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The Undersecured Creditor in Reorganizations and the Nature of Security

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The Undersecured Creditor in Reorganizations and the Nature of Security

*Theodore Eisenberg**

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I. Introduction

For better or for worse, bankruptcy law generally recognizes secured creditors' state law rights in collateral. The decision to honor secured creditors' state law interests and the need to modify those interests in bankruptcy generate an essential tension of bankruptcy law. Much of the Bankruptcy Act's complexity and several of its most controversial provisions arise from congressional efforts to resolve this tension.

In trying to walk the fine line between taming and preserving secured creditors' rights, Congress created one of the most extraordinary provisions in the history of bankruptcy law. Section 1111(b) of the Bankruptcy Act of 1978[1] suspends two fundamental rules of debtor-creditor law. This provision allows an undersecured claim to be treated as a fully secured claim[2] and deems nonrecourse debt to be recourse debt.[3]

Congress enacted section 1111(b) in response to a bankruptcy court decision perceived as overly favorable to debtors and thus unfavorable to secured creditors. In that decision, *In re Pine Gate Associates*,[4] the court allowed a reorganizing debtor to pay undersecured nonrecourse creditors the appraised value of collateral, to retain the collateral for use in reorganization, and to sever the secured parties' interests in the collateral. Under *Pine Gate*, therefore, the undersecured creditors would not receive full payment

1. All citations in this Article to the Bankruptcy Act, which is codified as Title 11 of the United States Code, refer to 11 U.S.C. §§ 101-1513 (1982), as amended by the Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, 98 Stat. 333.

2. 11 U.S.C. § 1111(b)(2) (1982).

3. *Id.* § 1111(b)(1)(A).

4. 2 Bankr. Ct. Dec. (CRR) 1478 (Bankr. N.D. Ga. 1976). Other cases in the *Pine Gate* line include: *In re* KRO Assocs., 4 Bankr. Ct. Dec. (CRR) 462 (Bankr. S.D.N.Y. 1978); *In re* Hobson Pike Assocs., Ltd., 3 Bankr. Ct. Dec. (CRR) 1205 (Bankr. N.D. Ga. 1977); *In re* Marietta Cobb Apartments Co., 3 Bankr. Ct. Dec. (CRR) 720 (Bankr. S.D.N.Y. 1977); *In re* Triangle Inn Assocs., 3 Bankr. Ct. Dec. (CRR) 716 (Bankr. E.D. Va. 1977); *In re* Hartsdale Assocs., 3 Bankr. Ct. Dec. (CRR) 460 (Bankr. S.D.N.Y. 1977).

and would have no continuing interest in the asset. In a nonbankruptcy setting, by contrast, the undersecured creditors could be entitled to the collateral itself unless they were paid in full.[5]

Most commentators who understand the Bankruptcy Act's confirmation standards have not questioned the premises of section 1111(b) and treat the provision as a reasonable effort, if sometimes technically awkward or flawed,[6] to correct the *Pine Gate* problem.[7] This Article explores that problem and section 1111(b)'s effect on it within the larger scheme of bankruptcy law.

Part II of this Article describes other bankruptcy rules that must be understood before analyzing section 1111(b)'s operation. Part III examines the *Pine Gate* decision and attempts to define the problem that it created and that led to Congress' enactment of section 1111(b). Analysis suggests that the *Pine Gate* problem does not differ from many other valuation problems that arise in bankruptcy. Accordingly, this problem is no more in need than they are of extraordinary remedial measures such as section 1111(b). Taking the analysis one step further, part IV discusses the *Pine Gate* problem's relation to the nature of security and the objectives of bankruptcy policy. Although section 1111(b) reflects a view of security in bankruptcy based on a secured creditor's in rem rights to collateral under state law, this approach is only one view of the nature of security in bankruptcy. An alternative approach regards state law security rules as a ranking mechanism, with secured creditors ranked ahead of unsecured creditors, but does not necessarily

5. *See* U.C.C. § 9-505(2) (1972) (personal property). When the debtor believes the collateral is worth more than the amount of the debt owed to tbe secured creditor, the secured party's authority to retain rather than sell the collateral is limited. *See id.* § 9-505. In the case of real property, states may require a foreclosing creditor to go through a foreclosure sale in which third parties may bid on the property.

6. *See, e.g.,* Blum *The "Fair and Equitable" Standard for Confirming Reorganizations Under the New Bankruptcy Code,* 54 AM. BANKR. L.J. 165 (1980); Kaplan, *Nonrecourse Undersecured Creditors Under New Chapter 11—The Section 1111(b) Election: Already a Need for a Change,* 53 AM. BANKR. L.J. 269 (1979).

7. *See, e.g.,* J. TROST, G. TREISTER, L. FORMAN, K. KLEE & R. LEVIN, THE NEW FEDERAL BANKRUPTCY CODE 309-11 (1979); Coogan, *Confirmation of a Plan Under the Bankruptcy Code,* 32 CASE W. RES. L. REV. 301 (1982); Klee, *All You Ever Wanted to Know About Cram Down Under the New Bankruptcy Code,* 53 AM. BANKR. L.J. 133 (1979); Pachulski, *The Cram Down and Valuation Under Chapter 11 of the Bankruptcy Code,* 58 N.C.L. REV. 925 (1980); Pusateri, Swartz & Shaiken, *Section 1111(b) of the Bankruptcy Code: How Much Does the Debtor Have to Pay and When Should the Creditor Elect?,* 58 AM. BANKR. L.J. 129 (1984); Stein, *Section 1111(b): Providing Undersecured Creditors with Postconfirmation Appreciation in the Value of the Collateral,* 56 AM. BANKR. L.J. 195 (1982). *But cf.* Miller, *Bankruptcy Code Cramdown Under Chapter 11: New Threat to Shareholder Interests,* 62 B.U.L. REV. 1059 (1982).

honor state rules allowing repossession of collateral. This alternative view is, of necessity, the more dominant in bankruptcy. To the extent section 1111(b) departs from the priority approach, the provision is inconsistent with the main thrust of bankruptcy law's treatment of secured creditors.

Finally, part V points out specific inadequacies of section 1111(b)'s solution to the *Pine Gate* problem. Even assuming that section 1111(b) addresses a problem demanding remedial measures, the statute fails to address the problem in an acceptable manner. Section 1111(b) treats the *Pine Gate* problem as if the matter can be resolved either in favor of the debtor or in favor of the debtor's undersecured, nonrecourse creditors. Section 1111(b) favors the undersecured creditors but simultaneously generates residual effects on other creditors. Although the section 1111(b) election was aimed at debtor behavior, other creditors often will bear the cost.

