Redefining Possessory Liens in Bankruptcy: Property, Contract, and What It All Means

Odelia Minnes

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Redefining Possessory Liens in Bankruptcy: Property, Contract, and What It All Means

Odelia Minnes*

CONTENTS

I. INTRODUCTION ............................................... 76

II. POSSESSORY LIENS AND THE CURRENT LEGAL ARRANGEMENT ............................................ 78
    A. Generally ................................... 78
    B. Possessory Liens and Bankruptcy .............. 83

III. QUESTIONING THE RATIONALES OF POSSESSORY LIENS IN BANKRUPTCY .............................. 84
    A. Enhancing the Value of the Property .......... 85
    B. Justice and Fairness ............................ 90
    C. Preserving and Improving the Commercial Dynamic of the Marketplace .................................... 91
    D. Possession as a Signal for Entitlement ........ 94

IV. ESTABLISHING POSSESSORY LIENS ON BETTER NORMATIVE GROUNDS ................................. 98
    A. The Contractual Grounds of Possessory Liens .... 98
    B. Possessory Liens and Mutualy of Performance .... 102

V. CONTRACT-BASED POSSESSORY LIENS AND BANKRUPTCY PROCEEDINGS .............................. 105
    A. Understanding the Problem ..................... 105
    B. The Appropriate Legal Arrangement .......... 111

VI. CONCLUSION ............................................ 113

ABSTRACT

Possessory liens are one of the long-established property rights acknowledged by the law. Under certain conditions, a creditor will be

* Post-Doctoral Fellow, Lady Davis & The Harry and Michael Sacher Institute for Legislative Research and Comparative Law, The Hebrew University of Jerusalem; Ph.D. Candidate, Bar-Ilan University, Israel. Dissertation advisors: Prof. Assaf Hamdani & Prof. David Hahn. I would like to thank Haim Sandberg, Dov Solomon, the participants of the 2012 Israeli Law & Economics Association Conference (IDC, December 2012), and the Law Faculty’s Doctoral Students and Junior Researchers’ Workshop at the Hebrew University of Jerusalem for their helpful comments.
entitled to withhold an asset owned by the debtor until the latter repays his debts. The creditor will gain priority over other creditors, even creditors that hold security interests over the same property that were perfected prior to his possession. This Article examines the current available justifications for the preferred position of possessory lien holders in bankruptcy. This Article shows that none of the property-law-based arguments explored is persuasive when the debtor is insolvent, as they are not coherent with other legal institutions and principles in bankruptcy. Instead, the analysis presented offers a contract-based approach to possessory liens, one that is founded on contractual logic and doctrines. Finally, the implications of this innovative perspective of executory contracts are shortly explored by examining the way they correspond with the law governing executory contracts. A legal arrangement that will more efficiently balance the parties involved is offered.

I. INTRODUCTION

Insolvency uncovers multiple issues that need to be resolved. One of bankruptcy procedure’s most prominent roles is distributing the estate\(^1\) between the different claimants. It is probably the hardest one to execute as well. Bankruptcy procedures aim to offer a solution for an economic situation in which a debtor has more obligations than assets,\(^2\) causing him to not pay those obligations when they are due.\(^3\) The legal arrangement for this economic circumstance must therefore create rules relating to the method in which creditors will be repaid considering the insufficient assets available. The law indeed established certain criteria by which creditors will be repaid in case their debtor is insolvent. According to these rules, there will be occasions in which it will depend on the nature of the creditor;\(^4\) however, other times it will rely on the nature of the claim.

This Article focuses on the priority given to a creditor who holds possessory liens. Under the laws governing possessory liens, a creditor is entitled to withhold an asset owned by the debtor until the latter fulfills his obligations to that creditor.\(^5\) Moreover, the possessory lien

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2. A debtor is deemed insolvent when his debt obligations exceed the value of his assets. *Id.* § 101(32)(a) ("The term 'insolvent means' . . . [a] financial condition such that the sum of such entity's debts is greater than all of such entity's property, at a fair valuation . . . .").
3. See *id.* § 303(h) (noting the conditions for commencement of an involuntary case against a debtor).
4. For example, the fact that a creditor is an employee of the debtor may play a role in the creditor’s priority during the distribution process. *See, e.g., id.* § 507(a)(4)(A)–(B).
creditor's claim has priority over secured and non-secured creditors who have interests over the same asset. Most of the objections to possessory liens in bankruptcy focus on the procedural aspect, namely that these liens enable the possessory lien creditor to detain the asset without judicial inquiry as to the validity of the creditor's claim. Opponents argue that it undermines due process, a principle protected by the Fourteenth Amendment of the Constitution, because the debtor does not have any opportunity to object to the possessory lien creditor's seizure of the asset or even to receive prior notice.

This Article will not analyze these procedural issues. Rather, it will focus on substantial, different issues that are often neglected when discussing possessory liens. Although the lack of academic research in this area is quite surprising and rather unusual, this Article aims to challenge the available theoretical justifications for this property right while offering a new justification. Bear in mind that a new justification, if available, may or may not lead to modifying possessory liens' position in bankruptcy, for the right should be shaped according to the rationales underlining it. Hence it is important to note that the discussion is not only about the priority rule in bankruptcy, but also, first and foremost, on the normative issue: the basis of the right to withhold another person's property, if such exists. The priority rule will be derived from the normative justification given.

As this Article's analysis will show, contractual reasoning is the most convincing justification for a creditor's right to withhold a debtor's asset. Examining this right as an integral part of the contractual relationship between the parties allows us to view it from a new perspective, which unfolds several economic and practical implications as discussed below. Furthermore, the analysis will explore the correlation between the central method of dealing with contracts in bankruptcy, namely by assuming or rejecting an executory contract, and the case of possessory liens. The application of bankruptcy law's


7. Property rights and obligatory rights receive, in general, different treatment in bankruptcy, and so the basis of the right may have a great impact on its priority ranking. On the distinction between property and obligatory rules, see Guido Calabresi & A. Douglas Melamed, Property Rules, Liability Rules, and Inalienability: One View of the Cathedral, 85 HARV. L. REV. 1089 (1972).
legal arrangements reveals the unique features of a contractual relationship in which the right to withhold property is relevant. Most of all, it exposes a problem of externalization by each party to the contract. Based on the analysis presented, this Article urges to reshape the legal arrangement governing possessory liens and suggests a model that corresponds with principles of bankruptcy law, complies with its goals, and manages to mitigate concerns stemming from inefficient behavior.

This Article proceeds as follows. Part II briefly presents the current legal arrangement of possessory liens, both within and outside of bankruptcy proceedings. Part III examines the rationales for possessory liens and points to their problems and limited persuasion. Part IV follows with an alternative, normative, and contract-based justification that is distinct from the common and historically accepted property perspective. Part V analyzes the implications of the new approach in bankruptcy proceedings while drawing upon the current method by which the law handles contractual relationships and applying that method to possessory liens. Part VI briefly concludes.

II. POSSESSORY LIENS AND THE CURRENT LEGAL ARRANGEMENT

A. Generally

Possessory liens\(^8\) are liens made valid by possession of a debtor’s property.\(^9\) The creditor’s possession of the property is intended to result in repayment of the debt owed by the owner of the property, often a debtor.\(^10\) The law recognizes different types of liens in which possession of the property triggers the right of the possessory lien creditor. Therefore, in this Article, possessory lien is a generic term that encompasses various and more specific types of liens, such as artisan’s liens and innkeeper’s liens. These liens, as their names indicate,
refer to a creditor of a particular profession for which the right was originally established.

The right to withhold another person’s property until the debt is repaid was acknowledged early in history by the common law.\footnote{11} Originally, the right was created to provide a person, who invested work and effort to improve his fellow’s property, with a remedy for when the owner of that property neglected to pay what he owed.\footnote{12} That person then became a creditor and was allowed to retain the asset until the debtor discharged his outstanding debt.\footnote{13} The right is non-consensual and does not require an agreement between the parties to become enforceable. Today, different laws entitle a possessory lien creditor to hold an asset against a debt he is owed.\footnote{14} Although this is a state-law right, each state has adopted its use with minimal variation between the states.\footnote{15}

Section 9-333 of the Uniform Commercial Code states the general legal recognition of the modern possessory lien:

\textbf{§ 9-333. Priority of Certain Liens Arising by Operation of Law}
\begin{enumerate}
\item \textit{[“Possessory lien.”]} In this section, “possessory lien” means an interest, other than a security interest or an agricultural lien:
\begin{enumerate}
\item which secures payment or performance of an obligation for services or materials furnished with respect to goods by a person in the ordinary course of the person’s business;
\item which is created by statute or rule of law in favor of the person; and
\item whose effectiveness depends on the person’s possession of the goods.
\end{enumerate}
\item \textit{[Priority of possessory lien.]} A possessory lien on goods has priority over a security interest in the goods unless the lien is created by a statute that expressly provides otherwise.\footnote{16}
\end{enumerate}

Section 9-333 does not create the right itself; rather, it states that where a possessory lien exists, either by state law or common law, it will be classified as a property right in favor of the creditor who holds

\footnote{11} See John C. Hogan, The Innkeeper’s Lien at Common Law, 8 Hastings L.J. 33, 43 (1956) (noting that the right was established around the 15th century); see also M’Intyre v. Carver, 2 Watts. & Serg. 392, 395 (Pa. 1841) (“It is not to be doubted that the law of particular or specific lien on goods in the hands of a tradesman or artisan for the price of work done on them, though there is no trace of its recognition in our own books, was brought hither by our ancestors; and that it is a part of our common law.”).
\footnote{12} See BROWN, supra note 8, at 510.
\footnote{13} See GERARD MCCORMACK, SECURED CREDIT UNDER ENGLISH AND AMERICAN LAW 44 (2004).
\footnote{14} See supra note 9.
\footnote{15} See, e.g., 75 N.Y. Jur. 2d Liens § 11 (2012).
the property. For the possessory lien creditor to establish this right, the creditor must gain possession over the debtor’s asset as part of their relationship. Holding the property serves as a guarantee if the debtor does not fulfill his contractual obligations. A possessory lien is thus an individual remedy, one that is not dependent upon the courts, a specific authorization by law, or the other party.

The question of when a possessory lien creditor acquires the right to continue holding a debtor’s asset, thereby establishing his security right, is a matter decided by law. Historically, this privilege dealt with circumstances in which it was common that the creditor rendered services prior to the debtor’s payment. And once rendered, the creditor was left with few methods by which the creditor could secure payment.

Possessing the property is a prerequisite to realizing an interest in the collateral. This occurs when the debtor fails to pay or complete his obligation for the creditors, i.e. when the debtor defaults. Thus, in a way, the debtor’s default transforms the asset from property that is merely held by a possessory lien creditor for a limited period of time into a security.

