists of what courts in at least one jurisdiction have referred to as a common law rule that an ABC takes priority over a later attachment only to the extent of assenting claims.[35] It is unclear whether the

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[32] *See generally* La Cholla Group, Inc. v. Timm, 844 P.2d 657, 659 (Ariz. Ct. App. 1992) (stating general rule that recorded obligatory advances have priority over "intervening liens"); Idaho First Nat. Bank v. Wells, 596 P.2d 429, 433 (Idaho 1979) ("The general rule in the United States is that if a future advance is obligatory, it takes its priority from the original date of the mortgage, and the subsequent creditor is junior to it."); James B. Hughes, Jr., *Future Advance Mortgages: Preserving the Benefits and Burdens of the Bargain*, 29 WAKE FOREST L. REV. 1101, 1115–16 (1994) (noting obligatory future advances date back to "original recordation of the mortgage").

[33] *Cf.* Strasnick v. Cinamon, 184 N.E. 389, 389 (Mass. 1933) ("[O]nly those creditors who assented and thus became cestuis que trust in accordance with the provisions of the assignment to the defendant had a right to share in the distribution.") (citation omitted).

[34] In some instances, accepting late-filed assents provides a practical benefit to timely-assenting creditors by bringing "inside the tent" creditors who might otherwise have an incentive to oppose the trust mortgage by filing a bankruptcy petition against the debtor or bringing legal actions. However, even when there is no benefit to timely-assenting creditors, trustees under trust mortgages and assignees under ABCs typically accept late-filed assents in the belief that they should not play "gotcha" with members of the constituency they have been appointed to serve.

[35] *See, e.g.*, A.G. Walton & Co., Inc. v. Levenson, 10 N.E. 2d 190, 191 (Mass. 1937) ("The assent itself, not its form, is important to the completion of the trust relationship contemplated. The assignor and assignee may effectively accept the oral assent of any individual creditor, despite the condition previously imposed by them.") (citation omitted); *see* Sinclair v. Napoli Cafeteria, 138 N.E. 327, 328 (Mass. 1923) ("'It has always been held that voluntary assignments by a debtor, in trust for the payments of debts, and without other adequate consideration, are invalid as against attachment, except so far as assented to by the creditors . . . ."

amount of assenting claims is to be computed as of the date of the attachment or at the date when the process of gathering assents has been completed.[36] As applied to an ABC, this "rule" is peculiar in recognizing any right to attach assets that the debtor has already transferred to the assignee. The better rule, which also finds support in the case law,[37] is that at most an attaching creditor may obtain an interest in the debtor's contingent right to a retransfer by the assignee of any remaining assets if assenting creditors were to be paid in full by the assignee. That rule has the benefit not only of logic, but also of making clear that the interest of the attaching creditor, who can obtain no greater rights than the debtor whose interest has been attached, is subject to the payment in full of all assenting creditors, no matter when they assented. But whatever rule is applied in the ABC context ought not be extended to trust mortgages because of the difference between the transfer involved in an ABC (an absolute transfer of assets in trust for the assignor's creditors) and a trust mortgage (the grant of a security interest to unsecured creditors). Insofar as the trust mortgage involves personal property, it is crystal clear under Article 9 of the Uniform Commercial Code that once a financing statement has been filed in favor of the trustee, all claims secured by the trust mortgage take priority over later-filed interests regardless of the time that any particular creditor assented to the trust

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(quoting May v. Wannemacher, 111 Mass. 202, 207 (1872))); *see also* Sawyer v. Levy, 38 N.E. 365, 365 (Mass. 1894):

> A preference given by an insolvent debtor to a bona fide creditor cannot be avoided by an attaching creditor, whether the form of preference which is adopted is a general assignment for the benefit of such creditors as should assent thereto, or an assignment for the benefit of certain specified creditors, or an assignment directly to a single creditor; otherwise it would simply amount to giving a preference to the attaching creditor, instead of to the creditor or creditors selected by the debtor.

[36] *See* Stowe v. Belfast Sav. Bank, 92 F. 90, 93 (D. Me. 1897):

> The defendants cites and relies on numerous cases . . . where attachments were made before any creditors had assented to the assignment, or where, at the date of the attachments, the demands of the assenting creditors were less in amount than the value of the property assigned, in which cases the attachments have been held good, at least upon the excess of the property above the demands of assenting creditors.

see also A.G. Walton & Co., 10 N.E. 2d at 192 (noting "certain creditors not expressly assenting in writing" were parties to assignment before creditor's attachment); Lee v. Brown, 7 Ga. 275, 275 (1849), *available at* 1849 WL 1676, at *2 (Ga. Aug. 1849) (noting mortgage that attached first was entitled to be first satisfied).

[37] *See* Reddy v. Raymond, 80 N.E. 484, 485 (Mass. 1907) ("The interest of the debtor in the goods could have been reached by the trustee process but the title to the goods themselves having vested in the assignee they were no longer attachable by a creditor of the debtor as the goods of the latter.") (citation omitted); *see also* Cropper v. Gorham, 109 N.E. 161, 162 (Mass. 1915) (observing "by executing the deed of assignment the assignee became bound by its terms. Such an assignment is valid against subsequent attaching creditors" and "[t]he deed of assignment became effective as soon as it was executed by the assignor and trustee. It was not necessary to have the consent of all the creditors in order to make it legal") (citation omitted).

mortgage.[38] As explained immediately above, the same result should obtain as to real estate subject to the trust mortgage.