II. What Section 1111(b) Does

A. *Bankruptcy Law Background*

To understand how section 1111(b) suspends basic bankruptcy rules, one must grasp the Bankruptcy Act's treatment of undersecured creditors and its mechanism for confirming a reorganization plan. A creditor is undersecured when the value of its collateral is less than the amount of the debt that the collateral secures. In describing an undersecured creditor's status in bankruptcy, section 506(a) of the Bankruptcy Act states in part:

> An allowed claim of a creditor secured by a lien on property in which the estate has an interest . . . is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property . . . and is an unsecured claim to the extent that the value of such creditor's interest . . . is less than the amount of such allowed claim.[8]

An undersecured creditor therefore has two claims in a bankruptcy proceeding. The first is a secured claim, entitled to priority over unsecured claims and equal to the value of the collateral. The second claim, for an amount equal to the difference between the total

8. 11 U.S.C. § 506(a) (1982). The scope of § 506(a) depends upon the meaning of the term "lien" in bankruptcy. Section 101(31) defines "lien" to mean "charge against or interest in property to secure payment of a debt or performance of an obligation." The term therefore is broad enough to include security interests arising under Article 9 of the UCC, real estate mortgages, judicial liens, statutory liens, and common-law liens. *See id.* § 101(30), (42), (43), (45) (1982 & Supp. 1984).

claim and the secured claim, is an unsecured claim that shares on a pro rata basis with other unsecured creditors. This difference usually is called the deficiency. To illustrate, if a secured creditor is owed $100 and has an interest in $75 worth of the debtor's property, the creditor has a secured claim of $75 and an unsecured claim of $25.

Section 1111(b) modifies this dual treatment in reorganization proceedings.[9] Through its effect on confirmation standards, section 1111(b) alters a debtor's ability to confirm a reorganization plan over creditors' objections. To understand how this modification operates, one must understand the requirements for confirming a reorganization plan over the objection of a class.[10]

Before a plan may be confirmed, each class of claims must approve the reorganization plan, not be impaired by the plan, or be treated fairly and equitably by the plan.[11] The interesting cases, those of concern here, deal with an impaired class[12] that has voted to reject the plan.[13] Confirmation of the plan thus depends on satisfying the "fair and equitable" requirement of section 1129(b).[14] Because a secured creditor often is the only creditor of its class, a single creditor may prevent the class from approving a plan.

For secured claims, the statutory description of the fair and

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9. Section 1111(b) applies only to cases brought under Chapter 11 of the Bankruptcy Act. *See id.* § 103(f) (1982). For a discussion of the issues and problems that attend limiting a provision's application to Chapter 11, see Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L.J. 857 (1982).

10. Chapter 11's confirmation provisions operate both on classes of claims and on individual claim holders. *See* 11 U.S.C. § 1129(a)(7), (8) (1982 & Supp. 1984). Determining the permissible classifications of claims and interests in a Chapter 11 plan is no simple matter. *See In re* Medical Equities, Inc., 39 Bankr. 795, 798-804 (Bankr. S.D. Ohio 1984); *In re* S & W Enter., 37 Bankr. 153, 157-65 (Bankr. N.D. Ill. 1984); 11 U.S.C. §§ 1122, 1123(a)(1) (1982 & Supp. 1984); *cf. In re* Bradley, 705 F.2d 1409, 1411 (5th Cir. 1983); Barnes v. Whelan, 689 F.2d 193 (D.C. Cir. 1982); *In re* Sanders, 13 Bankr. 320 (Bankr. D. Kan. 1981); 11 U.S.C. § 1322(b)(1) (1982 & Supp. 1984) (classification of claims in Chapter 13 cases). *See generally* Epstein, *Chapter 13: Its Operation, Its Statutory Requirements as to Payment to and Classification of Unsecured Claims, and Its Advantages*, 20 WASHBURN L.J. 1 (1980) (discussing operation of Chapter 13 and comparative advanteges over Chapters 7 and 11); Vihon, *Classification of Unsecured Claims: Squaring a Circle?*, 55 AM. BANKR. L.J. 143 (1981) (examining parameters of permissible § 1322 classifications).

11. 11 U.S.C. § 1129(a)(8), (b)(1) (1982 & Supp. 1984).

12. In general, a reorganization plan does not impair a class if the plan does not alter the legal, equitable, or contractual rights to which the members of the class are entitled, *id.* § 1124(1), or if the plan alters such rights in a manner permitted by § 1124(2) or (3).

13. Section 1126 sets out the standards governing when a class will be deemed to have approved a reorganization plan.

14. *See* 11 U.S.C. § 1129(b)(1) (1982). Section 1129(b)(2) contains a list of requirements included in the fair and equitable treatment standard.

equitable requirement suggests that each claim holder receive "deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property."[15] The present value of the income stream promised to the secured creditor must equal at least the value of the creditor's interest in collateral. For unsecured claims, the fair and equitable test requires that each claim holder "receive or retain on account of such claim property of a value, as of the effective date of the plan, equal to the allowed amount of such claim."[16] The present value of the income stream promised to the unsecured creditor must equal the amount of the claim. If the reorganization plan provides for payment of less than this amount, then no junior claimant may receive or retain value under the plan.[17] Because both of these tests are class oriented, a class may waive them and bind class members who dissent. This result cannot occur, however, when a secured class has only one member.[18]

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15. *Id.* § 1129(b)(2)(A)(i)(II)(1982 & Supp. 1984). This branch of the fair and equitable standard also requires that the secured claimant retain its lien on the collateral. *Id.* § 1129(b)(2)(A)(i)(I). The other principal statutorily endorsed way to satisfy the fair and equitable requirement allows the debtor to furnish the claimant with the "indubitable equivalent" of its claim. *Id.* § 1129(b)(2)(A)(iii) (1982). For discussions of the equivalency standard, see D. BAIRD & T. JACKSON, SECURITY INTERESTS IN PERSONAL PROPERTY 526-32 (1984) and T. EISENBERG, DEBTOR-CREDITOR LAW 514-17, 530-31 (1984).

The Bankruptcy Act does not define the phrase "fair and equitable." It merely provides what one must presume to be a nonexclusive list of plan provisions that satisfy the fair and equitable requirement. *See* 11 U.S.C. § 1129(b)(2) (1982). The fair and equitable test worked differently prior to the 1978 Bankruptcy Act. *See* Case v. Los Angeles Lumber Prods. Co., 308 U.S. 106 (1939) (holding that when plan of reorganization is not fair and equitable, it cannot be confirmed even though the percentage of classes of security holders required for confirmation have consented); Klee, *supra* note 7 (discussing additional requirements under the new Bankruptcy Act).

16. 11 U.S.C. § 1129(b)(2)(B)(i) (1982).

17. *Id.* § 1129(b)(2)(B)(ii) (1982 & Supp. 1984).

18. An individual claim holder within an impaired class receives protection in addition to the protection afforded its class. The plan must provide a dissenting claim holder an amount with a present value not less than the amount the holder would have received in a Chapter 7 liquidation. *Id.* § 1129(a)(7)(A)(ii). This standard, often called the "best interests of creditors" test, *e.g.*, *In re* Braniff Airways, Inc., 700 F.2d 935, 940 (5th Cir. 1983), protects dissenting class members.

In addition, when the § 1111(b)(2) election is made, a dissenting secured creditor must "receive or retain under the plan on account of such claim property of a value, as of the effective date of the plan, that is not less than the value of such holder's interest" in the collateral. 11 U.S.C. § 1129(a)(7)(B) (1982 & Supp. 1984). In other words, the plan must promise an undersecured creditor making a § 1111(b)(2) election a stream of payments with a present value equal to the value of the claimant's interest in the collateral. The additional protection of the best interests test will matter only when an individual undersecured creditor in a larger class objects to the class's approval of a plan.