The creditors’ right has several main features. First, as mentioned before, it grants the possessory lien creditor the right to withhold the debtor’s property. This right is valid even if, according to the parties’ agreement, the possessory lien creditor is supposed to return the asset to the debtor—when the agreement specifies a date at which the property is due. The creditor has the right to retain the asset until the debtor fulfills the debtor’s obligation. In essence, the possessory lien

17. See Walter W. Miller, Jr., Liens Created by Operation of Law: A Look at Section 9-310 of the Uniform Commercial Code, 76 COM. L.J. 221, 221 (1971).


19. A debate developed among the courts on the question of whether using the possessory right undermines principles of due process, originating from the fact that the possessory lien creditor is entitled to hold the asset and sometimes sell it through a public sale without a judicial hearing on opposing claims. See William C. Brown, The Due Process Challenge to Possessory Lien Enforcement, 10 TULSA L.J. 415, 415 (1975); Note, Possessory Liens: The Need for Separate Due Process Analysis, 16 WM. & MARY L. REV. 971, 975 (1975) (analyzing the issue while referring to the two important rulings of Fuentes v. Shevin, 407 U.S. 67 (1972), and Sniadach v. Family Finance Corp. of Bay View, 395 U.S. 337 (1969)).

20. See, e.g., Gordon v. Sullivan, 188 F.2d 980, 982 (D.C. Cir. 1951) (“[A] person in possession of property under a lien is the owner of it against all the world and even against the actual owner until his claim is paid; and no one, not even the actual owner, has any right to disturb his possession, without previous payment of such claim.” (quoting Brown v. Petersen, 25 App. D.C. 359, 363 (D.C. Cir. 1905)) (internal quotation marks omitted)).
gives the creditor a method of pressuring the debtor, assuming the latter wants his asset returned. The creditor's right is limited to holding the asset and does not normally extend to its sale and collection of the sale's proceeds, though in some cases the law grants specific types of possessory lien creditors the right to do so.\textsuperscript{21} In many circumstances, the creditor will be eligible to retain the asset as a means of forcing the debtor to pay without the option of selling the asset.\textsuperscript{22} It follows that if for some reason the debtor is not interested in reclaiming the asset, the creditor will need to file a debt claim, similar to creditors without a security interest. That differentiates possessory lien creditors from creditors holding other types of security interests where they are entitled to receive proceeds from its disposition.\textsuperscript{23}

Second, a possessory lien creditor is a secured creditor, therefore giving him priority over other creditors of the debtor. The creditor will not only gain priority over unsecured creditors but also be preferred over other secured creditors holding security interests over the same asset.\textsuperscript{24} This privilege entitles the possessory lien creditor to possess the debtor's property, even if another creditor perfected a security interest in the collateral before the possessory lien creditor took possession.\textsuperscript{25} As such, the legal arrangement of possessory liens serves as an exception to the basic rule that applies to priorities between secured creditors.

Generally, priorities between secured creditors who have interests in the same collateral will be determined based on the timing of filing or perfection.\textsuperscript{26} Security interests are, in essence, "first in time, first in right." The first creditor to perfect a security interest will usually have priority over others who have security interests in the same property. With possessory liens, however, it does not matter if a security interest was filed or perfected over the same asset before the creditor

\textsuperscript{21} See, e.g., Parks v. "Mr. Ford," 556 F.2d 132, 134, 142–43 (3d Cir. 1977) ("We believe that the Pennsylvania statutes under which a repairman may sell a customer's motor vehicle to satisfy his common-law lien do not meet the due process requirements articulated by the Supreme Court." (citation omitted)); see also Adams v. Dep't of Motor Vehicles, 520 P.2d 961, 967–68 (Cal. 1974) (declaring that the owner is denied due process when a creditor sells his vehicle without the owner's consent, but the creditor's detention of the vehicle does not).

\textsuperscript{22} See generally Adams, 520 P.2d 961.


\textsuperscript{25} Security laws are a product of state law, and yet the states acknowledge the priority given to the possessory lien creditor through direct legislation and application of the common law. See, e.g., NEB. REV. STAT. § 52-201 (2012); Mfrs. Acceptance Corp. v. Gibson, 422 S.W.2d 435, 437 (Tenn. 1967).

\textsuperscript{26} See U.C.C. §§ 9-308 to 9-316.
took hold of it. Regardless of the other security interests attached to the asset, a possessory lien creditor will still maintain the right to hold the asset and wait to collect the money that the debtor owes.

Third, possessory liens are established by and dependent on physical possession of the property. If the possessory lien creditor does not physically hold the asset, or if for some reason the creditor yields the asset, his rights to the asset cease to exist. Therefore, the creditor will neither be able to repossess the asset nor be entitled to repayment as a secured creditor. The physical aspect is not just one component but rather an essential one.

Fourth, the value of the asset held and the amount of debt owed do not have to match or even be proportional. To demonstrate, an asset worth $1,000 and the outstanding debt valued at $100 does not deprive the creditor’s possession of the asset. Such circumstances may occur if, for example, the creditor is contracted to fix machines for a manufacturer, and to perform his part of the agreement, the contractor moves the machines to his place of business. Presumably, such

27. Also, in some cases, courts have held that the possessory lien creditor should hold not only the property but also the physical and material work made, as opposed to intangible property. See, e.g., Monach Air Serv., Inc. v. Solow (In re Midway Airlines, Inc.), 383 F.3d 663, 672–73 (7th Cir. 2004) (citing RESTATEMENT (FIRST) OF SECURITY § 61 (1941)).

28. So will be the case, for example, if a third party held the asset. See generally Hutchison v. C.I.T. Corp., 726 F.2d 300, 302 (6th Cir. 1984).

29. See, e.g., Leonard v. Dahlke Trailer Sales & Leasing Co. (In re Express Fruit & Produce, Inc.), 16 B.R. 366, 368 (Bankr. D. Minn. 1982), aff’d, No. 4-82-103, 1982 WL 171055 (D. Minn. Aug. 4, 1982). A creditor who lost possession without his consent, for example, by force or fraud does not yield his rights. See, e.g., Brannon v. Gay (In re Browy), 527 F.2d 799, 800–02 (7th Cir. 1976). In such cases, the creditor will still be regarded as holding the property and having priority over the other creditors. See id. Conversely, the creditor can release the asset from his possession under an agreement between him and the trustee that states the creditor will receive the proceeds of the sale from the asset or after receiving adequate security in exchange without jeopardizing his priority right. Id.

30. This can be learned from the words in section 9-333 mentioned above that gives priority depending “on the person’s possession of the goods.” U.C.C. § 9-333(a)(3); see also Hayden v. Wells (In re Heyden), 308 B.R. 428, 434 (B.A.P. 9th Cir. 2004) (“[A]lthough not specifically stated in the statute, possession is necessary for the lien to retain its priority . . . . Possession is the only mechanism available to ensure satisfaction of the lien.”) (referring to a statute in Washington establishing a mechanic’s possessory lien); In re Winnett, 97 B.R. 7, 9-10 (Bankr. E.D. Cal. 1989) (regarding California’s right of an attorney to possess his client’s funds).

31. See, e.g., Robinson Bros. Motor Co. v. Knight, 288 S.W. 725, 725 (Tenn. 1926). But see Thorp Commercial Corp. v. Miss. Rd. Supply Co., 348 So. 2d 1016, 1017–18 (Miss. 1977) (declaring the validity of an artisan’s lien even though the creditor had given up possession of the property at one point but held the property at the time he was claiming his superiority over a perfected security interest).

32. Physical possession is an essential component unless there was an agreement between the parties that the creditor will give up his possession of the asset but will not give up his secured right over the proceeds. For such a claim, see In re Midway Airlines, Inc., 383 F.3d at 671–73 (dismissing the claim).
machines are worth far more than what the creditor's service is worth. Nevertheless, the creditor may possess the machines until his debt is satisfied.

After examining the possessory lien's legal arrangement and the main characteristics of the right, Part II(B) will explore how these types of claims affect bankruptcy proceedings and how possessory liens function when the debtor is insolvent.

B. Possessory Liens and Bankruptcy

A possessory lien grants the creditor holding it a two-fold right. First, the lien affects the relationship between the debtor and the creditor, and clarifies the rights and obligations of each party following the creditor's possession of the property. Second, the possessory lien is a property right33 given to the creditor, and as such, it influences the relationship between the creditor and the debtor's other creditors, if any. Therefore, the main issue is whether bankruptcy law should change the possessory lien law's approach towards each of these aspects, as well as the balance between them.

One might claim that the first aspect, as mentioned above, is irrelevant once the debtor becomes insolvent. The debtor's interest in the property should no longer be the focus of the legal arrangement; rather, the focus should be on the second aspect, i.e. the creditor's relationships with the debtor's other creditors. Once the debtor does not have enough assets to repay his debts in full, the main battle over the assets, as well as which creditors have rights to them, is the battle between the creditors. Accordingly, acknowledging the right, or not, will not often affect the debtor but the rest of the creditors. It is a matter of simple mathematics. If the creditor is allowed to hold the property until the payment is made and thus is repaid prior to the other creditors, less will be available to the other creditors. If the possessory lien creditor is not allowed to pressure the debtor into repaying him, then the possessory lien creditor will be repaid on a pro rata basis like the rest of the unsecured creditors.34 Therefore, the unsecured creditors' share from the debtor's pool of assets will be greater, and so each will receive a higher percentage of its claim.

Although the most apparent and perhaps the most important effect is on the creditors, there may be situations in which recognizing the

33. For a discussion on the difference between property and liability rules, see Calabresi & Melamed, supra note 7.
34. See 11 U.S.C. § 726(b) (2006) (outlining the distribution of the property of a debtor's estate); Nathanson v. NLRB, 344 U.S. 25, 29 (1952) (noting that the bankruptcy law is based on equality of distribution); see also H.R. Doc. No. 93-137, at 9, 19 (1973).
possessory lien creditor's right to withhold the asset may jeopardize the debtor's reorganization efforts. Sometimes, the assets withheld are so essential to the debtor’s business that his inability to use or sell them will damage his efforts to get the business back on track. This situation may arise if, for example, the asset in question is a machine that is essential for a factory’s operations or the possessory lien creditor withholds a factory’s products. The possessory lien creditor’s right prevents the debtor from selling or using the assets to improve or, at least, sustain income. Under these circumstances, the rules applying to the relationship between the debtor and the creditor may have significant outcomes.

The ultimate goal of bankruptcy remains maximizing utility on behalf of the creditors, not the debtor.35 Furthermore, many scholars of law and economic literature who analyze bankruptcy law assert that efforts to rehabilitate the debtor should not be at the expense of the creditors.36 This Article makes this assumption and holds that any legal arrangement and privileges given to creditors should be based on both the effect to creditors and the goal to protect their interests over those of the debtor.