In sum, regardless of the arguments that an attaching creditor might raise in certain jurisdictions to assert priority over an earlier-recorded trust mortgage to the extent of the claims of creditors whose assents are received after the attachment is recorded, courts should recognize the priority of a trust mortgage over junior liens to the full extent of all assenting creditors' claims, as well as other amounts secured by the trust mortgage, including all expenses of the trustee.

C. Effect of Bankruptcy on Trust Mortgage

The trust mortgage will provide that, by assenting, creditors agree not to file an involuntary petition against the debtor. However, non-assenting creditors obviously remain free to file an involuntary petition,[39] and may indeed feel compelled to do just that when presented with a trust mortgage they deem unacceptable. A trust mortgagee is a "custodian" under the Bankruptcy Code.[40] As a result, upon commencement of a bankruptcy case, section 543 will require the trust mortgagee

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[38] Since a security agreement may cover future advances, and priority will be determined based on the timing of the filing of competing financing statements, there is no issue under Article 9.

> Under a proper reading of the first-to-file-or-perfect rule of Section 9-322(a)(1) (and former Section 9-312(5)), it is abundantly clear that the time when an advance is made plays no role in determining priorities among conflicting security interests except when a financing statement was not filed . . . . This result generally obtains regardless of how the competing security interest is perfected and regardless of whether advances are made 'pursuant to commitment' (Section 9-102).

U.C.C. § 9-323 cmt. 3 (2008). *See* U.C.C. § 9-204(c) (2008) ("A security agreement may provide that collateral secures . . . future advances or other value, whether or not the advances or value are given pursuant to commitment."); U.C.C. § 9-322(a)(1) (2008):

> Conflicting perfected security interests and agricultural liens rank according to priority in time of filing or perfection. Priority dates from the earlier of the time a filing covering the collateral is first made or the security interest or agricultural lien is first perfected, if there is no period thereafter when there is neither filing nor perfection.

[39] *See* Eugene V. Rostow & Lloyd N. Cutler, *Competing Systems of Corporate Reorganization: Chapters X and XI of the Bankruptcy Act*, 48 YALE L.J. 1334, 1337 (1939) (noting unhappy creditor cannot be forced to agree to delay liquidation of debtor's property); Comment, *Bankruptcy Reform and the Chandler Bill*, 46 YALE L.J. 1177, 1186 (1937) (observing "honest assignees and assignments" may be hindered by "nuisance creditors or unscrupulous attorneys" who threaten with commencement of bankruptcy proceedings).

[40] *See* 11 U.S.C. § 101(11)(C) (2006):

> The term 'custodian' means . . . trustee, receiver, or agent under applicable law, or under a contract, that is appointed or authorized to take charge of property of the debtor for the purpose of enforcing a lien against such property, or for the purpose of general administration of such property for the benefit of the debtor's creditors.

to turn over property in its possession and to provide an accounting.[41] In sum, the general rule is that the bankruptcy trumps the trust mortgage.[42]

This general rule is subject to a discretionary or mandatory determination by the bankruptcy court to defer to the trust mortgage.[43] Section 543(d)(1) allows the bankruptcy court, on notice and a hearing, to excuse compliance with section 543 "if the interests of creditors and, if the debtor is not insolvent, of equity security holders would be better served by permitting a custodian to continue in possession, custody, or control of such property . . . ."[44] Section 543(d)(2) states that the court "shall" excuse compliance, but only "if the custodian is an assignee for the benefit of the debtor's creditors that was appointed or took possession more than 120 days before the date of the filing of the petition, unless compliance with such subsections is necessary to prevent fraud or injustice."[45] In *Wasserman v. Driscoll*[46]—a decision under section 2a(21) of the former Bankruptcy Act, predecessor to and analog of current section 543—the court treated a trust mortgagee as an assignee for the benefit of creditors for purposes of this provision.[47] Since the trust mortgage in *Wasserman* was granted in connection with a liquidation under which the mortgagees exercised substantial control over the debtor's assets—in other words, the arrangement looked a whole lot like an ABC—it is unclear whether *Wasserman* would extend to a reorganizing trust mortgage or even to a liquidating trust

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[41] *See* 11 U.S.C. § 543(b)(1)–(2) (2006) ("[A] custodian shall . . . deliver to the trustee any property of the debtor . . . in such custodian's possession . . . and file an accounting . . . ."); *In re* Lizeric Realty Corp., 188 B.R. 499, 506 (Bankr. S.D.N.Y. 1995) (stating custodian who knows bankruptcy case has begun must give debtor property of bankrupt estate); *see also In re* Constable Plaza Assocs., 125 B.R. 98, 103 (Bankr. S.D.N.Y. 1991) (positing custodian must stop collection actions against debtor's estate upon learning of bankruptcy case).