By suspending two basic rules of debtor-creditor law, section 1111(b) makes it more difficult for debtors to confirm plans over the objection of undersecured creditors or nonrecourse creditors and enables undersecured creditors to retain an interest in property in the hope that the property's value will appreciate. To develop and illustrate these assertions, it is necessary to explore section 1111(b) in detail.

B. The Undersecured Creditor's Election

Section 506(a) bifurcates an undersecured claim into two claims, one secured and one unsecured.[19] Section 1111(b)(2) provides that, "notwithstanding section 506(a)," an electing undersecured creditor's "claim is a secured claim to the extent that such claim is allowed."[20] Section 1111(b)(2) thus permits an undersecured creditor to waive its section 506(a) unsecured claim and to be treated as fully secured. The undersecured creditor may treat its claim as fully secured regardless of the value of its collateral,[21] which, under section 506(a), normally would determine the amount of its secured claim. A previously unsecured portion of a claim may thus be deemed secure.

Deeming an undersecured creditor to be fully secured, however, does not increase the value of the collateral to the full amount of the creditor's claim. If it did, the creditor's interest in the collateral of increased value would then vindicate its newly found fully secure status. Even Congress, however, lacks the power to command that an asset's value increase from $75 to $100,[22] and the undersecured creditor who makes the section 1111(b)(2) election still finds itself with only $75 worth of collateral. The election operates in a more subtle manner.

Through section 1129's confirmation mechanism,[23] the election alters the debtor's ability to obtain confirmation of a reorganization plan and allows an undersecured creditor to try to benefit from postconfirmation appreciation of its collateral. For the creditor with a $100 claim and $75 worth of collateral, comparing its status without and with the election is instructive.

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19. 11 U.S.C. § 506(a) (1982); *see supra* text accompanying note 8.

20. 11 U.S.C. § 1111(b)(2) (1982).

21. When the class's interest in collateral "is of inconsequential value," the class may not make the election. *Id.* § 1111(b)(1)(B)(i).

22. Congress might, however, influence value througb taxation or other regulatory measures.

23. *See supra* notes 14-18 and accompanying text.

Without the section 1111(b)(2) election, the creditor has a $75 secured claim and a $25 unsecured claim. Under section 1129's confirmation standards, a reorganization plan must provide for payments with a present value of at least $75 to a creditor class with a $75 secured claim and provide that the class retain its liens to secure repayment of such amounts.[24] Regarding the $25 unsecured claim, the plan must provide for payments to a nonconsenting creditor with a present value equal at least to what the creditor would have received in a liquidation proceeding. Furthermore, if any junior interests (usually shareholders) participate in the reorganization, the plan must include a promise to make payments to the unsecured claimant with a present value of at least $25.

By making the section 1111(b)(2) election, the undersecured creditor is deemed to have a secured claim of $100. A dissenting secured creditor class is entitled to a stream of payments with a present value equal to its interest in collateral and a total equal to the allowed amount of its constructively fully secured claim. The electing undersecured creditor therefore becomes entitled under the plan to a stream of payments totaling $100 with a present value of at least $75. The creditor is more difficult to cash out because the total payout requirement has increased by the amount of the deficiency.

What is the net effect of the election? One may examine this question from the separate viewpoints of the debtor and its creditors. The increased total payout requirement often will not burden the debtor's effort to repay. With or without the election, the reorganization plan must provide for a stream of payments with a present value equal to the value of the collateral. Satisfying this present value component of the payout requirement often will result in payments to the section 1111(b) creditor that equal or exceed the total amount of the creditor's secured claim, as increased through the section 1111(b)(2) election.

In some circumstances, however, the total payout requirement may make confirmation more difficult. If a plan's terms cover only a few years during which interest rates are not exorbitant and if the section 1111(b) creditor is substantially undersecured, then the total payment requirement may be an important factor in the reor-

24. *See* 11 U.S.C. § 1129(b)(2)(A)(i)(I) (1982 & Supp. 1984). For a discussion of the limit on the protection that this requirement affords, see *infra* notes 121-22 and accompanying text.

ganization proceeding. For example, consider an undersecured creditor owed $1,000,000 with security worth $100,000. With a discount rate of ten percent, the creditor's secured claim normally would entitle it only to payments totaling $100,000 with a present value of $100,000. The section 1111(b) election would entitle the creditor to payments totaling $1,000,000 with a present value of at least $100,000. Even if all payments are deferred for three years, the creditor would receive payments with a present value well in excess of the value of the collateral.[25] Nevertheless, many potential section 1111(b) creditors will not substantially increase their current payout by making the election.

From the creditor's perspective, section 1111(b) provides two primary benefits. First, the power to elect gives the creditor an enhanced bargaining position in the reorganization negotiations.[26] Second, the collateral subject to the now fully secured claim may increase in value. Since the secured creditor retains its lien and, by making the election, is deemed to have an increased secured claim, the debtor's subsequent sale of the collateral, before repayment under the plan is completed, will generate funds subject to the electing creditor's lien exceeding the amount the secured creditor would receive absent the election.[27] The creditor thus retains a right to enjoy future appreciation in the collateral or to compensate for an initially low appraisal.

What price does the electing creditor pay for its new status?

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25. The present value of $1,000,000 to be paid three years in the future at 10% is $751,000. One must defer payment of $1,000,000 at least 24 years before the present value of the payments would be $100,000. Deferring all payments to a substantially undersecured creditor for a period of time sufficient to assure that the creditor will receive payments with a present value of no more than $100,000 may present problems. If the period of time is sufficiently long, a court simply may refuse to require the creditor to wait so long for any substantial payments. *Cf.* 11 U.S.C. § 1129(a)(11) (1982) (plan must be feasible).

26. This tactical advantage will affect cases settled through informal creditor agreements that never reach bankruptcy courts. Professor Gilmore has stated:

> No doubt many more cases are settled by informal creditor's committees than ever reach the bankruptcy courts. But the tactical situation of a secured creditor in such negotiations is decisively affected by the status that his security interest will have if other creditors (or the debtor himself) decide on the last resort of filing a bankruptcy petition.

2 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 45.2, at 1288 (1965).

27. This analysis assumes that the contract covering the collateral accelerates the debt when the debtor sells the collateral and that the debtor sells the collateral before the electing undersecured creditor has received payments under the reorganization plan totaling the allowed amount of the now fully secured claim. After payments equal to the allowed amount of the claim have been made, the § 1111(b) creditor may no longer have a lien securing repayment of its debt. *See* 11 U.S.C. § 1129(b)(2)(A)(i)(I) (1982 & Supp. 1984); Pachulski, *supra* note 7, at 948; *infra* notes 121-22 and accompanying text.