The next part focuses on the possible rationales for possessory liens' legal arrangement. As noted before, sparse academic work has been done to thoroughly examine the normative arguments supporting or opposing possessory liens.

III. Questioning the Rationales of Possessory Liens in Bankruptcy

In order to decide whether a possessory lien’s legal arrangement is justifiable in bankruptcy, it is necessary to first examine the rationales supporting that arrangement. However, the courts and academics have made little progress in this area of law. This part examines and investigates four explanations that support possessory liens' legal ar-


36. This view comes from the opinion that bankruptcy law is a procedural, technical field of law, which aims to function as a debt collection mechanism. Hence, it should not redistribute rights established before bankruptcy, nor should it alter them. Since Chapter 11 routinely causes such deviations from the prior bankruptcy entitlements, this view led to opposing Chapter 11. See, e.g., Bebchuk, supra note 35; Lucian A. Bebchuk & Howard F. Chang, Bargaining and the Division of Value in Corporate Reorganization, 8 J.L. ECON. & ORG. 253 (1992).
rangement in bankruptcy.\textsuperscript{37} Some have been previously mentioned and, to some extent, analyzed, while others can only be implied from previous discussions. This Article's aim here is to demonstrate that while these explanations may seem appealing when applied in a nonbankruptcy setting, each loses much of its appeal when examined under the realities of insololvency. Each argument is presented and then followed by a critique on its relevance and its ability to justify this preference.

A. \textit{Enhancing the Value of the Property}

The first argument that supports the legal recognition of possessory liens' preferred status in bankruptcy is that the possessory lien creditor's actions improve the asset and enhance its value, entitling the creditor to continue holding the asset until the creditor is paid.\textsuperscript{38} Because the possessory lien creditor invests his efforts, talent, and materials in the asset, ultimately resulting in the asset's higher value, the creditor should be entitled to keep it until the debtor pays the creditor for his work.\textsuperscript{39} If the possessory lien creditor is not given priority over secured creditors, the creditor will have improved the secured creditors' chances for repayment while not gaining anything as a result.\textsuperscript{40}

The common law of some states requires that a possessory lien creditor's service must enhance the value of the asset to obtain possessory lien privileges.\textsuperscript{41} This perhaps implies that enhancing the market value of the asset is the motive for the possessory lien creditor's priority. Nevertheless, the value does not have to be represented through the market price.\textsuperscript{42} Consequently, the right has been extended to situations where the possessory lien creditor's actions did not necessarily

\begin{footnotes}
\footnote{37}{Indeed, some of these explanations that are mentioned in other legal systems, such as the Israeli system, acknowledge the right of a creditor to continue holding the debtor's property in some circumstances. \textit{See} CA 790/85 Isr. Airport Auth. v. Gross 44(3) PD 185 [1990] (Isr.).}
\footnote{38}{\textit{See}, e.g., Stewart v. Flowers, 44 Miss. 513, 517–18 (1870).}
\footnote{39}{\textit{See} \textit{Brown}, supra note 8, at 511 ("[H]e who by labor, skill, or materials adds value to the chattel of another whether under an express or an implied agreement has a possessory lien thereon for the value of his services and may retain the chattel in his possession until the same be paid.").}
\footnote{41}{\textit{See}, e.g., Lake River Corp. v. Carbonrandum Co., 769 F.2d 1284, 1287 (7th Cir. 1985) (noting that "a lien is . . . a device for preventing unjust enrichment").}
\end{footnotes}
reflect a price increase of the property. However, the formal legal requirement reflects that there must be some relationship between the purposes and the economic results of the transaction, i.e. the increase in the asset's value. This relationship is addressed in the following paragraphs.

This Article posits that there are three central problems with the value enhancement argument. First, the argument does not entirely comply with other instances where the law favors creditors. Indeed, as mentioned before, the equality between a claim's value and the associated asset's value is not a definite principle. It is a principle that is expressed by treating analogous claims similarly. Following this reasoning, one might claim that a creditor who improved a debtor's asset holds a different status than other creditors who did nothing to improve the asset's value. As such, the possessory lien creditor earns the right to repayment before other creditors that did not improve the asset's value. In fact, there are other situations where the law favors parties who contributed to a business and enhanced its value. However, this Article argues that these circumstances are usually dedicated to a value increasing activity made during the bankruptcy process and not before it.

Take, for example, the preferred status of a contractual party with which the debtor assumed a contract. The debtor bases his decision on the economic value attached to the specific contract. The debtor will assume a contract if he believes it will benefit him and thus the rest of the creditors. According to the Bankruptcy Code, a party to such a contract will be paid in full if the debtor assumes the contract. Otherwise, if it does not contribute to the debtor's position or is bur-

43. This argument is somewhat related to the justice and fairness arguments examined in Part III(B). If a creditor contributed to an asset's value, it seems unfair that his monetary claim will be left unsatisfied while other creditors' claims will benefit from his actions.

44. See supra Part II(A).

45. Indeed, this is considered to be the core concept of formal equality. See Donna Greschner, Does Law Advance the Cause of Equality?, 27 Queen's L.J. 299, 302-03 (2001).

46. This could be the rationale for the preferred priority of purchase-money security interests, for example. On this type of security interest, see infra note 70. So too for the status of debtor-in-possession financing or post-petition financing, in which lenders finance Chapter 11 and gain preferred ranking as secured creditors, and frequently even to have a super-priority over other secured interests. See 11 U.S.C. § 364 (2006).

47. See generally 11 U.S.C. § 365 (outlining the ability to accept or reject executory contracts and expired leases).

48. Either the debtor-in-possession under Chapter 11 reorganization or the trustee under Chapter 7 liquidation has the right to assume or reject a contract. Id. § 365(a).
densome to it, the debtor will reject the contract. The debtor examines the benefit or lack thereof through the lens of the debtor's current condition and the potential to benefit the debtor's creditors. Unlike the grant of a possessory lien preference in bankruptcy, the debtor will not make his decision to assume a contract based on the value the contract added in the past. Hence, the debtor may reject the party's contract even though it was beneficial in the past. In addition, the creditor of the rejected contract becomes an unsecured creditor and thus is left with only a limited likelihood that his claim will be repaid in bankruptcy.

In many cases, perhaps even in the majority of them, a debtor may have benefited from a transaction or a relationship the debtor initiated prior to bankruptcy. The value of the debtor, as opposed to a specific asset of the debtor, may increase as a result of the bargain. In fact, this is practically one of the basic assumptions underlying the economic analysis of contract law: that people act rationally in a way that will maximize their utility. And yet, none of these creditors will necessarily gain priority over others because of the mentioned, or rather assumed, increase in value. The question is, therefore, why should the law treat a possessory lien creditor differently? This possessory lien creditor's claim, like his fellow creditors' claims, benefited the debtor before the debtor filed for bankruptcy. The argument's reliance on a previously created benefit seems weak, especially when individually examined.

Second, the value enhancement argument for possessory liens does not validate a possessory lien creditor's right to hold the asset. In other words, it neglects to explain why a possessory lien creditor should get priority over creditors that have enhanced the value of the debtor's asset without possession being an integral part of the transaction. Why should physical possession, an opportunity that parties may claim as merely circumstantial, decide the creditor's fate? It is possible that a creditor worked on the debtor's asset and enhanced its value, but did so without gaining physical possession of it. Such a scenario may occur if, for example, the contractor from the previous example could have fixed the debtor's machines in the debtor's factory


50. Debtors sometimes have to reject contracts even though they will be beneficial in the future. This may occur if they have limited financial means and have to grade the contracts to which they are bound on their economic implications. If the debtors are in bankruptcy, especially Chapter 7 bankruptcy, or decide to focus solely on certain fields or markets—a likely scenario in Chapter 11—they lack the practical ability to complete their obligations.
and added the same value to the machines. Although the creditor's improvements allowed the debtor to continue operating his business and increased the contractor's chances of repayment, bankruptcy law would not grant the contractor special privileges or priority like a possessory lien. He obviously will not be paid prior to a creditor who had a security interest in the improved machines. In this case, how can value enhancement supporters claim that enhancing the value of a debtor's asset is a viable rationale for possessory liens preferential treatment in bankruptcy? If the value enhancement argument supported the possessory lien creditor's priority in bankruptcy, then any improvements that a creditor made to a debtor's assets would have given that creditor priority and rights over other creditors. However, it seems difficult to prioritize claims of a creditor that provides a benefit in a transaction that involves only his possession of the debtor's asset. Meaning, in order for the value enhancement argument to be valid, it is necessary to show the difference between this type of transaction and the other transactions in which the work enhances the value of a debtor's asset while the debtor still maintains possession. In other words, what is the efficiency of a transaction with a possessory lien creditor compared to any other? Is there something intrinsically beneficial when it comes to transactions in which the possessory lien creditor possesses the debtor's property in the course of performing the contract?

Third, the value enhancement argument also does not comply with the goals of bankruptcy law as perceived by either economic analysis supporters or those that hold fair distribution as its principal goal. Under the economic analysis approach, two intertwined objectives underlie bankruptcy law. The first is minimizing the cost of credit for legal entities, especially law firms because they encompass the vast majority of economic activity.\(^{51}\) As parties consider the risks associated with entering into a contract with one another, they also consider the risks of default due to insolvency. An efficient bankruptcy law—one that minimizes the costs associated with bankruptcy proceedings—will lower transaction costs prior to entering the relationship. Because lower risks entail lower costs, credit costs will decrease, and parties will execute more efficient transactions. The second goal, which has a direct connection to the first, is to maximize the returns

\(^{51}\) That is the reason a market for firms was created, both nationally and globally. States and governments around the world compete with each other, targeting corporations and businesses to encourage them to incorporate and do business in their territory. Tax reductions for businesses are one major way of doing so. See generally Reuven S. Avi-Yonah, Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State, 113 HARV. L. REV. 1573 (2000).
for the creditors of the debtor once the debtor becomes insolvent.\textsuperscript{52} Bankruptcy law should present a system in which inefficient relationships cease to exist, while efficient ones remain, in order to maximize the payoffs creditors collect.

Considering the second economic goal, there seems to be no apparent benefit gained from a legal arrangement that gives priority to a possessory lien creditor who holds a debtor’s asset.\textsuperscript{53} Bankruptcy will not maximize the creditor’s return because the debtor’s asset gained value before he became insolvent. In other words, granting a possessory lien creditor this right, it could be said, will not enlarge the pie or the estate because the debtor received the benefit of the bargain before entering bankruptcy.