[42] *See In re Constable Plaza Assocs*., 125 B.R. at 103 (acknowledging custodian relinquishing debtor's property is general rule); *In re* Poplar Springs Apartments of Atlanta, Ltd., 103 B.R. 146, 150 (Bankr. S.D. Ohio 1989) (determining general rule under statute is "turnover"); *see also In re* Uno Broad. Corp., 167 B.R. 189, 200 (Bankr. D. Ariz. 1994) (finding custodian must give assets in his possession to trustee). Even if section 543 did not expressly provide for bankruptcy to trump the trust mortgage, any trust mortgage with less than 100% creditor assent would almost certainly be set aside as a preferential transfer under section 547(b) of the Bankruptcy Code. *See* 11 U.S.C. § 547(b) (2006).

[43] *See In re* Northgate Terrace Apartments, Ltd., 117 B.R. 328, 331 (S.D. Ohio 1990) (highlighting there are two exceptions to general rule of turnover and termination of state court receivership).

[44] 11 U.S.C. § 543(d)(1) (2006). *See In re* Willowood East Apartments of Indianapolis II, Ltd., 117 B.R. 320, 322 (Bankr. S.D. Ohio 1990) (providing section 543(d)(1) allows court to decide if creditors' interests would be better protected by custodial possession); *see also In re* Dill, 163 B.R. 221, 225 (E.D.N.Y. 1994) (compiling factors to weigh in determining best interest of creditors).

[45] 11 U.S.C. § 543(d)(1)–(2) (2006). *See In re* Hydratech Utils, Inc., 384 B.R. 612, 616 (Bankr. M.D. Fla. 2008) (indicating courts cannot force turnover if custodian is assignee for creditors and took possession over 120 days before case was filed "unless compliance with such subsection is necessary to prevent fraud or injustice"); *see also In re* Paul, 67 B.R. 342, 348 n.5 (Bankr. D. Mass. 1986) (construing section 543(d)(2) to "protect[] an assignee for the benefit of creditors from turnover" except to prevent fraud or injustice).

[46] 282 F.2d 502 (1st Cir. 1960).

[47] *Id.* at 506–07 (affirming ruling of district court treating mortgage trustee as assignee for benefit of creditors); *see* 11 U.S.C. § 543 (2006) (providing duty on part of custodian to submit debtor's property to bankruptcy trustee under some circumstances); 11 U.S.C. § 11(a)(21) (1958) (repealed 1978) (providing duty on part of custodian under former Bankruptcy Act to submit debtor's property to bankruptcy trustee under some circumstances).

mortgage in which the debtor retained some degree of control over the liquidation process.[48] It could also be argued that the juxtaposition of section 543(d)(1), providing that bankruptcy courts *may* defer to a custodian (defined to include a trust mortgagee), with section 543(d)(2), providing that bankruptcy courts *shall* defer to an assignee for the benefit of creditors, casts doubt on the vitality of *Wasserman*'s inclusion of a trust mortgage as a species of ABC.[49]

Even if *Wasserman* is still good law, section 543(d)(1) of the Bankruptcy Code, conferring discretion on the bankruptcy court to determine what is in the best interest of creditors, almost always governs the court's decision whether to defer to a trust mortgagee (or, for that matter, an ABC) because opponents of a trust mortgage or ABC seldom wait 120 days to file an involuntary bankruptcy petition.[50] The trust mortgage should refer to section 543 and expressly provide that, in the event of a bankruptcy, the trustee shall move for an order under section 543(d) if the trustee determines that creditors would be better served by the trust mortgage than by a bankruptcy.[51] This provision will buttress the trustee's standing and assure that the trustee's motion under section 543(d) will be seen as serving the pecuniary interests of assenting creditors, not just the trustee. However, success of the motion under section 543(d) will rest primarily on two factors. First, the trust mortgage should provide for a distribution scheme similar, if not identical, to the Bankruptcy Code,[52] should contain fair provisions concerning allowance of claims, and should otherwise be fair to creditors so as to support the assertion by the trustee and assenting creditors that the particular trust mortgage serves as a cost-effective alternative to bankruptcy rather than an attempt to circumvent the Bankruptcy Code. Second, apart from the provisions of the trust mortgage, the trustee and assenting creditors should demonstrate that based on the facts of the particular case, creditors will likely receive a quicker and greater net distribution from the trust mortgage than from a chapter 11 reorganization or a chapter 7 liquidation.

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[48] *Wasserman*, 282 F.2d at 504 (explaining trustee and creditors liquidated debtor's business against debtor's will). *See* Alloyd Gen. Corp. v. Bldg. Leasing Corp., 361 F.2d 359, 363 (1st Cir. 1966) (considering nature of trust mortgage, court notes "[a] trust mortgage looks towards the rehabilitation of the mortgagor and differs from an assignment for the benefit of creditors in that the debtor is allowed to retain and operate its assets as an integral part of a going business" (citing United States v. Gargill, 218 F.2d 556, 561 (1st Cir. 1955))); *Gargill*, 218 F.2d at 561 (explaining assignments for benefit of creditors do not allow mortgagors to retain control of property whereas trust mortgages do).

[49] *See* 11 U.S.C. § 543(d)(1) (permitting court discretion to allow custodian to retain possession if beneficial for creditors); 11 U.S.C. § 543(d)(2) (prohibiting court discretion to order turnover if custodian is assignee for benefit of creditors); 11 U.S.C. § 101(11) (2006) (providing definition of term "custodian").