Because section 1111(b) treats the electing creditor's claim as fully secured, the creditor no longer has an unsecured claim. If there is any value in being a member of an unsecured class—for example, when a substantial dividend will accrue to that class—the electing undersecured creditor loses that benefit.[28]

C. *Nonrecourse Debt as Recourse Debt*

Understanding section 1111(b)'s second unusual provision requires knowledge of the difference between recourse debt and nonrecourse debt. When a secured creditor agrees to look only to collateral to satisfy a claim against a debtor, that claim is nonrecourse because the creditor does not have recourse against the debtor's general assets to seek repayment of the debt. The creditor may not bring an action against the debtor for any deficiency remaining after realizing the value of the collateral. In other words, a nonrecourse creditor who is owed $100 and who has an interest in collateral with only $75 has no recourse against the debtor for the $25 deficiency. A recourse secured creditor, on the other hand, may look not only to its collateral but also to any other property of the debtor against which a money judgment is enforceable.

Section 1111(b)(1)(A) suspends this basic rule of debtor-creditor law: "A claim secured by a lien on property of the estate shall be allowed or disallowed under section 502 of this title the same as if holder of such claim had recourse against the debtor on account of such claim, whether or not such holder has such recourse

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28. One could generate a set of circumstances in which the electing creditor reacquires the benefit of membership in the unsecured class. Assume that the electing undersecured creditor has a debt of $100 secured by collateral worth $75. Assume also that a reorganization plan is confirmed but that the reorganization effort fails soon after confirmation, before any payments have been made, and before any change in the value of the collateral. If the electing creditor is treated as having a secured claim of $100 as of the date of confirmation, then that creditor's situation is similar to that of an actual secured creditor owed $100 whose collateral actually was worth $100 on the date of reorganization. What status would the creditor have in the second bankruptcy if its collateral were worth $100 at the time of confirmation but later depreciated to the collateral's actual value of $75? One possible result is that the actual creditor would have a $75 secured claim and a $25 unsecured claim in the second bankruptcy.

If Congress intended the § 1111(b) creditor to be treated as if the creditor actually emerged from the initial reorganization with $100 of security, then at the time of the second bankruptcy the electing creditor might also have a $75 secured claim and a $25 unsecured claim. This combination of claims is the same combination that the creditor would have had in the first bankruptcy without the § 1111(b) election. The creditor's deficiency claim, supposedly waived by the § 1111(b) election, thus has reemerged in the second bankruptcy. This analysis, admittedly tentative, clouds statements to the effect that an electing creditor waives its deficiency claim.

. . . ."[29] The provision thus allows nonrecourse secured claims as if they have recourse against the debtor. More particularly, the provision treats undersecured creditors holding nonrecourse claims as if they have unsecured claims for the amount of the deficiency.[30] Given section 1111(b)(1)(A), no form of debt may be worthy of the name nonrecourse because the creditor's inability to enjoy a deficiency claim in bankruptcy could be considered an essential characteristic of nonrecourse debt.

III. Why Enact Section 1111(b)?: The *Pine Gate* Problem

The rules that section 1111(b) affects—section 506(a)'s limitation of secured claims to the value of the collateral and the usual treatment of nonrecourse claims—are well within the mainstream of bankruptcy and debtor-creditor law. Changing these rules should require a reasonably clear showing that the rules do not work. The impetus for both parts of section 1111(b) clearly stems from *Pine Gate* and similar cases, but against the background of what has transpired in its name, *Pine Gate* is somewhat disappointing. The case involved no massive fraud, contained no clear judicial blunder, and presented no plainly erroneous results. Furthermore, *Pine Gate* raised no problem significantly different from other, commonly ignored bankruptcy law problems.

A. *The Case*[31]

Pine Gate Associates, a limited partnership that owned and operated an apartment project, filed a petition for a real property arrangement under Chapter XII of the Bankruptcy Act of 1898. Secured creditors held a mortgage on the apartment project. The promissory notes evidencing the underlying debts stated that the debtor would not be liable on the notes beyond the value of the property and improvements constituting the apartment project. In other words, neither Pine Gate Associates nor any of the partners was personally liable on the debts owed to the secured creditors; the loan was nonrecourse. The secured creditors disapproved of Pine Gate's plan of arrangement. Pine Gate, therefore, proposed

29. 11 U.S.C. § 1111(b)(1)(A) (1982).

30. Section 1111(b)(1)(A)(i) seems to suspend the conversion of nonrecourse debt to recourse status when a creditor makes the § 1111(b)(2) election to treat an undersecured claim as fully secured. On the question whether undersecured creditors who benefit from the conversion of nonrecourse debt to recourse debt may also make the § 1111(b) election to treat their undersecured claim as fully secured, see Kaplan, *supra* note 6.

31. The statement of this case is based on T. Eisenberg, *supra* note 15, at 834-35.

an appraisal of the apartment project and payment to the creditors of the appraised value so that the plan could be confirmed. The secured creditors objected and insisted that Chapter XII required either full payment of their debts or surrender of the mortgaged property.

The court rejected the creditors' argument. "[I]f the creditor in lieu of the return of the property receives cash in the appraised value of that property, the creditor receives the 'value of the debt' and the creditor is adequately protected . . . and the plan can be confirmed without the consent of said creditor."[32] The court also held that the nonrecourse secured creditors were not entitled to vote on Pine Gate's plan of arrangement as unsecured creditors because they had limited their claims to the value of security.[33]

The *Pine Gate* decision thus enabled a debtor to cash out a dissenting nonrecourse secured creditor by paying that creditor the value of its security. According to some commentators *Pine Gate* gave debtors too powerful a weapon.

> [H]ighly leveraged limited partnerships which were established as investment vehicles were able to use the automatic stay[34] against lien enforcement to prevent mortgagees from foreclosing during the Chapter XII case and in many cases successfully avoided the adverse tax consequences to the partners which foreclosure might entail. In addition, the partnership upon confirmation of its plan and the scaling down of its mortgage obligations was able to derive the exclusive benefits of any appreciation in the real estate markets which may not have been anticipated by the court at the time of the court's valuation of the secured creditor's interest in the property.[35]

Applying the *Pine Gate* result to our numerical example, if the debtor cashed out the secured creditor for the value of its collateral, $75, the creditor would have no further interest in the property and no further debt obligation from the debtor. If the debtor then sold the property for $100 after confirmation of the plan, the debtor would enjoy the postconfirmation appreciation, or the benefit of a low appraisal.

Section 1111(b) strives mightily to avoid the *Pine Gate* result. Generally, that result may be avoided in three ways: First, if the debtor is required to turn over the collateral to the secured creditor; second, if the creditor may retain an interest in the property in

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32. 2 BANKR. CT. DEC. (CRR) 1478, 1484 (Bankr. N.D. Ga. 1976).

33. *Id.* at 1487.

34. Under § 362 of the Bankruptcy Act, the filing of a bankruptcy petition triggers an automatic stay against acts to enforce liens. 11 U.S.C. § 362 (1982). *Pine Gate* was decided at a time when old Bankruptcy Rule 12-43 imposed the automatic stay.

35. 5 COLLIER ON BANKRUPTCY ¶ 1111.02, at 1111-18 (L. King 15th ed. 1981).

the debtor's hands; and last, if the creditor may block confirmation of the plan by voting the deficiency as an unsecured claim. Section 1111(b) invokes the second and third approaches. It makes nonrecourse debt into recourse debt and thus creates a deficiency claim for the undersecured creditor to vote against the plan. Furthermore, section 1111(b) allows the undersecured creditor to elect to treat its claim as fully secured, to retain its lien, and to wait for the property to appreciate.