Furthermore, the value enhancement argument has explicit distributional and societal implications. A possessory lien transfers wealth from either the secured creditor to the possessory lien creditor or the general creditors to the possessory lien creditor. Possessory liens undermine the principle of equality of distribution; as claimed earlier, this deviation does not lie on solid grounds.\textsuperscript{54} The value enhancement argument itself does not explain why a possessory lien creditor should receive such privilege because the value enhancement argument does not differentiate a possessory lien creditor from other creditors whose actions have benefited the debtor. In order to justify deviations from the equality principle, one needs to show why it is necessary to give more protection to certain types of creditors as opposed to other types. A similar claim is sometimes mentioned with regards to tort creditors\textsuperscript{55} or employees,\textsuperscript{56} for example.

In sum, the value enhancement argument does not support a possessory lien creditor’s right to withhold the debtor’s asset until the debtor repays his debt, particularly when it stands as the sole one.


\textsuperscript{53} This Article examines the first objective of the economic analysis in Part IV(B).

\textsuperscript{54} See supra Part III(A).


\textsuperscript{56} See, e.g., 11 U.S.C. § 507(a)(3)–(4) (2006) (noting the priority of the employers); United States v. Embassy Rest., Inc., 359 U.S. 29, 33–34 (1959); see also Donald R. Korobkin, Employee Interests in Bankruptcy, 4 AM. BANKR. INST. L. REV. 5 (1996); Elizabeth Warren, Bankruptcy Policy, 54 U. CHI. L. REV. 775, 788 (1987) (“Congress . . . accepted the idea that bankruptcy serves to protect interests that have no other protection. The older employee, the regular customer . . . .”).
B. Justice and Fairness

A leading argument in favor of possessory liens’ preferred ranking is the justice and fairness argument. The argument provides that a possessory lien creditor’s right to hold a debtor’s asset until the debtor pays the creditor promotes justice and fairness between the parties involved.\(^{57}\) It also supports the idea that it is only fair to let the creditor continue holding the asset in which the possessory lien creditor invested work, material, and effort to improve its value on behalf of the debtor. From an equity point of view, it is not reasonable to demand that a possessory lien creditor return the property to the debtor when the debtor himself does not comply with the terms of the agreement.\(^{58}\) A possessory lien creditor does not have many other means to help collect the debt he is owed. In fact, it is assumed that denying the creditor of the right will almost inevitably leave the possessory lien creditor in a hopeless position.

But whereas these arguments make perfect sense when the debtor is solvent, they may seem flawed when the debtor is insolvent. Focusing solely on the relationship between the two parties, and how to advance fairness within it, appears problematic when, in fact, the debtor is not the only party in the picture, perhaps a less important party. It may still be held that justice between the specific parties to the transaction will be enhanced, but once one of them is insolvent, this relationship cannot be analyzed separately from relationships with other creditors. The possessory lien creditor does not compete with only the debtor over the asset, as he did before; he also competes with the other creditors that have legitimate claims against the debtor’s asset and the rest of his estate.\(^{59}\) The impact of granting the possessory lien creditor the right to continue holding a debtor’s asset and preference over other creditors’ claims should not be examined as if the debtor was solvent. Furthermore, it is necessary to examine the possessory lien creditor’s relationship not as an independent one but as one that is interlocked with other relationships of which the debtor is a part.\(^{60}\)

\(^{57}\) See, e.g., Gen. Motors Acceptance Corp. v. Colwell Diesel Serv. & Garage, Inc., 302 A.2d 595, 596–97 (Me. 1973) (stating that the reasons for acknowledging possessory liens are justice and commercial necessity).

\(^{58}\) This argument is also connected to the human instincts and the tendency of the law to sometimes acknowledge them. See Oliver Wendell Holmes, The Common Law 168 (1963) (explaining that the law must base itself on actual human interaction, and not philosophy, to maintain societal equity).

\(^{59}\) See 11 U.S.C. § 541 (noting the potential claimants of a debtor’s estate).

\(^{60}\) See, e.g., Warren, supra note 56, at 790–93 (explaining a non-exhaustive list of distribu-
tional priorities).
Even if the widely held view that possessory liens promote justice between the parties to the original transaction is accepted, the question of whether they promote justice between the creditors themselves must still be addressed. Possessory liens give the possessory lien creditor the chance to collect his debt before the other secured and unsecured creditors. Obviously, the other creditors will be negatively affected because they will likely collect less than what they were originally owed had bankruptcy law not acknowledged a possessory lien's priority. A state of insolvency is defined as a situation where the debtor does not have enough assets to pay his debts at the time they are due. Therefore, complete repayment of a possessory lien creditor's claim means a smaller piece of the debtor's estate for the remaining creditors.

The mere fact that under a certain legal arrangement a possessory lien creditor's portion of a debtor's estate will be larger than other creditors' distributions is not a sufficient ground to determine that there is a problem with a possessory lien's preference in bankruptcy. However, it does mean that the justice and fairness argument should be examined in a broader point of view than the reasoning offered for the solvent debtor. In order to establish solid ground for preferring a possessory lien creditor, it is necessary to establish a valid reason for why protecting a possessory lien creditor promotes justice and fairness more than protecting the debtor's other creditors. The next part examines whether a possessory lien and its original transaction offers an explanation to support the need to secure the interests of a possessory lien creditor.

C. Preserving and Improving the Commercial Dynamic of the Marketplace

A possessory lien creditor's right to withhold an asset from a debtor is a measure that enhances the fluency and dynamic of commerce in the market. The claim is that if a possessory lien creditor did not have this right, the creditor would not have any leverage to force the debtor to repay his debt. The debtor would have already received his benefit from the agreement, and if he were to default, he would do so knowing that the only way a former possessory lien creditor could force repayment is to file a lawsuit. Although there is a good chance

61. The "cash flow" or "equitable solvency" test determines whether the debtor has generally ceased to pay debts in the ordinary course of business and is unable to pay them as they become due. See J.B. Heaton, Solvency Tests, 62 Bus. Law. 983, 988–91 (2007).

the possessory lien creditor would win, especially if a written contract existed, it would cost him both time and money.

Additionally, a possessory lien creditor may even refrain from suing for the value of his claim either because he does not have the financial resources or because its value is not enough to make litigation worthwhile. Thus, a possessory lien creditor would be reluctant to perform the services for a debtor without making certain that he would be able to collect the payment owed to him upon completion of the agreement. If a possessory lien creditor did not have the right to hold a debtor’s asset, similar market transactions would transform into one of three outcomes: (1) a possessory lien creditor will decide to not enter into an agreement with the debtor; (2) a possessory lien creditor will require a debtor to pay him before performing his service; or (3) a possessory lien creditor will demand some kind of guarantee or collateral from a debtor to protect him in case the debtor defaults. Any one of these outcomes may yield inefficient transactions.

Without possessory liens, creditors would not enter into certain bargains for fear that they would not be able to collect payment after fulfilling their obligations. Each party may profit from a transaction, but without possessory liens, certain transactions may leave both parties in a worse condition because creditors may not recognize their earnings without the security of possessing a debtor’s asset. One purpose of the law, contract law in particular, is to minimize such barriers to contract and enable parties to agree to and perform efficient transactions. The absence of a possessory lien may jeopardize efficient transactions by increasing the uncertainty between parties that wish to engage in such contracts.

The other two results mentioned hold that the creditor will ask for the payment upfront or require some type of security for the service rendered. Neither method is necessarily an ideal transaction. Asking for payment upfront burdens the other party and may negatively influence his willingness to participate in the bargain. Although the risks associated with a transaction shift to the other side when a party agrees to pay for a service in advance, the increased risk still exists and the willingness to participate in the transaction has not changed; it


64. On the role of uncertainty and the importance of minimizing the effect of it within contract law, see Benjamin E. Hermalin, Avery W. Katz & Richard Craswell, Contract Law, in THE HANDBOOK OF LAW & ECONOMICS (A. Mitchell Polinsky & Steven Shavell eds., 2007).
has only been displaced. Therefore, the second outcome would result in the exact same inefficiency as before; only this time, a debtor would be reluctant to agree to a bargain.

As for the last type of solution, the problem is that it turns the transaction from one that is or should be relatively easy and common, as it applies to everyday life, to something that is far more complicated and expensive. If the creditor wants some guarantee over the payment, then more requirements must be fulfilled prior to executing the contract. Sometimes, formal requirements need to be met,\textsuperscript{65} which takes time and, in some cases, money.\textsuperscript{66} Requiring a creditor to take some other form of security will, once again, set barriers between the parties instead of minimizing them and allowing parties to transact.

By acknowledging the right to withhold the property until the debt is fulfilled, the law creates certainty and enhances the trust between the parties or, in other words, the ability to rely on one another. The creditor knows that it will be easier for him to collect the debt later, so he is willing to seal the deal much faster and at a lower price. Possessory liens also withdraw from the party rendering the service the need to make sure the asset does not have any prior claims. If the creditor will have to check that before accepting the transaction, it will complicate matters and again make the whole transaction more expensive. The sorts of transactions contemplated here are not necessarily long-term ones, and they are usually quite simple. Hence, it might not be economically worthwhile to investigate the current security interests in the property. In sum, possessory liens contribute to efficiency in the market by reducing the risks associated with these types of bargains.

This argument is indeed plausible. It is quite obvious that as more risks are associated with a bargain, fewer parties will be inclined to enter into it. The greater confidence parties have in gaining the final outcome they desire through the contract, the more they will be ready to contract with each other. This is the fundamental principle of contract law.\textsuperscript{67}

The only challenge this argument raises is that it does not provide an explanation why it is necessary, in these types of transactions, to

\textsuperscript{65} So too with liens, for example. See generally U.C.C. § 9-203(b) (1977) (specifying when a security interest is enforceable).

\textsuperscript{66} Such fees include the issuance of a bank's guarantee. Also, when taking a security interest in property, it is required to insure the property, which means more expenses associated with the transaction.

\textsuperscript{67} See Hermalin, Katz & Craswell, supra note 64.
provide the parties with this high level of protection. Obviously, there are many other transactions in which the parties do not have complete assurance that the transaction will be completed. Are transactions involving asset transition inherently riskier to the parties involved than others? That is quite doubtful. There is no reason to assume upfront that in those transactions the party invested more effort, money or any other resource in performing its obligations. Also, there is no reason to assume that parties to those transactions will refrain from bargaining or raise their price, whereas in other transactions for future performance the parties will not act in the same way. One can even claim that when parties to other unsecured transactions examine the risks associated with their bargain, they will take into account the advantages given to possessory lien holders, as well as the impact upon them, and raise prices accordingly.