[50] *See* 11 U.S.C. § 543(d)(1) (2006) (permitting courts to exercise discretion in determining whether to "excuse compliance" with turnover requirements in interest of creditors).

[51] As an alternative, the trust mortgage might flatly state that the trustee shall move for relief under section 543(d). This provision is not optimal, however, because it would be inconsistent with the trustee's fiduciary duties for the trustee to be bound to argue against a bankruptcy that the trustee determined—perhaps based on new information such as discovery of a major preferential transfer that would be avoidable in a bankruptcy case—would be in the best interest of creditors.

[52] An important exception is the need for a trust mortgage to accord priority to all claims of the United States. *See infra* Part IV.D.

D. Avoidance of a Trust Mortgage as a Fraudulent Transfer

Generally, a trust mortgage granted for the benefit of all unsecured creditors will not be subject to avoidance as a fraudulent transfer under section 548 of the Bankruptcy Code or sections 4 and 5(a) of the Uniform Fraudulent Transfer Act ("U.F.T.A.").[53] A trust mortgage can never be set aside as a "constructive" fraudulent transfer since granting a lien to secure pre-existing claims is defined as "value"[54] and such value is "reasonably equivalent" because the trust mortgage itself provides for claims to be secured only to the extent determined by the trustee to be legally valid.[55] For the same reason, a trust mortgage may not be set aside as an "actual" fraudulent transfer.[56] Although a non-assenting creditor might argue that the trust mortgage was made with intent to hinder or delay him—thus meeting the threshold requirement that the debtor have actual intent to "hinder, delay or defraud" creditors[57]—both the Bankruptcy Code and U.F.T.A. protect such transfers to the extent that the transferee gave reasonably equivalent value and acted in good faith.[58] The good faith requirement would almost certainly be met by any trust mortgage or ABC that is open to participation by all valid unsecured claims.[59]

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[53] *See* 11 U.S.C. § 548(a)(1) (2006) (providing trustee power to avoid a fraudulent transfer made within two years before petition filing date in interest of creditors); UNIF. FRAUDULENT TRANSFER ACT §§ 4–5(a), 7A U.L.A. 58–59, 129 (2006) (defining fraudulent transfer as "transfer made or obligation incurred by a debtor . . . if the debtor made the transfer or incurred the obligation" intending to defraud creditor or "without receiving a reasonably equivalent value . . . .").

[54] 11 U.S.C. § 548(d)(2)(A) (2006) (defining value as "property, or satisfaction or securing of a present or antecedent debt of the debtor, but does not include an unperformed promise to furnish support to the debtor or to a relative of the debtor"); UNIF. FRAUDULENT TRANSFER ACT § 3(a), 7A U.L.A. 47 (2006) (defining value as "given for a transfer or an obligation if . . . property is transferred or an antecedent debt is secured or satisfied, but value does not include an unperformed promise made . . . to furnish support to the debtor or another person").

[55] *See* 11 U.S.C. § 548(a)(1)(B)(i) (2006) (requiring debtor's receipt of "less than a reasonably equivalent value" in order to set aside transfer as fraudulent transfer); UNIF. FRAUDULENT TRANSFER ACT § 4(a)(2), 7A U.L.A. 58 (2006) (limiting fraudulent transfer to cases where debtor does not receive "a reasonably equivalent value in exchange for the transfer or obligation"); UNIF. FRAUDULENT TRANSFER ACT § 5(a), 7A U.L.A. 129 (2006) (adopting similar language).

[56] *See* 11 U.S.C. § 548(a)(1)(A) (2006) (defining actual fraudulent transfers); Peter J. Lahny IV, *Asset Securitization: A Discussion of the Traditional Bankruptcy Attacks and an Analysis of the Next Potential Attack, Substantive Consolidation*, 9 AM. BANKR. INST. L. REV. 815, 849–850 (2001) (discussing standards for actual and constructive fraudulent transfers). *See generally* Oksana Lashko, *Enhancing Creditor Recovery: Should Services Be Deemed "Property" For The Purpose of Fraudulent Transfer Law?*, 72 BROOK. L. REV. 317, 324 (2006) (examining purpose and function of fraudulent transfer laws).

[57] *See* 11 U.S.C. § 548(a)(1)(A) (stating required intent); UNIF. FRAUDULENT TRANSFER ACT § 4(a)(1), 7A U.L.A. 58 (2006) (adopting similar language).

[58] *See* UNIF. FRAUDULENT TRANSFER ACT § 8(a), 7A U.L.A. 178 (2006) ("A transfer or obligation is not voidable [as an "actual" fraudulent transfer] against a person who took in good faith and for a reasonably equivalent value . . . ."); 11 U.S.C. § 548(c) (2006):

> Except to the extent that a transfer or obligation voidable under this section is voidable under section 544, 545, or 547 of this title, a transferee or obligee of such a transfer or obligation that takes for value and in good faith has a lien on or may retain any interest transferred or may enforce any obligation incurred, as the case may be, to the extent