B. The Problem

Several commentators discuss the secured creditor's optimal strategy under section 1111(b) and criticize that provision as poorly drafted and in need of amendment.[36] To date, however, no one has written to question the underlying premises of section 1111(b). I understand these premises to be: (1) that *Pine Gate* presented a problem or set of problems requiring solution and (2) that section 1111(b) constitutes a reasonable effort to furnish that solution. Both premises are questionable.

Analysis of *Pine Gate* and section 1111(b) can proceed on two levels. The first level raises questions about the bankruptcy appraisal process and corresponds to the specific catalysts that begat section 1111(b): *Pine Gate* itself, concerns about erroneous valuations, and the problem of allocating appreciation between debtor and creditor. The second level focuses less on matters of valuation and more on the nature of secured credit. *Pine Gate* and section 1111(b) stand for different views of the nature of secured credit and, in choosing between *Pine Gate* and section 1111(b), one should recognize this more fundamental dichotomy. The valuation aspects of *Pine Gate* and section 1111(b) are less interesting than the nature-of-security aspects, but because valuation matters dominate thinking about *Pine Gate*, this Article deals with them first and then discusses in part IV the more interesting questions about the *Pine Gate* problem's relationship to the nature of security.

1. *Pine Gate* as a Valuation Problem

Did *Pine Gate* create a problem that commanded complex legislative solution through the Bankruptcy Act? The *Pine Gate* creditors' principal complaint was that they were cashed out at one price even though the collateral could be worth more than that

36. *See supra* notes 6-7.

price. This objection raised a plain and simple valuation problem: either the timing of the valuation was unfortunate, because it occurred shortly before substantial unanticipated appreciation in the value of the collateral or the valuation was incorrect. Neither of these possibilities, however, suggests the existence of a new problem that commands solution.

Both the timing and accuracy of valuations are factors that the law, particularly bankruptcy law, must live with.[37] The entire bankruptcy process depends on accepting valuations that often are little more than educated guesses. The secured creditor's rights, from adequate protection against the automatic stay, to the amount of a secured claim, to rights on confirmation, depend on valuation of the collateral in which the secured creditor claims an interest.[38] These valuations occasionally require appraising an entire business as a going concern as well as a liquidated entity.[39] Furthermore, the Bankruptcy Act's confirmation standards require discounting to present value the payments that creditors will receive in the future.[40] None of these matters is determinable with methods approaching perfection.

The prevalence of valuation questions in bankruptcy is neither good nor bad. Unless and until someone creates a satisfactory market-based mechanism for valuing a failing enterprise, valuation problems necessarily will continue. Once one accepts the premise underlying formal reorganization law—that parties through private negotiation cannot always agree how to apportion interests in a failing enterprise—establishing mechanisms for valuing the enterprise and valuing the parties' interests in that enterprise becomes necessary.

Building in "second-looks" or other mechanisms designed to overcome poorly timed or erroneous valuations would hamper the bankruptcy process.[41] For the most part Congress has refused to

37. For suggestions that reliance on market valuations could replace bankruptcy court valuations, see Roe, *A New Model for Corporate Reorganizations*, 83 COLUM. L. REV. 527, 530 (1983) (recommending stock sale to ascertain value of the firm). *But see* 1 L.J. BONBRIGHT, THE VALUATION OF PROPERTY 233-66 (1937)(questioning use of stock market prices as a valuation mechanism).

38. *See* 11 U.S.C. §§ 361, 362, 506(b), 1129(b) (1982).

39. *See id.* § 1129(a)(7), (a)(8), (b).

40. *Id.* § 1129(a)(7), (b). For some of the varied methods used to discount to present value, see, *e.g.*, *In re* Southern States Motor Inns, Inc., 709 F.2d 647 (11th Cir. 1983), *cert. denied*, 104 S. Ct. 1275 (1984).

41. Striving for improvements in the valuation process generally, however, might not hamper the bankruptcy process.

authorize such procedures except through the normal mechanism of appeal. The *Pine Gate* problem raises no special concerns that require departure from this longstanding principle, yet Congress has made that departure in section 1111(b).

The principle of protecting creditors from erroneous valuations, however, has implications that Congress did not explore when it enacted section 1111(b). First, a Congress concerned about valuations should consider providing checking mechanisms for the many other valuation issues that arise in bankruptcy. Justification for section 1111(b) requires, at a minimum, some explanation why this valuation question differs from other bankruptcy valuation questions. No one addressed this and related matters in developing section 1111(b). Everyone approached the *Pine Gate* problem as if it were an abstract issue independent of an old-fashioned valuation problem.[42]

Second, if undersecured creditors are to enjoy protection against the risk of low appraisals, should not bankruptcy law prevent them from enjoying the benefit of high appraisals? In our illustration, suppose the undersecured creditor were cashed out for $75 and the debtor later could sell the property for only $50. Should the secured party be required to return the excess $25? Before Congress enacted section 1111(b), such a requirement could evoke little support. True, the secured party enjoyed the benefit of an erroneous or fortuitously timed appraisal, but in other cases the secured party will suffer from too low an appraisal. Section 1111(b) may reduce such a long-run balancing effect.

Third, a secured party cashed out in a reorganization must sell its interest under extraordinary circumstances. In many areas of debtor-creditor law, debtors routinely suffer the burdens of undervaluation and inadequate prices fetched at forced sales. State law efforts to protect against these results is strong evidence of their existence.[43] Debtors or their unsecured creditors probably lose a

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42. *See, e.g., supra* notes 31-41 and accompanying text; *infra* notes 43-60 and accompanying text. Section 502(c), which requires estimation of the value of contingent, unliquidated claims, may present particularly vexing valuation problems.

43. *See, e.g.,* U.C.C. §§ 9-501 to -507 (1972) (personal property); CAL. CODE CIV. PROC. §§ 701.540 - .640, .660 - .680 (1980) (real property). The routineness of inadequate prices in forced sales is emerging in an important series of bankruptcy cases. *See* Baird & Jackson, *Fraudulent Conveyance Law and Its Proper Domain*, 38 VAND. L. REV. 829 (1985) (article in this Symposium). *Compare In re* Hulm, 738 F.2d 323 (8th Cir.) (sale price at foreclosure cannot automatically be assumed to provide reasonable equivalent of debtor's interest), *cert. denied*, 105 S. Ct. 398 (1984); Durrett v. Washington Nat'l Ins. Co., 621 F.2d 201 (5th Cir. 1980) (consideration received at nonjudicial foreclosure sale found not to be "fair considera-

good deal more than secured creditors from erroneous valuations and coerced sales of interests. The emergence of bankruptcy protection only for undersecured creditors is troubling.[44]

2. *Pine Gate* as a Timing Problem

Pine Gate raised another aspect of the valuation problem. Since the creditors feared that the collateral might be valued more highly after the time of appraisal, part of the difficulty may have rested on the valuation's timing.[45] From this perspective, whether or not the collateral received a faulty valuation, the secured creditors suffered from valuation at an erroneous or unfortunate time. Yet here as well justifying special treatment for *this* timing problem is difficult.