And so this argument may give a solid, contract-law-based explanation, but it does not resolve the question as to why the shift in possession of the property should raise the risks of the parties. The next part will refer to the meaning of physical possession and try to analyze it and its influence on supporting or dismissing the justifications for possessory liens.

D. Possession as a Signal for Entitlement

As noted before, neither the value enhancement explanation nor the commercial requirement explanation can stand on its own. They do not clarify why, in these particular circumstances, the possessory lien creditor’s contribution to the value of the asset should give the creditor a preference over others, or why there is something unique about these transactions that drives us to protect possessory lien creditors. There are many other transactions in which the creditor’s actions and work have improved the value of the debtor’s property. But no one argues that a creditor should gain priority in every case in which his actions enhanced the value of the debtor’s assets. Thus, unless we give the same advantages to every creditor who contributes to the debtor’s assets, enhancing the value is not, and cannot be, the sole basis for possessory liens. Similarly, it is hard to understand the rationale for securing the rights of these creditors, as opposed to others who may have been involved in other relatively simple and short-term transactions for future performance.

68. See supra Parts III(A), (C).
Moreover, as noted before, the possessory lien creditor enhanced the asset's value in the cases referred to in this Article before the debtor entered the bankruptcy process. Even if there is a tendency to grant higher priority for a creditor who adds value to the estate, that tendency usually does not extend to actions made before insolvency occurred but rather to gains earned during bankruptcy proceedings. This is so for a rather good reason. The ex post goal of bankruptcy law is to maximize the returns for the creditors. It seems reasonable that the law will encourage a creditor to act in a way that will promote that goal. If that creditor will not receive higher priority, why would he be willing to act at all? But this is not the case here. Here, the creditor is rewarded for something he did in an earlier stage, when bankruptcy had yet to occur.

To justify relying on any of the above-mentioned arguments one must, therefore, differentiate between the possessory lien creditor and other creditors. It appears that the central difference lies in the possessory lien creditor's ability to physically withhold the asset that the creditor improved whereas others do not have that opportunity. This difference has been mentioned in case law, though not as the basis of the right, but as a component in its examination and recognition.

69. See supra Part III(A).

70. An exception to that rule could be seen in purchase-money security interests. These security interests have priority over floating charges, which typically include all of the debtor's assets. Section 9-103(a) of the Uniform Commercial Code defines purchase-money security interests. Section 9-324(a) of the Uniform Commercial Code states general priority of security interests over other perfected security interests in the same collateral, while subsection (b) gives a priority for purchase-money security interests in inventory. The reason for why the priority is not identical to the case of possessory liens is that, with purchase-money security interests, the assumption is that the collateral could not have been obtained by the debtor but for the creditor's extension of value. That funding might have not been supplied if it was not for the preferred position that the creditor will have in case of financial distress. Since the law encourages efficient projects, and sometimes funding is necessary in order to complete such projects, the law grants the creditor who is willing to lend for the project superiority over other creditors. With possessory liens, however, no one argues that, without the work, the property could not have been purchased or owned by the debtor in the first place. Also, with purchase-money security interests, the other creditors are not really deprived of the collateral since it was not the debtor's property to begin with, and would not have been if not for the financing offered by that specific creditor. On purchase-money security interests, see, for example, Grant Gilmore, The Purchase Money Priority, 76 HARV. L. REV. 1333 (1963); Keith G. Meyer, A Primer on Purchase Money Security Interests Under Revised Article 9 of the Uniform Commercial Code, 50 U. KAN. L. REV. 143 (2001).

71. See Schwartz, supra note 52.

72. See, e.g., Peyton v. Farris (In re Farris), No. 93-6445, 1994 U.S. App. LEXIS 34136, at *12 (6th Cir. Dec. 1, 1994) ("Under the circumstances here, it is somewhat puzzling as to what else Ingram could have done to make his possession more open, notorious, and complete. Thus, there were circumstances that could put outside parties and creditors on notice that Ingram had an interest in the inventory.").
Is that a legitimate difference on which to base preferred ranking in bankruptcy? In today's complex and dynamic economy, an asset's value can be enhanced in ways other than possessing it or working on it physically. The division between laborers and artisans who possessed the asset while improving it on behalf of the debtor, and other service providers who did not, seems arbitrary and unjustifiable in the modern world. Indeed, throughout history, physical possession was considered an important component of ownership,\textsuperscript{73} sometimes even resulting in ownership,\textsuperscript{74} and served as a signal of entitlement over an asset. But it is by no means such an essential ingredient in today's world.\textsuperscript{75} In fact, many assets today are not physical, and entities own them nonetheless. Physically holding property as a sign of entitlement does not appear to be as important as it once was. As such, it does not support the claim that there is something unique about the creditor holding property compared to a creditor who does not. That by itself does not give any justification for the privilege.\textsuperscript{76}

Additionally, the possession of property by the possessory lien creditor used to serve as a means to publicize the entitlement the creditor has over the asset.\textsuperscript{77} The notion was that other creditors will know of his holding of the property and will take that into account while dealing with the debtor. But this has also changed in the modern world. In many cases, creditors will not know whether the asset is still in the debtor's possession or if it is now held by one of the debtor's possessory lien creditors. Parties do not necessarily enter into transactions


\textsuperscript{74} See, e.g., Pierson v. Post, 3 Cai. 175 (N.Y. Sup. Ct. 1805) (defining possession that will result in ownership as a clear act that involves a notice to the world and a reward to useful labor).


\textsuperscript{76} See Note, \textit{supra} note 19, at 975.

\textsuperscript{77} This probably stems from the same motivation as acquiring an ownership right through possession that required a clear act, a sufficient notice to the public. See Brumagim v. Bradshaw, 39 Cal. 24 (1870); Note, \textit{supra} note 19, at 957; see also Rose, \textit{supra} note 73, at 81 (“Possession as the basis of property ownership, then, seems to amount to something like yelling loudly enough to all who may be interested.”) (referring to first ownership). For a parallel discussion regarding the perfection of security interests through possession of the property instead of by filing, see 1 \textit{Grant Gilmore, Security Interests in Personal Property} § 14.1 (1965) (“The basic idea is that the secured creditor must do something to give effective public notice of his interest.”).
with others that reside in close proximity to them, and so other parties may not be aware of who currently possesses the asset. Tracking assets and who holds them is much more complicated than it used to be. This barrier will affect a creditor's ability to understand how a change in possession will alter his rights.

Furthermore, bear in mind that possessory liens can be created at any time, thus changing the former set of creditors' entitlements. A creditor who had a security interest that included the asset now being held by the possessory lien creditor and who calculated his risks ex ante based on that might end up losing his advantage. In many cases, a creditor will not be able to foresee this, and he will be exposed to the enhanced risk without a chance to protect himself.\footnote{To note, it is of course possible to include a clause in the agreement between the parties that requires the debtor to notify the secured creditor of any changes in the debtor's property. Such clause can even state that the debtor needs the creditor's approval before engaging in any transaction regarding the property that is not part of the routine use. The disadvantage in that sort of arrangement is that it will complicate business and impose more costs on the parties involved.}

On the other hand, a creditor has the legal option to perfect a security interest using possession instead of the more common method of filing.\footnote{See U.C.C. § 9-302 (1977).} If there is a possibility to gain priority over others using only possession of the property as a pledge, why wouldn't such a priority system be just as valid when it comes to the types of liens contemplated here? First, it should be clarified that although this Article does not focus on perfecting security interests through possession, it also does not claim that the current legal arrangement is necessarily justifiable. It may very well be that this arrangement should be reexamined to address global changes in business culture and practice. Second, and perhaps more fundamentally, there is an apparent, major difference between these two methods of receiving priority on a debtor's property: the initial intent. When it comes to perfection of a security interest by possession, there is no question that the purpose is to secure one's claim over a debtor, as well as to gain an advantage over other creditors. But when it comes to possessory liens, an argument exists that the creditor did not possess the property in order to guarantee collecting his debt at a later time. The asset was held either (1) because the creditor had to physically withhold it to fix or improve it in some way or (2) because, in some cases, the creditor created it at the debtor's request. In many cases, the initial motive for possession was not to gain any priority, and the parties did not explicitly agree to it. Only after the breach of the contract between the parties did the creditor use the property as a way to gain an advantage. Therefore, it
is much harder to predict and calculate the risks for the other parties involved, and there is a problem claiming that others publically knew of the possessory lien.

This Part demonstrated difficulties created by the available justifications for possessory liens. Part IV will offer a new approach to examine them.

IV. Establishing Possessory Liens on Better Normative Grounds

A. The Contractual Grounds of Possessory Liens

Part III examined the arguments supporting possessory liens and whether they were plausible. Supporting these liens based on the creditor's ability to gain possession of the property seems almost an arbitrary factor. There is also no reason to believe that recognizing a creditor's right to take possession of certain property will create efficiency because it will negatively affect other creditors who do not have the option to obtain possession of the debtor's property while performing the contract. So even if the risks associated with the transaction decrease for the asset holder, they increase for others who will probably collect a smaller portion of the debt they are owed. This may result in more costly transactions. The real justification for possessory liens could only be the agreement between the parties. Thus, possessory liens will be accepted as a valid right in bankruptcy only when the possession of the asset by the creditor explicitly results from the agreement.80 Meaning that it will be considered tenable when the possessory lien creditor's right to withhold the asset is inseparable from the economic setting and structure outlined by the parties to the contract.

When parties contract with each other, there are mutual understandings upon which the contract is based. These understandings are an integral part of the contract itself; they help sustain the delicate balance between the parties. For a contract to be made, every party should be willing to risk something of his own, whether talents or as-

80. Indeed, possessory liens are sometimes referred to as established by the agreement between the parties. The debtor, when transferring his property to the creditor, in order for the creditor to work on it, impliedly consents to the latter keeping hold of the property in case the debtor does not fulfill his obligations. See New Britain Real Estate & Title Co. v. Collington, 129 A. 780, 781 (1925); see also Nathan Isaacs, The Standardizing of Contracts, 27 YALE L.J. 34, 37 (1917) ("This is illustrated in the history of possessory liens. The presence or absence of a lien has come imperceptibly to depend on the implied contract.").
sets, to receive something else from the other. Economic analysis predicts that a contract voluntarily entered into will improve the condition of both of its parties. A party will be willing to release an asset only when that party believes that releasing the asset will be worthwhile—when, in exchange, the party will get something that is more valuable than the released asset. But it is not just about the value of one asset compared to another. A contract contains many other features that have a huge effect on a party's willingness to be a part of the bargain. Other clauses may influence a party almost as much as the price itself. Primarily, the risks associated with a contract are also a part of the bargain, something that the party takes into account before deciding if it wants to go through with the bargain. Minimizing these risks through the contract is obviously an important component of the give and take process.