The U.F.T.A. added a new category of fraudulent transfer: a preferential transfer to an insider.[60] This provision creates an argument that a trust mortgage in which insider creditors may participate is a fraudulent transfer. The insider-preference provision applies only to a transfer made "to an insider"[61] and not (in contrast to the Bankruptcy Code's preference provision[62]) to a transfer made for the benefit of an insider. Thus, the insider-preference provision does not apply to a trust mortgage that includes insiders as beneficiaries. Nor should it. If the debtor filed for bankruptcy instead of granting a trust mortgage, an unsecured insider claim would have the same priority as any other general unsecured claim, subject only to the same challenges applicable to every other claim, i.e., the claim may be disallowed if invalid[63] or equitably subordinated if the holder engaged in inequitable conduct that damaged other creditors.[64] Where the trust mortgage permits insider claims to be disallowed and/or equitably subordinated if warranted or else provides for waiver of these challenges after full disclosure to creditors as part of the solicitation of assents, non-insider creditors have no cause for complaint. Creditors aggrieved by a trust mortgage under which defenses to insider claims were waived without proper disclosure may well be able to set aside the trust mortgage as a fraudulent transfer and might have other remedies as well.

> that such transferee or obligee gave value to the debtor in exchange for such transfer or obligation.

[59] It is possible to imagine a trust mortgage constituting an improper collusive scheme between the debtor and trustee, for example, where the trust mortgage was subject to conditions subsequent that were not intended to be met.

[60] *See* UNIF. FRAUDULENT TRANSFER ACT § 5(b), 7A U.L.A. 129 (2006) (declaring insider preference provision of U.F.T.A. is applicable when insolvent debtor transfers property or gives security interest to "insider" (as defined in UNIF. FRAUDULENT TRANSFER ACT § 1(7), 7A U.L.A. 14–15 (2006)) on account of antecedent debt); *see also* Frank R. Kennedy, *Reception of the Uniform Fraudulent Transfer Act*, 43 S.C. L. REV. 655, 664 (1991) (comparing U.F.T.A. to Bankruptcy Code in that they both consider preferential transfer to insider as fraudulent transfer when there is "evidence of intent").

[61] UNIF. FRAUDULENT TRANSFER ACT § 5(b), 7A U.L.A. 129. *See* Michael L. Cook & Richard E. Mendales, *The Uniform Fraudulent Transfer Act: An Introductory Critique*, 62 AM. BANKR. L.J. 87, 88 (1999) (discussing how in order to be voidable, transfer must be made to insider, and section 5(b) narrows definition of fraudulent transfer to insider as given in section 1(7)).

[62] *See* 11 U.S.C. § 547(b)(1) (2006) (stating preference avoidance powers of trustee under Bankruptcy Code).

[63] 11 U.S.C. § 502(b)(1) (2006) (providing for disallowance of claims not enforceable under applicable non-bankruptcy law).

[64] 11 U.S.C. § 510(c) (2006) (permitting equitable subordination). *See, e.g.*, *In re* Mobile Steel Co., 563 F.2d 692 (5th Cir. 1977). *See generally* Andrew DeNatale & Prudence B. Abram, *The Doctrine of Equitable Subordination as Applied to Nonmanagement Creditors*, 40 BUS. LAW. 417, 423 (1984) (stating doctrine of equitable subordination is meant to "offset the harm" to other creditors caused by "inequitable conduct"); Matthew Nozemack, *Making Sense of Bankruptcy Courts' Recharacterization of Claims: Why Not Use § 510(c) Equitable Subordination?*, 56 WASH. & LEE L. REV. 689, 697 (1999) (declaring equitable subordination will occur when there was "inequitable conduct" by claimant, creditors were disadvantaged or claimant got unfair advantage, and that Bankruptcy Act is consistent with "equitable subordination of the claim").

E. Potential for Default Under Leases and Other Contracts

Granting a trust mortgage will almost invariably constitute a default under the debtor's primary lending arrangement. Typically, by the time a trust mortgage is made, other defaults under the loan agreement have already occurred. In the unlikely event they are unsecured, the lenders will be the principal beneficiaries of the trust mortgage. It is far more common for the lenders to have their own pre-existing security interest in substantially all of the debtor's assets. In this instance, the lenders' cooperation, or at least their consent, is essential both as a legal and a practical matter for the trust mortgage to proceed.

Under other agreements to which the debtor is a party, it is not a foregone conclusion that granting a trust mortgage for purposes of reorganization (i.e. not accompanied by sale or liquidation of the debtor's assets) will be a default. Thus, each important contract or lease should be reviewed with this issue in mind. Even where the *ipso facto* clause[65] is not drafted with sufficient breadth to include a trust mortgage as such, the parties should consider the potential applicability of *Alloyd General Corp. v. Building Leasing Corp*.[66] In *Alloyd*, the court held that a tenant's grant of a trust mortgage constituted a default under its lease because the trust mortgage was sufficiently akin to an assignment for the benefit of creditors, which was expressly included in the *ipso facto* clause.[67] The court relied on the fact that the debtor was no longer operating and had no hope of rehabilitating.[68] Based on that finding, the court concluded that the instrument was not really a trust mortgage, but instead an assignment for the benefit of creditors.[69] Because the lease in that case was below market, the debtor tenant had been able to sublease the premises, pay the landlord its rent, and service its creditors. However, the court held:

> Under the circumstances of this case, in order to be a trust mortgage in the true sense, there must be [sic] real lessee—not a fleeting one, but one who is ready and able to stand liable for the present and future rent—even if it had no profitable subtenants. Here the lessor had no such cushion. The economic risk which the

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[65] In this context, an "*ipso facto* clause" is a provision in an executory contract that provides that certain acts of insolvency constitute a default under the contract sufficient to excuse the non-debtor party from performance. Section 365(b)(2) of the Bankruptcy Code invalidates *ipso facto* clauses to the extent they apply to the debtor's bankruptcy, insolvency, appointment of a custodian, etc. However, outside of bankruptcy, that same *ipso facto* clause may be enforced.