The timing of an appraisal, like the amount of an appraisal, is an issue that regularly arises in bankruptcy. Values determined during a bankruptcy proceeding might be fixed as of the date of the petition, the date of proposal of a reorganization plan, the date of plan confirmation, or some other time. In some important areas of bankruptcy law, Congress has refused to prescribe the time for valuation of property or a debtor's interest, even when the valuation must occur during the bankruptcy proceeding.[46]

A bankruptcy proceeding may require valuing a business or property before commencement of the proceeding. A preference challenge to a prebankruptcy transfer may require valuations as of a year before the filing of a bankruptcy petition.[47] A fraudulent conveyance challenge to a prebankruptcy transfer may require reaching back even further in time.[48] Although no one believes that

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tion" or "fair equivalent" under Bankruptcy Act) *with In re* Madrid, 725 F.2d 1197 (9th Cir. 1984) (transfer occurred at time trust deed was perfected and, therefore, beyond the period during which transfers are vulnerable under § 548).

44. Creditors may stand in a better position to protect themselves. If creditors perceive that they are suffering from low valuations, they can raise interest rates. If erroneous valuations cause harm, they cause harm to all parties by reducing the benefits of security and by creating artificial incentives to force or resist the bankruptcy forum.

45. An accurate appraisal would, of course, reflect the possibility of a future increase or decrease in value.

46. Section 1129's confirmation standards, for example, which often depend on ascertaining the liquidation and "going concern" values of a business, do not specify when the valuation determinations must occur. *See* 11 U.S.C. § 1129(a)(7), (b) (1982); H.R. REP. No. 595, 95th Cong., 1st Sess. 339 (1977) ("section [361] does not specify . . . when [value] is to be determined"). *But see* 11 U.S.C. § 522(a)(2) (1982) (for exemption purposes, value "means fair market value as of the date of the filing of the petition").

47. *See* 11 U.S.C. § 547(b)(3), (4) (1982).

48. A fraudulent conveyance proceeding may be brought under § 548(a) of the Bankruptcy Act to recover transfers made within one year of the date of the filing of the bank-

these values are determinable with scientific precision, Congress has fashioned no mechanism comparable to section 1111(b) to address difficulties arising from timing questions.

If one remains convinced that *Pine Gate* presents a special timing problem, another bankruptcy provision may suggest a more promising approach. Section 541 of the Bankruptcy Act addresses timing problems in the makeup of the bankruptcy estate.[49] For reasons that sometimes are not entirely clear, bankruptcy law long has been concerned with the debtor who inherits property shortly after declaring bankruptcy. Perhaps the fear is that the debtor or persons affiliated with the debtor may have the power to manipulate the date of receipt. The scheming debtor may try to maneuver the receipt of property to a time after the filing of a bankruptcy petition so that the property does not become part of the estate available for distribution to creditors.[50] In *Pine Gate* situations as well creditors may fear that the debtor could influence the timing of an already questionable cash-out valuation so that subsequent appreciation in the value of the collateral is not includable in the valuation.[51]

An approach similar to the one employed in section 541(a)(5) in inheritance and similar situations might address the timing concerns. Section 541(a)(5) provides for a 180-day period after the filing of the bankruptcy petition during which inheritances or similarly treated property become part of the estate.[52] A similar lookback provision could be useful in the *Pine Gate* situation to assuage fears about the timing of a cash-out valuation. If a debtor sells property for substantially more than the valuation amount within a fixed period of time after the valuation, perhaps the

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ruptcy petition. *Id.* § 548(a) (Supp. 1984). If the fraudulent conveyances also are vulnerable under state law, the trustee may rely on § 544(b) of the Bankruptcy Act to seek recovery. *See id.* § 544(b) (1982). Actions brought under § 544(b) are not subject to § 548(a)'s one year limitation. Section 550(e), however, does require that an action against a transferee of a fraudulent conveyance be brought within one year after the avoidance of the transfer. *See id.* § 550(e) (Supp. 1984).

49. *See id.* § 541 (1982).

50. Perhaps a better view of the lookback provisions is that the payments to which they apply sometimes constitute windfalls. A debtor who has recently filed for bankruptcy should be required to share such windfalls with creditors who have not been fully paid. Not all of the payments that § 541(a)(5) covers may be viewed easily as windfalls, however. Marital property settlements, to which § 541(a)(5) has applied since the Bankruptcy Reform Act of 1978, *id.* § 541(a)(5)(B), usually are not considered windfalls.

51. For a suggestion that opportunities for debtor manipulation may remain despite the enactment of § 1111(b)(2), see *infra* notes 121-22 and accompanying text. *See also* Roe, *supra* note 37, at 577-78 (noting possible manipulation of market valuations).

52. 11 U.S.C. § 541(a)(5) (Supp. 1984).

debtor should be required to turn over the excess amount to the trustee for the benefit of creditors who did not receive full payment.[53] The more elaborate section 1111(b) solution, which has substantial side effects,[54] is not needed.

3. The Risk of Systematic Undervaluations

Concerns about the accuracy and timing of valuations are common in reorganization law. Standing alone, these concerns cannot justify the unusual, complicating provisions in section 1111(b). Section 1111(b) may make most sense if viewed as addressing not only the risk of erroneous valuations but also the risk of systematic undervaluation of secured creditors' interests.[55] This theory might help to explain the special treatment of the risk of erroneous valuation and why the treatment tilts toward offering undersecured creditors additional leverage in the reorganization process. Although one might expect erroneous valuations to have long-run effects that cancel out, systematic undervaluations, by definition, are not so benign.

Do courts systematically undervalue secured creditors' interests in collateral? One can imagine an argument why courts might do so. A reorganization court dealing with a financially distressed debtor might err, even subconsciously, on the side of undervaluing collateral. Undervaluing collateral enables the debtor to use the collateral at a lower cost and, therefore, enhances the chances for successful reorganization. Erroneous overvaluation of collateral may increase a debtor's costs to the point of endangering the reorganization. Thus, a bankruptcy court with an inclination towards a reorganization might naturally err on the side of undervaluing collateral.

Viewed in this light, section 1111(b), which tempers the effects of undervaluation of collateral, begins to look like a rare effort to account for the realities of reorganization. Section 1111(b) suspends the usual implicit statutory assumptions of a world in which valuation issues are evenly and smoothly resolved and considers the behavior of the flesh and blood participants in a reorganization.

But no one has made a persuasive case for the systematic un-

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53. *See* Fitzgerald v. Davis, 729 F.2d 306 (4th Cir. 1984) (requiring reassessment of fair market value when sale price exceeded original estimate).

54. *See infra* notes 107-20 and accompanying text.