Take, for example, a contract in which one of the parties agrees to supply a warranty for his product as part of the sale agreement. Suppose the party providing the warranty breaches it. In that case his breach will distort the balance between the parties' obligations, giving the affected party the right to seek contractual remedies. Similarly, in some circumstances, a party's possession of the debtor's property while performing the transaction and option to continue holding it until the debt is fulfilled could be an essential ingredient of the transaction. Separating the possessory lien from the rest of the contract's terms will create an imbalanced agreement—an agreement that does not reflect the parties' consent.

Founding possessory liens on normative grounds in this manner may seem insignificant at first. To begin with, many laws already ac-

82. See, e.g., Daniel A. Farber, Contract Law and Modern Economic Theory, 78 Nw. U. L. Rev. 303 (1983). There are exceptions of course. One example is when there is a market failure such as monopoly. Another is when one of the parties is not informed, which results in an imbalance between the parties. The latter problem has led to the development of the unconscionability doctrine, which is intended to handle an imbalance in a commercial setting. See Richard A. Epstein, Unconscionability: A Critical Appraisal, 18 J.L. & Econ. 293 (1975).
83. For that reason, a contract is supposed to achieve, in a perfect world, Pareto superiority, a situation that is better than the one that took place before its execution. On Pareto superiority, see generally A. Mitchell Polinsky, An Introduction to Law and Economics 7 n.4 (3d ed. 2003).
84. On the importance of reducing transaction costs in economic theory, see Steven N. S. Cheung, Transaction Costs, Risk Aversion, and the Choice of Contractual Arrangements, 12 J.L. & Econ. 23 (1969).
knowledge contractual possessory liens\textsuperscript{85} or equitable liens\textsuperscript{86} These liens are distinguished from statutory liens in which the law grants a possessory lien to the creditor, usually based on the type of service rendered. Equitable possessory liens arise when parties agree that certain property will be held by a party as collateral for a debt owed by the other.\textsuperscript{87} The agreement’s intent must (1) be explicitly or impliedly clear to create a security agreement and (2) identify the specific property intended to secure the payment.\textsuperscript{88}

What difference does it make if there is a contractual ground to the right to withhold property or not? This Article’s claim is that, in some cases, it can make all the difference. The other explanations reviewed above\textsuperscript{89} view possessory liens as something you add to the transaction only after a breach occurred—something that is external and based on general features that the transaction has and not on the parties themselves. As demonstrated before, these arguments cannot logically establish the right.\textsuperscript{90} If the right to continue possessing the property was initially inseparable from the rest of the contractual terms, meaning it was one of the terms without which the party would not have signed the contract, then it should be acknowledged in bankruptcy as well.\textsuperscript{91} This means that the right is not external to the contract, something that the law creates regardless of what the parties’ intentions and understandings were, but rather a substantial component of the contract. Instead of trying to base the right on general grounds, which are difficult to detect, this Article proposes that courts analyze the specific contract, the specific parties, and the role the withholding option

\textsuperscript{85} California law, for example, acknowledges the right of an attorney to a possessory lien only when it is created by the contract between the parties. See Fletcher v. Davis, 90 F.3d 1216, 1219 (Cal. 2004); Severdia v. Alaimo, 116 Cal. Rptr. 405, 411 (Cal. Ct. App. 1974).

\textsuperscript{86} These are liens that are acknowledged from justice or fairness rationales and are not dependent on physical possession. Due to their nature, and the fact they are basically created by the court as an equity remedy, there is no specific law governing their application but, rather, a case-by-case analysis. See, e.g., Ralph A. Boyer & Barry Kutun, The Equitable Lien in Florida, 20 U. MIAMI L. REV. 731 (1966); Barbara E. Cotton, The Equitable Lien: New Life in an Old Remedy?, 16 ADVOC. Q. 385 (1994); Note, The Equitable Lien Alternative in Ohio, 44 U. CIN. L. REV. 265 (1975).

\textsuperscript{87} See RepublicBank, Lubbock, N.A. v. Daves (In re Daves), 770 F.2d 1363, 1367 (5th Cir. 1985).

\textsuperscript{88} See In re "Ronfin" Series C Bonds Sec. Interest Litig., 182 F.3d 366, 371 (5th Cir. 1999).

\textsuperscript{89} See supra Part III(A)-(D).

\textsuperscript{90} See supra Part III(A)-(D).

\textsuperscript{91} See David G. Epstein, Steve H. Nickles & James J. White, Bankruptcy § 8-25, at 628 (1993) ("A security interest is nonpossessory unless the parties have deliberately created a pledge, that is, it is possessory only if they structured the secured transaction so that the secured party would hold the collateral.").
played in that relationship. Thus, the argument presented by this Article is not based in property law but in contract law.

Now, assume that in some relationships, one of the parties can gain possession of the asset during performance, allowing him to continue holding it until payment is made as part of the terms of the contract. In such situations, denying that right will result in changing the terms of the contract. Under the framework presented, possession is no longer viewed as a means of completing the contract but as an extra stage in the contract performance. If the parties agreed, explicitly or implicitly as a result of custom in the specific market, for example, that the asset will remain in the possession of the creditor until full payment by the debtor, then the contract was not complete until that time. Only in these circumstances can one convincingly claim that the availability of continued possession was an economic factor that created an advantage worth protecting. When the parties made an agreement in which neither considered that the creditor party would hold the debtor's property during performance, there is no justification for preferring the possessory lien creditor over other creditors who did not get hold of an asset during the course of the transaction. If it is not an essential part of the contract to begin with, the assumption that it is economically beneficial to acknowledge it is not entirely convincing.

Conversely, when holding the property is a part of the contract negotiations, not acknowledging the possessory lien creditor's right to hold the property will result in distorting the balance of the bargain as originally created by the parties. The reason why, in almost all circumstances, interfering with the contract's terms is considered to be both economically and morally wrong is that such interference prevents the parties from deciding for themselves what will benefit them. Contracts exist to benefit both parties involved. The obligations of one party stand against the obligations of the other party, creating equivalence. Removing just one variable from this equation disrupts

92. In essence, this means protecting the mutuality or equivalence between the parties' obligations and performance. See Eyal Zamir, The Missing Interest: Restoration of the Contractual Equivalence, 93 VA. L. REV. 59, 120–23 (2007) (protecting the mutuality between the obligations, or, according to Zamir, restoring the contractual equivalence helps to give the right incentives to the parties by making them internalize their actions; actions that do not comply with the contract's terms will result in sustaining the performance by the other party).


94. So is the will theory approach, for example, which views the basis of the contract as driven by the will and freedom of the parties. It is therefore understandable why the parties must execute that will as initially intended. See CHARLES FRIED, CONTRACT AS PROMISE 7–21 (1981).
the notion that contracts usually produce efficiency. The parties are forced to change the game for which they signed up.

When viewed in this light, possessory liens do not seem to prefer one creditor to another per se, but they treat the creditor holding the property as simply continuing in the regular course of the contract as the parties agreed. It is not that the possessory lien creditor completed his obligation and is now seeking to force the debtor to fulfill his. Rather, neither party has completed the contract; the possessory lien creditor is actually exercising his contractual right, not his property right. The next part discusses the practical implications of Part IV(A).

B. Possessory Liens and Mutuality of Performance

Contractual relationships entitle the contracting parties to certain rights. One of these rights is the right of one party to stop performing the contract, so long as the other party is not performing its obligations or there is an anticipatory breach. This right has been long recognized in courts and in academic literature. It is based on the notion that a contract consists of mutual obligations, creating a structure that holds the contract and needing the protections of law. A contract is viewed as something that the parties created to achieve something—a goal, a target, or an outcome. If one of the parties does not behave as required under the contract, and in doing so damages the possibility of achieving the goals set out by the parties, the other party has the right to withhold performance of his obligations as well. This right to withhold performance is meant to restore the balance that was lost due to the breaching party’s behavior. The right to withhold performance is meant to protect the party not in breach from exposing itself to greater risks, encourage the breaching party to complete its obligations, and, in the end, restore the balance between the parties. If both parties eventually perform the contract in full, then it is, of course, the ideal and represents that the equivalence originally

95. On anticipatory breach, including a party’s right to sustain performance in case of such breach, see Henry Winthrop Ballantine, Anticipatory Breach and the Enforcement of Contractual Duties, 22 Mich. L. Rev. 329 (1924).
98. This methodology was developed greatly by Eyal Zamir. See Zamir, supra note 92, at 68.
sought by the parties was achieved. If, in the end, the contract is permanently breached and thus annulled, then the right of the injured party to abstain from its performance helped minimize the potential damage caused by the breaching party's actions.

The right to stop performing the contract, while seemingly intuitive, is actually not so trivial. In general, a party is expected to fulfill its obligations according to the contract; otherwise, the contract's goals are jeopardized. Historically, the parties' obligations were considered independent unless the parties declared otherwise. This historical approach meant that one party had to continue acting according to the contract even if the other one did not. There was no connection or dependability between one obligation and the other. Of course, the party could seek relief using legal remedies, but until the party not in breach formally annulled the contract, for example, in a method required by law, that party had no way to protect itself or to minimize its damages. Now, instead, the parties' obligations are generally not independent unless the contract explicitly states otherwise. According to the constructive conditions doctrine, substantial obligations in the contract will be referred to as dependent upon each other. This means that a party has the right to refrain from performing the contract when the other party fails to complete its side of the bargain, provided that the breach involves a substantial obligation.

As noted, this doctrine has long been established in contract law theory and practice. In essence, the doctrine reflects the modern era in which contract interpretation is not limited solely to its language but takes into account the circumstances and the specific parties. This doctrine also complies with the notion that parties should act in good faith because dependent obligations are meant to decrease a party's ability to gain from the bargain without supplying

100. Meaning those obligations that, if breached, would be considered a material breach. Minor breaches over things that are insignificant in the contract will not allow a party to stop performing its obligations. This doctrine is referred to as material breach or substantial performance. See Jacob & Youngs, Inc. v. Kent, 129 N.E. 889 (N.Y. 1921).
102. See supra notes 96–97.
what was agreed to in the contract. This doctrine, therefore, reduces the incentive of a party to act in bad faith.

Next, this Article examines the circumstances in which the issue of possessory liens' priority arises, most frequently when the creditor fulfilled a substantial part of its obligations and the debtor did not fulfill its obligations. The creditor's last obligation is to release the debtor's asset from the creditor's possession and return it to the debtor. A reasonable assumption exists that if the creditor releases the debtor's asset from its possession, then the debtor has no incentive to fully complete its obligation. It is indeed recognized by law, on quite solid grounds, that the creditor is not obliged to continue completing its obligation when the debtor does not fulfill its own obligations. In most of these cases, the benefit that the debtor denies the creditor results in a material breach. Usually, the obligation that the debtor fails to fulfill is one of the most substantial obligations in the contract: the agreed payment.