[66] 361 F.2d 359 (1st Cir. 1966).

[67] *Id.* at 364.

[68] *Id.* at 363.

[69] *Id.* at 363–64. *See* Williams v. Banana Distrib. Co., 59 F.2d 645, 645 (6th Cir. 1932) (interpreting state law to treat trust mortgage as assignment for benefit of creditors if it "conveys all of the assets of a debtor to a trustee for the benefit of his creditors"); *In re* Mackin, 208 F. Supp. 45, 49 (D. Mass. 1960) ("An assignment for the benefit of creditors may take the form of a 'trust mortgage' and yet be ruled an assignment.") (citation omitted).

> lessor is being called upon to take is the very one against which it sought to protect itself by inserting this condition in the lease.[70]

Even in the First Circuit, it is unlikely that *Alloyd* represents a threat in the situation where the debtor continues to operate after granting a trust mortgage. In that case, the words of the contract will govern.

F. Corporate Authority for a Trust Mortgage

The unique nature of a trust mortgage may present a difficult issue of corporate law: for purposes of corporate authorization, does a trust mortgage constitute a mere security interest, a disposition of substantially all assets, or even a corporate dissolution? It is not safe for counsel to assume that whatever authorization would be required to grant an ordinary lien to secure borrowed funds will suffice to authorize a trust mortgage. A trust mortgage granted in connection with a wind-down of the corporation's affairs could be deemed a "dissolution," thus requiring a shareholder vote.[71] This was the holding in *McKnight v. Paul D. Osborne Desk Co., Inc.*,[72] where a Massachusetts court invalidated a trust mortgage challenged by the debtor's 50% shareholder, who persuaded the court that the trust mortgage should require the same corporate vote as a dissolution, which under the applicable statute was a two-thirds vote of shareholders.[73] The governing corporate law and bylaws did not require shareholder consent for the granting of a security interest on corporate property.[74] However, the court viewed the trust mortgage as akin to an ABC in that it had "the aspects of a private bankruptcy designed for the voluntary and orderly dissolution of the Company."[75] Since the mortgage was given for the

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[70] *Alloyd*, 361 F.2d at 363–64.

[71] *See, e.g.*, DEL. CODE ANN. tit. 8, § 275 (2001) (requiring majority vote of shareholders for dissolution of corporation); *see* McKnight v. Paul D. Osborne Desk Co., No. 001191BLS, 2001 WL 1540583, at *4 (Mass. Super. Ct. Oct. 9, 2001) (reasoning trust mortgage can be regular mortgage or instrument for dissolution, requiring shareholder vote); *see also* REV. MODEL BUS. CORP. ACT § 14.02 (2008) (stating shareholders have right to vote to approve proposal to dissolve).

[72] No. 001191BLS, 2001 WL 1540583 (Mass. Super. Ct. Oct. 9, 2001), *aff'd sub nom*. McKnight v. Troderman, No. 03-P-1391, 2005 WL 36155 (Mass. App. Ct. Jan. 7, 2005).

[73] *See McKnight*, 2005 WL 36155, at *2 (noting end of 121-year-old business required approval of two-thirds of stockholders); *McKnight*, 2001 WL 1540583, at *4 (observing two-thirds stockholders vote required for corporate dissolution (citation omitted); *see also* MASS. GEN. LAWS ANN. 156B § 100 (West 2009) (stating corporation may voluntarily dissolve "by the vote of two thirds of each class of its stock").

[74] *See McKnight*, 2001 WL 1540583, at *3 (noting stockholder authorization not required for granting security interest unless provided for by corporation's articles of incorporation (citing MASS GEN. LAWS ANN. § 75(b)); *see also McKnight*, 2005 WL 36155, at *2 (noting MASS. GEN. LAWS ANN. do not require authorization of shareholders "before mortgaging the assets of the corporation"); MASS. GEN. LAWS ANN. 156B § 75 (West 2009) (describing when shareholder voting is necessary).