55. Even in that perspective one would have to ask whether the problem § 1111(b) addresses requires a more general solution.

dervaluation assumption. Neither the data gathered before the 1978 Bankruptcy Act nor what one might predict without hard data would support section 1111(b). The hearings accompanying the 1978 Bankruptcy Act provided a forum in which the assumption could be tested and debated, yet those hearings did not include evidence of a systematic undervaluation phenomenon.[56] Even some evidence to the contrary was available. In the area of preferences, the 1978 Bankruptcy Act made important changes in a valuation-related issue because Congress viewed results of preference litigation as too unfavorable to trustees litigating for the estate.[57] Bankruptcy courts hell-bent on fostering reorganizations would not be expected frequently to resolve such issues against trustees. The final text of section 1111(b) developed so late in the legislative process, with so little public discussion and consideration, that any correlation between that provision and the real world problems reflected in the hearings would have been fortuitous.[58] It is as if someone happened to catch the ear of a sympathetic member of Congress late in the legislative process and achieved insertion of a pet provision.

Furthermore, given the presence of other valuation issues in bankruptcy, systematic undervaluation of collateral is a questionable mechanism for bankruptcy courts to employ in support of an unconscious inclination toward debtors. Systematic undervaluation in another context may hinder, rather than assist, the debtor. For example, when a secured party moves for adequate protection against the effect of section 362's[59] automatic stay, placing an arti-

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56. For references to the *Pine Gate* problem, see *Hearings on S. 2266 and H.R. 8200 Before the Subcomm. on Improvements in Judicial Machinery of the Senate Comm. on the Judiciary*, 95th Cong., 1st Sess. 703-04, 709-10, 720-21, 857-58, 871-75 (1977). *Cf.* Roe, *supra* note 37, at 547-48 (courts may overvalue enterprise out of sympathy for junior interests).

57. Section 547 of the new Bankruptcy Act eliminates the previous requirement that the trustee prove that the recipient of a preference have reasonable cause to believe that the debtor is insolvent. The requirement was viewed as making a trustee's ability to recover preferences too difficult. *See* National Bankruptcy Conference, Report of the Comm. on Coordination of the Bankruptcy Act and the Uniform Commercial Code (1970), H.R. REP. No. 595, 95th Cong., 1st Sess. 204, 209 (1977). Many of the gains made on behalf of trustees by elimination of the reasonable-cause-to-believe requirement may have been lost through the 1984 amendments. These amendments except from preference treatment payments made in the ordinary course of business or financial affairs without regard to the 45 day limitation contained in the 1978 Bankruptcy Act. Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, § 462(c), 98 Stat. 333 (amending 11 U.S.C. § 547(c)(2) (1982)).

58. The legislative history of § 1111(b) is traced in COLLIER ON BANKRUPTCY, *supra* note 35, 1111-11 to -15. *See* Coogan, *supra* note 7, at 341.

59. 11 U.S.C. § 362 (1982).

ficially low value on collateral may contravene the debtor's interest. A low value for purposes of a request for relief from the automatic stay means that the secured creditor has either no equity cushion or a diminished equity cushion and, therefore, may be entitled to greater protection through cash payments,[60] an entitlement that will not assist a debtor struggling to reorganize. One suspects that the immediate prospect of a secured creditor's reclamation of collateral to compensate for lack of adequate protection threatens more reorganizations than does the later problem of confirmation standards. The valuation phenomenon in bankruptcy is too complex to support the simple assumptions that section 1111(b) implicitly embodies.

IV. *Pine Gate* AND THE NATURE OF SECURITY

Upon initial examination, section 1111(b) responds either to commonplace questions about the accuracy and timing of valuations or to an implicit assertion, unsupported by hard data and of questionable theoretical accuracy, about systematic valuation biases of bankruptcy judges. There is, however, yet another, perhaps deeper, way of looking at section 1111(b) and the *Pine Gate* problem.

A. *Two Views of Security*

The *Pine Gate* secured creditors arguably received less than their due if, under state security law, they obtained rights in the property constituting the collateral for their loans. A security interest, the argument might run, consists of more than the right to be bought out at an appraised value. That interest also gives the secured creditor in rem rights in the collateral until the loan is repaid in full, without forcing the secured creditor to bear the burden of others' guesses about the value of the collateral.[61]

60. A creditor seeking relief from the automatic stay is entitled to adequato protection of its interest in collateral. *See id.* § 362(d). Section 361 describes adequate protection. Furthermore, several courts have taken into account the size of an equity cushion in determining the scope of the necessary protection. *See, e.g., In re* Mellor, 734 F.2d 1396, 1400-01 (9th Cir. 1984); *In re* Curtis, 9 Bankr. 110, 111-13 (Bankr. E.D. Pa. 1981); *see also* D. BAIRD & T. JACKSON,, *supra* note 15, at 532 (noting that secured party's incentive at adequate protection stage may be to undervalue collateral; later in proceeding incentive may be to overvalue collateral); T. EISENBERG, *supra* note 15, at 530.

61. U.C.C. §§ 9-501 to -507 (1972). For an analysis that deemphasizes the secured creditor's state law in rem rights, see Baird & Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. CHI. L. REV. 97, 112-13 (1984).

The *Pine Gate* secured creditors claimed in rem rights in the collateral by arguing that they should receive the property itself and that Pine Gate Associates could not cash out their interest in the property at an appraised value. Under this approach, on default the creditors would have become entitled to repayment in full or to the property itself—the basic state law rights of a secured creditor with an acceleration clause in its debt instrument.[62] The *Pine Gate* creditors claimed an in rem interest in the security that was independent of any valuation process.[63] On default, if the property was not worth more than the debt, the debtor could satisfy the secured creditors' interest only by allowing the creditors to retake the property or by redeeming the property through payment of the full amount of the debt. The debtor could not satisfy this in rem interest merely by paying the creditors the value of the collateral.

Section 1111(b) thus may be viewed as providing an undersecured creditor a way to vindicate its state law in rem interest without requiring physical surrender of the property to the creditor. By making the election, the creditor retains a greater interest in the collateral than if the creditor were cashed out. The in rem right is not gutted but honored in a way that allows the reorganization to continue by permitting the debtor to retain possession of the collateral.[64]

If this were the only acceptable view of the secured creditor's rights in bankruptcy, then section 1111(b)(2) would rest on its most solid footing.[65] An alternative, scaled-down view of the nature of a secured creditor's rights in bankruptcy, however, does not regard the secured creditor in a bankruptcy proceeding as retaining

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62. *But see supra* note 5 (discussing limits on secured creditors' rights).

63. A valuation limitation on their interest would arise upon any plausible assertion that the collateral was worth more than the full amount of the debt. In that case, the debtor would be entitled to any surplus.

64. The kinsbip between rights created by § 1111(b) and state law in rem rights may provide tbe most natural explanation for the provision's existence, but ultimately this justification fails. Whetber the provision works is open to question, *see infra* notes 121-23 and accompanying text, as is the provision's theoretical connection to the mderlying in rem right. As Professor Jackson has noted, one can view furnishing the creditor with rights in a bankruptcy proceeding as a means to honor and substitute for the actual nonbankruptcy rights tbat the creditor must compromise to satisfy the needs of the bankruptey proceeding. *See* Jackson, *Translating Assets and Liabilities to the Bankruptcy Forum*, 14 J. LEGAL STUD. 73 (1985). If the § 1111(b) rights are in fact substitutes for state law rights, it is unclear how fiddling with matters of valuation respects the underlying in rem rights.