Therefore, the creditor's right to withhold the property is morally and economically justifiable. Such a right represents the current view with regards to the contracting parties' relationship, according to which they aim to create value through the contract and rely on each other's performance to achieve that value. Complying with the contract's terms is required when compliance promotes the mutual goal of the contracting parties. But when it results in deviations from the parties' mutual goals, compliance can no longer be required.

Withholding a debtor's asset is thus a contractual right, founded on contractual logic and reasoning. As opposed to the property arguments reviewed before, the contractual right argument does not falter due to inconsistencies with other legal doctrines. On the contrary, the contractual right argument complies with the general understanding regarding a contract party's right during the contract performance. This argument corresponds with the true nature of the bargain and does not assume a priori that the transaction has certain features that it may not have. This right is relevant and justifiable only when it results directly from the contract itself. Therefore, the contractual right argument will not apply where the party gained possession of the asset coincidently and not as part of the consented structure of future performance and obligations. Viewing a creditor's right to withhold a debtor's asset as such eliminates the problem, noted before, that may arise in the current legal arrangement, which creates a random preference without establishing it on either solid economic or moral
grounds. When the law protects the agreement, as well as the understandings and expectations of the parties, it gives security and certainty to the parties, which can enhance efficiency by minimizing transaction costs and securing the benefit of the bargain as set by the parties.

V. Contract-Based Possessory Liens and Bankruptcy Proceedings

A. Understanding the Problem

Part IV focused on establishing possessory liens on more convincing grounds, such as their compatibility with the principles of contract law. The question still remains, however, regarding the appropriate priority of a possessory lien creditor among the other creditors. Will this creditor be favored and allowed to hold the asset until the debtor makes payment? Or, should this right be ignored once the debtor is insolvent?

Generally, rights are neither annulled nor cancelled, but bankruptcy has a tendency to change the game. In bankruptcy, rights are frequently ignored or dismissed in favor of other goals, which may include satisfying the claims of other creditors. Bankruptcy law assumes, though perhaps not explicitly, that certain rights will not be fulfilled. This assumption is evident in a situation where the debtor is insolvent, meaning that either (1) the debtor cannot meet his obligations when they become due or (2) the debtor's total liabilities exceed his total assets. Although every creditor has a right to be repaid, there will always be creditors who will not receive the full amount of their claims in bankruptcy simply because the debtor does not have enough assets. The crucial question then becomes what standards decide

106. See supra Part III.
107. This complies with the ex ante goal of bankruptcy law to minimize the costs of credit.
108. On the impact of bankruptcy on contract law, see, for example, Charles J. Tabb, Of Contractarians and Bankruptcy Reform: A Skeptical View, 12 Am. Bankr. Inst. L. Rev. 259, 268 (2004) ("Almost by definition, bankruptcy and insolvency implicate market failures and market distortions for the debtor firms. . . . Freedom of contract does not work well in such a setting, viewed ex ante. Instead, ex post sorting promises a more effective and coherent resolution. . . . [D]ereference to contractual regimes only is appropriate if the risks and benefits being allocated in the contract are internalized to the contracting parties. This condition often is not satisfied in bankruptcy.").
109. Research shows that the percentage of payment towards unsecured creditors is very low. See Lynn M. LoPucki, A General Theory of the Dynamics of the State Remedies/Bankruptcy System, 1982 Wis. L. Rev. 311, 311 (showing that unsecured creditors receive approximately 30% of the money they are owed in reorganization procedures, while in liquidation they receive less than 5%, and in 80% of the cases they do not get anything at all); Lynn M. LoPucki & William C. Whitford, Bargaining Over Equity’s Share in the Bankruptcy Reorganization of
who should be repaid and in what amount. As a general rule, creditors are paid equally in bankruptcy,\textsuperscript{110} but that gives only part of the picture. In reality, there is a scale of priority according to the type of creditor or the type of debt; some creditors will get more than others.

Founding possessory liens on the contractual relationship between the parties necessitates an examination of the way contracts are handled in bankruptcy. Bankruptcy law dedicates a unique arrangement to contracts in bankruptcy proceedings. Section 365 of the Bankruptcy Code specifies two ways of dealing with executory contracts in bankruptcy.\textsuperscript{111} The first is choosing to reject the contract, meaning de facto annulment. The second is assuming a contract, i.e., enforcing its performance on both parties.\textsuperscript{112} Those are the only ways to decide a contract's fate once one of the parties declares bankruptcy. The decision to assume or reject a contract is made solely by the debtor-in-possession or the bankruptcy trustee. As opposed to the regularly applied contract law, these rights can be exercised by only one of the parties to the contract. Furthermore, in many circumstances, the party exercising the right to annul or enforce the contract is the breaching, insolvent party. Contractual rights do not remain as they are in bankruptcy. Other interests—perhaps broader ones as some suggest—influence the option to seek these rights. The next step is to investigate the motives to limit the contractual rights of the parties and whether such limitations apply to a creditor's right to withhold a debtor's asset.

A debtor's decision to assume or reject the contract should ideally be based on economic considerations. If performing the contract will negatively affect the debtor's financial condition, the Bankruptcy

\textit{Large, Publicly Held Companies}, 139 U. Pa. L. Rev. 125, 142 (1990) (showing that, in reorganization of a large, publicly held corporation, the average return is 50%); Michelle J. White, \textit{Bankruptcy Liquidation and Reorganization}, in \textit{HANDBOOK OF MODERN FINANCE} 37-1, 37-39 (Dennis E. Logue ed., 2d ed. 1990) (stating that the average return in liquidation of small firms is around 4%).

\textsuperscript{110} See, e.g., John C. McCoid, II, \textit{Bankruptcy, Preferences, and Efficiency: An Expression of Doubt}, 67 Va. L. Rev. 249, 260 (1981) ("From the creditor's standpoint, bankruptcy's principal theme is equality, or ratable distribution of the debtor's assets, among unsecured creditors.").

\textsuperscript{111} The term "executory contract" is not defined in the Bankruptcy Code. The most commonly-used definition was suggested by Countryman. See Vern Countryman, \textit{Executory Contracts in Bankruptcy: Part I}, 57 Minn. L. Rev. 439, 460 (1973) ("[A] contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other.").

Code gives the debtor a way out by rejecting the contract.\textsuperscript{113} This privilege derives from the understanding that if the debtor continues engaging in relationships that are not financially efficient, the debtor will eventually worsen the state of the creditors. Financially inefficient relationships may also negatively affect the debtor's reorganization efforts. The debtor can choose to reject the contract even if he has already breached it. Instead, the debtor will choose to assume a contract when its performance yields positive outcomes that will improve the debtor's ability to repay the debts owed to the creditors by enlarging the pool of assets available for distribution.\textsuperscript{114}

The current legal arrangement, as described here, expresses something crucial to understanding the connection between contracts and bankruptcy. In essence, the law is willing to accept that the solvent party will be denied the ability to execute its regular rights except for those granted in bankruptcy. Although the law does not explicitly state this, one of the parties has more rights available to it than the other. The balance that contract law intends to achieve does not have the same force once a party has declared bankruptcy. This is especially true as far as contractual remedies are concerned. One party can inflict its preferences on the other while the latter cannot do much about it. The question that now remains is, if the motives for possessory lien's preference are contract based, whether the debtor can reasonably be denied the right to decide the enforceability of the contract.

Presumably, in the case of the right to withhold an asset, the debtor should be given the choice to decide whether it wants the contract to be continued or discontinued. If the contract benefits the estate, then the debtor will choose to assume the contract and, consequently, bear all contractual obligations\textsuperscript{115}: most important, the payment due for the service rendered. Conversely, if performance of the contract creates a loss for the debtor, then the debtor will choose to reject it. Applying the executory contracts arrangement in bankruptcy to the case of contract-based possessory entitlements, the result is that the possessory lien creditor will not be able to continue holding the asset unless the


\textsuperscript{115} See 11 U.S.C. § 365(b)(1). The debtor will need to cure past defaults as well as guarantee future performance. This has been the legal arrangement in the United States long before the enactment of the Bankruptcy Code in 1978. \textit{See}, e.g., Conway v. White, 9 F.2d 863, 871 (2d Cir. 1925).
debtor assumes the contract. In that case, the possessory lien creditor will be able to continue holding the debtor's asset until the debtor makes full payment. Otherwise, once the debtor rejects the contract, the contract is annulled and the principle of restitution is applied to both parties.\textsuperscript{116} To begin, each party will have to return what it received during the contract's performance. This means the solvent party is obliged to return the asset. The creditor's claim against the debtor—whether it includes expectation damages or reliance damages—will be fulfilled, in part, when the debtor's assets are distributed. Most of the contractual creditors are unsecured, which means the possessory lien creditor will receive its share under the pro rata distribution rule.\textsuperscript{117} Thus, the possessory lien creditor's claim will be handled in the same manner as any other claim of a creditor with a rejected contract.

There is one crucial problem with this solution. In many circumstances there is no possibility that the debtor will choose to assume a contract under such legal arrangement because, in most cases, the possessory lien creditor has already rendered services according to their agreement. The only obligation left for the possessory lien creditor is to return the asset to its owner. Why would a debtor not choose to reject a contract in such circumstances? The debtor has no incentive to assume the contract once the creditor substantially completes his obligation. The debtor's assumption of the contract will lead him only to spend additional money and will not provide him much in return, as the creditor already satisfied his obligations.

The circumstances of the possessory lien creditor holding the asset should be divided into two categories for analysis: (1) when the asset was created by the creditor and (2) when the property was owned by the debtor before the parties' agreement. In the first category, the debtor arguably does not own the asset until payment is made. In many of these contracts, the transfer of the asset to the debtor occurs simultaneously with the debtor's payment for the service or shortly thereafter. Until that point in time, the asset is not considered the property of the debtor. Rejecting the contract may therefore prevent the asset from being transferred to the debtor because it was not his in the first place. Because rejecting the contract amounts to an annulment, the parties should remain as though the contract was never signed. Thus, each party should receive only restitution upon the

\textsuperscript{116} On restitution see, for example, Douglas Laycock, \textit{The Scope and Significance of Restitution,} 67 \textit{Tex. L. Rev.} 1277 (1989).