[75] *See McKnight*, 2001 WL 1540583, at *4; *see also* John C. DiDonato, et al., *Alternatives to Chapter 11: Receiverships, Operating 7s, Mortgage Trusts and More*, American Bankruptcy Institute 14th Annual Central States Bankruptcy Workshop (June 14–17, 2007) (*available on* Westlaw at 070614 ABI-CLE 161) (stating courts may declare "trust mortgage[s] [that] deprive[] the debtor of possession and control" as ABCs (citing Williams v. Banana Distrib. Co., 59 F.2d 645 (6th Cir. 1932))); *cf.* United States v. Gargill, 218 F.2d 556, 560 (1955) (observing jurisdictions differ when defining transaction as mortgage or ABC).

purpose of "accomplishing liquidation and dissolution . . . a two-thirds stockholders' vote of approval must be required . . . ."[76]

The analysis in *McKnight* was driven by the liquidating nature of the particular trust mortgage. What about a trust mortgage granted for the purpose of reorganization? Other than whatever negative inference can be drawn from *McKnight*'s analogy of the particular trust mortgage to an ABC, case law offers no guidance. To be conservative, counsel might wish to proceed on a worst-case basis by obtaining whatever vote is required under the bylaws, incorporation documents and corporate law for a dissolution of the corporation, or at least for an outright disposition of all assets. Where such vote is not feasible, however, the parties might wish to proceed on the basis that for purposes of corporate authorization, courts will surely treat a trust mortgage the same as any other loan and security agreement that permits the debtor to continue its operations in the absence of a default and that provides for the lien to be discharged upon completion of the debtor's payment obligations.

IV. DRAFTING A TRUST MORTGAGE

Trust mortgages present a myriad of drafting issues. Some of these are unique to trust mortgages; others are applicable to ABCs as well. Without attempting to be comprehensive, certain of the more important issues are discussed below.

A. Requisite Assents

Because of the difficulties that can be caused by non-assenting creditors, the debtor may wish for the trust mortgage to be effective only if a high percentage (say, 80 or even 90 percent) of the total amount of unsecured debt assents to the trust mortgage. In situations where, as discussed above,[77] the trust mortgage is likely to be subject to statutes governing ABCs, the statute may impose a minimum level of assent in order for the trust mortgage to be valid. If the collateral includes real estate and applicable law distinguishes between non-discretionary and discretionary advances for purposes of lien priority (see discussion above[78]), the assent requirement should be drafted so as not to undermine the argument that creditor assents are the equivalent of non-discretionary advances. Thus, the trust mortgage should take effect immediately, not when the requisite number of assents

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[76] *McKnight*, 2001 WL 1540583, at *4.

[77] *See supra* Part III.A (stating when debtor transfers his property to trustee for benefit of creditors, without priority, that transaction may be subject to ABC law); Murray Bros. v. Mackinac Circuit Judge, 216 N.W. 914, 915 (Mich. 1928) (positing party's trust mortgage is governed by law of assignments for benefit of creditors). *But see* Alloyd Gen. Corp. v. Bldg. Leasing Corp., 361 F.2d 359, 363 (1st Cir. 1966) ("A trust mortgage looks towards the rehabilitation of the mortgagor and differs from an assignment for the benefit of creditors in that the debtor is allowed to retain and operate its assets as an integral part of a going business.") (citation omitted).

[78] *See supra* Part III.B (depending on jurisdiction, priority of trust mortgage in relation to an attachment measured either by date when trust mortgage is recorded or date when creditors assent).

has been received, and the lien of the trust mortgage should cover the claims of all assenting creditors on a mandatory basis. The percentage-of-assent requirement should be expressed as an event of termination, e.g., "This agreement shall terminate, and the lien created hereby shall be discharged of record, if assents on account of *x* percent of Eligible Claims have not been received by *y* date."

B. Trustee's Fiduciary Duty Regarding Late Assents

Because the trust mortgage may require that a certain level of assent be obtained by a certain date and in any event because it is advantageous to obtain the greatest degree of assent at the earliest possible date, the typical trust mortgage will set a deadline by which an assent must be filed with the trustee. A trust mortgage will typically permit but not require the trustee to accept late-filed assents.[79] Most creditors will not deliberately take the chance of waiting until after the deadline to tender their assents, but sometimes a creditor will miss the deadline through inadvertence, and then ask the trustee to accept its assent as though timely filed. As discussed earlier,[80] accepted practice among trustees is to accept late-filed assents. This approach dilutes the interests of creditors who timely assented (although it may have offsetting benefits), creating the prospect that they might sue the trustee.[81] To avoid this possibility, the trust mortgage should expressly state that in determining whether to accept a late-filed assent, the trustee shall have no duty to avoid dilution of prior assenting creditors.

C. Establishment of a Committee

In cases where there are a handful of large, active creditors, the creditors may prevail upon the debtor to include in the trust mortgage the establishment of a creditors' committee or advisory committee to consult with or even give direction to the trustee. Alternatively, these large creditors might negotiate for the appointment of multiple trustees, with each such creditor appointing one of the trustees. Either approach will lead to added administrative complexity and cost, although these will likely be minimal in the case of a committee (committees constituted under trust mortgages do not typically have the right to engage professionals) and may be more than offset by the benefit of making creditors more comfortable and thus more likely to assent.

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[79] *See generally* McKnight v. Paul D. Osborne Desk Co., No. 001191BLS, 2001 WL 1540583, *2 (Mass. Super. Ct. Oct. 9, 2001) (describing part of trustee's duty in creating trust mortgage is obtaining creditors' assents).

[80] *See supra* Part III.B.

[81] *Cf.* Tufts Energy, LLC. v. Bryan (*In re* Crutcher-Tufts Res., Inc.), 504 F.3d 535, 544 n.24 (5th Cir. 2007) (explaining trustee owed trust beneficiaries fiduciary duty to prevent dilution of "equity interest owned by the trusts").