\textsuperscript{117} Usually leaving the creditor, as noted before, without much to collect from the debtor at the end of the proceeding. \textit{See supra} note 109.
debtor's rejection of the contract. The result is that the breaching party returns the benefit conferred upon it by the party not in breach and vice versa.118

When the possessory lien creditor created the asset on behalf of the debtor, the law governing executory contracts should apply quite easily. Should the debtor wish to retain possession and ownership of the product, the debtor can choose to assume the contract and its terms. The possessory lien creditor will deliver the asset to the debtor and, in return, will receive the agreed payment. If performing the contract will yield no positive outcome for the debtor, then the debtor can choose to reject it and, consequently, will not be obligated to pay for the service rendered at that time; instead, the debtor must pay certain creditors on a pro rata basis after the rest of the debts are repaid. By assuming the contract, the debtor does not prefer the possessory lien creditor to other creditors. Rather, the creditor is treated in the same manner as other creditors. If continued performance will benefit the estate, the possessory lien creditor will be repaid prior to other creditors, and if continued performance will not benefit the estate, then the possessory lien creditor will not be repaid before other creditors.

The second category, in which this problem arises, is when the property was owned by the debtor before the parties’ agreement. What should the result be when the debtor assumes or rejects the contract? If the debtor rejects the contract, then the remedy of restitution applies. According to this principle, every party to the contract should be returned to its pre-contractual condition. Thus, the asset should presumably return to its owner, the debtor. Assuming the contract yields the same result, the debtor gets the asset and must pay what he owed according to the contract. This leads to the problem pointed out before that if there is no difference from the debtor's point of view regarding what the debtor gains by assuming the contract, as opposed to rejecting it, what is the debtor’s incentive to assume the contract? Assuming the contract not only gives the debtor the benefit of the bargain but also requires the debtor to provide something in return. In this case, the debtor's rejection gives him the benefit of the bargain with a legal authorization, which essentially means the debtor is not obliged to compensate the possessory lien creditor in full. Is there even competition between assuming and rejecting the contract from the debtor's point of view?

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118. The purpose of the restitution interest is to prevent unjust enrichment to any of the parties. On the connection between the two, see, for example, Jack Beaton, The Use and Abuse of Unjust Enrichment (1991); Emily Sherwin, Restitution and Equity: An Analysis of the Principle of Unjust Enrichment, 79 Tex. L. Rev. 2083 (2001).
The legal arrangement described appears defective, which is how this Article differentiates these types of transactions from others. It is a situation where there is no incentive to assume the contract. Or rather, it is a situation where the application of the standard rules regarding contracts in bankruptcy does not yield the desired results. The rules as they are cannot promote efficiency as they do not encourage the debtor to act in an efficient way. This derives from the imbalanced position the contract was in when bankruptcy occurred. Although neither party fulfilled its obligations in full, a significant gap between the parties' performance existed. The creditor completed the services that the debtor originally desired while the debtor did not complete his obligations to the creditor.\textsuperscript{1}

One can argue that the debtor should not receive the asset in order to restore the balance between the parties, but this will not produce the optimal outcome either. In this scenario, the risk of unjust enrichment goes both ways. On the one hand, the collateral is the debtor's property, so it makes sense to give it back to the debtor, whether or not the parties performed the contract. Otherwise, the possessory lien creditor will be unjustly enriched.\textsuperscript{2} On the other hand, if the asset is handed out to the debtor, then the debtor receives extra value, value that belongs to the creditor.

In many executory contracts, the debtor unjustly receives value. The difference between regular executory contracts and the scenarios referred to here is two-fold. First, in the circumstances described, there is no way that the debtor will prefer to assume the contract, even if, viewed aggregately, the debtor's assumption is the preferred decision based purely on economic grounds. The debtor may benefit from rejecting the contract, but the loss or damage imposed on the possessory lien creditor might be greater than the debtor's benefit, thus producing an aggregate loss. Second, while in other circumstances the possessory lien creditor already gave value to the debtor before the commencement of the case, here, supposedly, no value was transferred until the asset itself was transferred. If the law allows for the transfer of the asset back to the debtor, then it essentially authorizes damaging the possessory lien creditor because the harm does not exist until the creditor actually gives up, legally or voluntarily, possession of the asset. Holding the asset has a value, and the possessory lien creditor realizes that value by depriving the debtor of his contractual rights until the debtor's obligations are fulfilled. Preventing the

\textsuperscript{119} See supra note 111 (discussing the definition of executory contracts).

\textsuperscript{120} This is true unless the value of the service provided by the creditor is higher than the value of the property itself. But that is a rare situation.
creditor from holding the asset imposes a premature loss upon the creditor, which changes the pre-bankruptcy financial state of the parties. Part V(B) offers a way out of this complex dilemma.

B. The Appropriate Legal Arrangement

Part V(A) previously described the difficulty that arises where a party takes possession of the other party's property as an inseparable component of a contract's structure. Holding the property in such a manner should be viewed as a contractual right when it is based on contractual consents. But this contract-based view offers neither a solution to the question of whether the possessory lien creditor is entitled to hold the asset nor an answer concerning the scope of that right if it indeed exists. This scenario directs us towards the legal arrangement of executory contracts, but this arrangement cannot enhance contractual efficiency. It does not offer a solution to a situation where there is an imbalance between the parties' obligations at the time the decision regarding the contract is made. It is also characterized by forcing the possessory lien creditor to worsen its financial position compared to the one it had when the proceedings began.

This last characteristic is an important one, since it is not typical under bankruptcy law. Usually, the law assumes the debtor created the loss prior to bankruptcy, whereas now the law's goal is to straighten things out. Bankruptcy law is not supposed to decrease a creditor's return or to force a creditor to risk his assets to help the debtor. When a creditor risks his assets in bankruptcy, he is usually compensated for that by receiving a higher priority in the distribution process. This principle should also be applied to a possessory lien creditor who holds an asset that the debtor wishes to retrieve. However, the debtor does not gain any benefit while it is still in the possession of the creditor. Therefore, transferring the asset is not only a physical transfer but also a value-creating transfer of the possessory lien creditor.

One can criticize this approach by saying it goes back to the earlier examined and dismissed approach that justifies possessory liens because the creditor enhanced the asset's value on behalf of the debtor, but this approach is different. It does not rely on the value enhancement created for the debtor as a rationale. It focuses on the value of withholding the asset for the creditor based on the contract between the parties, as well as that in such cases there is difficulty in implementing bankruptcy law. The goal is thus to create a legal arrangement that requires the debtor to internalize the costs inflicted on the possessory lien creditor if the debtor chooses to repossess the asset.
Ranking the possessory lien creditor as a preferred, though unsecured, is a solution that seems to correspond with the basis of the right and the problems arising from it. This solution forces the possessory lien creditor to release the asset, giving the creditor a priority that reflects a goal to continue business with the debtor after the debtor has filed for bankruptcy protection.121 Unlike a secured creditor, the possessory lien creditor will neither be repaid before all of the other creditors122 nor have any of the rights designated to secured creditors.123 The possessory lien creditor will be referred to as a contractual creditor, a creditor with whom the debtor chose to continue its business based on economic grounds.

If the debtor chooses not to assume the contract, the contractual creditor will be obligated to return value equal to the market value of the asset before the creditor’s improvements. If possible, on both a practical and an economic level, the contractual creditor can also remove the improvements and return the asset in its original condition. The contractual creditor, like the debtor, is not entitled to earn profits that do not belong to him in the first place. Therefore, if the debtor chooses not to assume the contract, the creditor will not be obligated to return the improved asset but will have to comply with the principle of restitution124 and return its value. Under this arrangement, neither party unjustly gains value that belongs to the other party. The debtor is not entitled to take the asset as part of restitution, and the contractual creditor is not entitled to claim the entire asset’s value but rather only the value of the improvements made.

Such a legal arrangement succeeds in achieving several important goals. First, it prevents the debtor from externalizing the costs associated with the contractual relationship to the creditor, which would result in inefficient bargaining.125 Second, it gives the debtor a chance

121. 11 U.S.C. § 726 (2006) (stating that the first items to be paid after secured claims were satisfied are expenses and claims with priority according to § 507 of the Bankruptcy Code).
122. The trustee distributes the estate to satisfy secured claims first. Only then do the other creditors start to get repaid, according to § 726 of the Bankruptcy Code. Id. This is also known as the absolute priority rule.
123. These rights include receiving relief from the automatic stay under § 362(d) of the Bankruptcy Code. Id. § 362(d). The solvent party will not be considered as a creditor with an interest in the property because this is a contract-based relationship in which no security interest was created on behalf of the creditor. When holding a possessory lien under current law, the creditor is exempt from the scope of the automatic stay and is not considered to be in violation of the stay if the creditor maintains possession over the property. See, e.g., Hayden v. Wells (In re Hayden), 308 B.R. 428 (B.A.P. 9th Cir. 2004); Boggan v. Hoff Ford, Inc. (In re Boggan), 251 B.R. 95 (B.A.P. 9th Cir. 2000).
124. See supra note 116 and accompanying text.
to earn the benefit of the bargain without forcing the debtor to simulta-
neously pay the contractual creditor when assuming the contract. Requiring the debtor to pay the contractual creditor at the initial stage might be difficult on a practical level and may prevent the debtor from being able to afford to assume the contract at all. Allowing the debtor to pay later, when the debtor pays his other creditors, will be easier and will enable the debtor to smoothly pay off his debt under the reor-
ganization plan. Third, this solution represents, as this Article argues, the true debtor-creditor relationship. It is a contractual relationship and should be treated as such under bankruptcy law. This is the cor-
rect framework, and it corresponds with other legal arrangements in bankruptcy law, creating a coherent system. Fourth, the solution shifts the decision to assume or reject the contract, or transfer the as-
set, from the creditor to the debtor, as it should once the debtor has entered bankruptcy. The solution provides the debtor with more con-
trol and allows the debtor's relationships and their outcomes to be examined from an efficiency point of view, accounting for the impact on all the debtor's creditors and the bankruptcy proceeding as a whole.

VI. CONCLUSION

The case of possessory liens is intriguing on a theoretical and a prac-
tical level. So far, academic literature does not offer convincing expla-
nations for the priority given to a possessory lien creditor or his legal arrangement with a debtor as a whole. This Article has examined the issue of possessory liens and explained the problems with current argu-
ments favoring its legal arrangement while offering an innovative approach. Viewing possessory liens as an inherent part of contract law provides a different perspective for analysis. The analysis this Ar-
ticle suggests corresponds with other procedures and issues that arise in bankruptcy and leads to a legal arrangement that is more logically sound than other analyses. Thus, this approach is theoretically inno-
vative and produces practical legal applications.

a third party, and the third party has no opportunity to affect the outcome . . . "}). For a current demonstration of how externalities can negatively influence parties' behavior in a contractual setting when third parties are involved, see Dov Solomon & Odelia Minnes, Non-Recourse, No Down Payment and the Mortgage Meltdown: Lessons from Undercapitalization, 16 FORDHAM J. CORP. & FIN. L. 529 (2011).