D. Distribution Scheme

As in the case of an ABC, the trust mortgage will typically provide for a distribution scheme that closely mirrors the Bankruptcy Code. This feature helps to persuade creditors that the trust mortgage is a faster and simpler version of bankruptcy rather than a radical departure. Following bankruptcy priorities may also be instrumental in persuading a bankruptcy court, if the trust mortgage is followed by an involuntary petition, to defer to the trust mortgage and dismiss the case.[82] However, for the protection of the trustee, and perhaps also the debtor's directors and officers, one departure from the Bankruptcy Code's priority scheme is mandatory: claims of the U.S. government entitled to the benefit of 31 U.S.C. section 3713 must be accorded priority subject only to administrative expenses. This is because section 3713(b) provides: "A representative of a person or an estate (except a trustee acting under title 11) paying any part of a debt of the person or estate before paying a claim of the [United States] Government is liable to the extent of the payment for unpaid claims of the Government."[83] Because the federal government must be accorded priority under a trust mortgage (or ABC) but not in a bankruptcy case, a bankruptcy filing will almost always be preferable from the standpoint of non-governmental creditors when the United States is a major creditor.

E. Allowance of Claims

One of the most difficult decisions for the drafter of a trust mortgage concerns the process for allowance of claims. Providing complete discretion to the trustee concerning allowance of claims has the benefit of simplicity, speed and low cost. This approach is the norm in small cases where the value of the assets or expected payment percentage is small. But creditors may choke at the prospect that their claims could be reduced or disallowed by arbitrary action of the trustee, and insist on some kind of appeal mechanism. Arbitration, sometimes with expedited procedures specified, is frequently used for this purpose. Resort to the judicial system should be avoided at all costs because of expense and delay.

F. Remedies

Where the best approach to maximizing value in the event of sale by the trustee would be a going-concern sale, especially where the important assets include both realty and personalty, the parties to the trust mortgage should plan in advance for how such a sale would be conducted. In many jurisdictions, it is difficult if not impossible to coordinate a real estate foreclosure with an Article 9 sale so as to permit buyers to bid on the entire package of assets. Secured lenders sometimes

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[82] *See supra* Part III.C.
[83] 31 U.S.C. § 3713(b) (2006).

skirt this problem by first conducting a private sale of personal property under Article 9, including a provision for the purchaser to back out if unable to acquire the real estate at the upcoming foreclosure sale. This approach entails no drafting other than the usual (but, under Article 9, unnecessary) provision in any security agreement permitting private as well as public sales.[84] Another approach, in jurisdictions where receiverships are available and effective, would be to include in the trust mortgage the debtor's advance assent to a receivership in the event of default under the trust mortgage, since a receiver would be in a position to sell all assets—real estate as well as personal property—through a single process. Finally, the trustee could be permitted to acquire the assets by credit bid at the (separate) real estate and Article 9 foreclosure sales, and then resell the assets as a package.[85]

G. Protecting Trustee from Liability

In order to protect the trustee, the trust mortgage should provide for a heightened barrier to liability (for example, "The Trustee shall have no liability except in the case of gross negligence or willful misconduct.") and should include indemnification for the trustee. The lien-granting clause of the trust mortgage should specify that the lien secures not only the claims of assenting creditors but also all amounts to which the trustee is entitled under the trust mortgage, which will include compensation, reimbursement of expenses, and indemnification. The provisions concerning priority of distribution should make it clear that indemnification is a first-priority expense. From the trustee's perspective, it would be ideal for the trust mortgage to permit the trustee to set aside and withhold from distribution any reserves the trustee deems appropriate to assure that the trust estate has funds to meet its responsibility for indemnification. However, other parties—particularly creditors, if represented in the negotiating/drafting process—will usually balk at permitting the trustee to delay distribution to creditors of any significant amount of funds.

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[84] *See* U.C.C. § 9-610(c) (2008) (providing for disposition of collateral by public or private sale).

[85] To assure that this approach is available to the trust mortgagee, the instrument should expressly authorize the trustee to credit bid. *See* Union Guardian Trust Co. v. Bldg. Secs. Corp., 276 N.W. 697, 698 (Mich. 1937) (noting importance of including in trust mortgage "whose bonds have been so used and to what extent payment has been made by bidding through the trustee at the foreclosure sale"); Bradley v. Tyson, 33 Mich. 337, 337 (1876), *available at* 1876 WL 3999 (Mich. 1876) (trust mortgagee not authorized to credit bid without express authorization in instrument); *see also* Cluett v. Rosenthal, 58 N.W. 1009, 1009–10 (Mich. 1894) (illustrating bidding process). This rule may be confined to Michigan. Michigan has adopted a statute governing mortgages to bond trustees, including procedures to obtain court approval for the trustee to credit bid at a foreclosure, to deal with bondholders who do not assent to the trustee's bidding at a foreclosure, and to administer the property after the foreclosure. MICH. COMP. LAWS ANN. § 451.401–405 (West 2008).

CONCLUSION

The trust mortgage is an extremely useful and under-utilized device. Debtors and creditors should consider the trust mortgage in any situation calling for a cost-effective alternative to chapter 11 bankruptcy.