65. Constructing a rational explanation for the part of § 1111(b) that converts nonrecourse debt to recourse debt is more difficult.

its state law in rem interest in collateral. This view translates secured status into a priority claim equal to the value of the creditor's collateral, which alone is the measure of the value of the creditor's secured status in bankruptcy.

Under the priority approach, secured creditors have merely a right to be paid ahead of other creditors to the extent of the value of the secured creditors' collateral. They have no right to force surrender of specific property. This security-as-priority view limits the *Pine Gate* secured creditors' complaints to questions about technique and timing of valuation. *Pine Gate* honored the secured creditors' priority by paying them ahead of general unsecured creditors.

The in rem and security-as-priority views may not be the only plausible ways to think about security interests. But these concepts do capture widely shared notions about security. Many secured creditors tend to think of themselves as having a tangible, physical interest in collateral. Some believe their rights violated when the collateral turns out not to be "theirs." This in rem view runs sufficiently deep to generate constitutional overtones to the treatment of secured credit,[66] and the Supreme Court has given lip service to a sharp distinction between the constitutional rights of secured and unsecured creditors.[67] With respect to the priority view, many secured creditors are less concerned about ownership of particular collateral than with ranking ahead of competing claimants.[68]

Which view of security—in rem interest in property or a ranking mechanism—should prevail in bankruptcy? Without pretending that they are the only possible bases for discussion, I mention two criteria that influence analysis of this question: (1) consistency of approach with other bankruptcy provisions, and (2) desirability in light of bankruptcy policy. One can analyze the first factor more easily because consistency analysis requires merely noting the assumptions implicit in secured creditors' treatment under other bankruptcy provisions. The second factor raises basic questions about the rationales for reorganizations and for the decision to honor secured credit.[69]

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66. *See infra* note 69.

67. *See id.*

68. *See* Baird & Jackson, *supra* note 61.

69. One doubts that the Constitution requires more favorable treatment of secured creditors than they received in *Pine Gate*. First, Congress probably is free to change prospectively the status of security in bankruptcy, perhaps even to the point of eliminating its

B. The Dominance of the Security-as-Priority View in Bankruptcy

Pine Gate presents one of many situations in bankruptcy proceedings in which the security-as-priority view prevails over in rem interests that state law may confer. Most bankruptcy provisions affecting secured creditors rest on the premise that such creditors may be cashed out for the value of their collateral. In the context of a bankruptcy proceeding, section 1111(b) is unusual in its effort to preserve the secured creditor's right either to receive full payment or to retain an interest in the property.

Bankruptcy law goes to some lengths to assure that state repossession rules do not thwart prospects for a successful, or at least orderly, reorganization. Upon the filing of a bankruptcy petition, section 362 imposes an automatic stay—a form of injunction—on

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priority. *See* Louisville Joint Stock Land Bank v. Radford, 295 U.S. 555, 589 (1935); *In re* Groves, 707 F.2d 451 (10th Cir. 1983); *In re* Webber, 674 F.2d 796 (9th Cir.), *cert. denied*, 459 U.S. 1086 (1982); 11 U.S.C. § 522(f) (1982), *sustained in In re* Ashe, 712 F.2d 864 (3d Cir. 1983), *cert. denied*, 104 S. Ct. 1279 (1984); D. BAIRD & T. JACKSON, *supra* note 15, at 610-12; Rogers, *The Impairment of Secured Creditors' Rights in Reorganization: A Study of the Relationship Between the Fifth Amendment and the Bankruptcy Clause*, 96 HARV. L. REV. 973, 1005-12 (1983). *But see* Rogers, *supra*, at 977 n.14, 981 n.34. The more difficult issues concerning bankruptcy's inroads on state law security rights have arisen in the context of efforts to apply new bankruptcy provisions to pre-existing liens. *See id.* at 1013-30; *see also* United Statcs v. Security Indus. Bank, 495 U.S. 70 (1982).

Even for bankruptcy provisions enacted after attachment of a lien, it is unlikely that the *Pine Gate* treatment went too far. Language in a leading case, Louisville Joint Stock Land Bank v. Radford, 295 U.S. 555 (1935), calls into question any bankruptcy mechanism that does not allow a secured creditor on default either to realize the liquidation value of the collateral through sale or to retain the property until the debt is paid in full. *See id.* at 580-83. The troublesome aspects of the Frazier-Lemke Act, ch. 869, 48 Stat. 1289 (1934) (held void in *Radford*) considered in *Radford*, however, did a good deal more than require a secured creditor to accept cash payments of the collateral's appraised value in lieu of the secured interest. Under the Frazier-Lemke Act, a dissenting secured creditor could lose both the right to repossess security immediately and the right to receive its value. A creditor could be limited to receiving the annual rental value of the property for a period of five years. The Act did not require payment of the appraised price of the property during the five-year period. *Radford*, 295 U.S. at 575-76. This limitation constituted a more drastic inroad on security than any encroachment in *Pine Gate*.

Furthermore, after *Radford* the Supreme Court sustained bankruptcy provisions, including one strikingly similar te the one invalidated in *Radford*, that impaired secured creditors' interests more severely than *Pine Gate* did. In Wright v. Vinten Branch of the Mountain Trust Bank, 300 U.S. 440 (1937), the Court sustained a version of the Frazier-Lemke Act that authorized the debtor to wait three years before paying the appraised value of the secured party's collateral. In Continental Ill. Nat'l Bank & Trust Co. v. Chicago, R.I. & P. Ry., 294 U.S. 648 (1935), the Court sustained provisious substantially delaying secured creditors' right of enforcement. For further discussion of the tension between *Radford* and later cases, see Rogers, *supra*, at 979-85.

actions by creditors against the debtor and against collateral.[70] This stay interferes with a secured creditor's right to possession. Even if a secured claimant succeeds in repossessing collateral before bankruptcy, section 542 may require that the creditor return the property to the bankruptcy trustee.[71] Section 363 authorizes the trustee to use, sell, or lease collateral to which the secured party would be entitled under state law.[72] Debtors in both Chapter 11 and Chapter 13 proceedings may "deaccelerate" mortgage loans that the lender has accelerated under state law prior to bankruptcy.[73]

In some reorganizations the trustee must furnish a secured party "adequate protection" for its state law interest in collateral. Although the Bankruptcy Act does not define the exact contours of the concept,[74] adequate protection never requires more than current payment to the creditor of the full appraised value of its interest in the collateral.[75] Even *In re Murel Holding Corp.*,[76] the case usually relied on as giving the firmest protection to secured creditors' interests, would have allowed appraisal and payment of the value of the secured creditor's lien.[77] Yet this is precisely what the *Pine Gate* court offered the undersecured creditors. If *Pine Gate*'s implicit view of security-as-priority created a problem wor-

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70. *See* 11 U.S.C. § 362(a) (1982).

71. *See id.* § 542(a); *cf.* United States v. Whiting Pools, Inc., 462 U.S. 198 (1983) (Internal Revenue Service must return assets seized prior to bankruptcy to satisfy tax lien).

72. *See* 11 U.S.C. § 363 (1982).

73. *See id.* §§ 1124(2), 1322(b)(5); *see also* Grubbs v. Houston First Am. Sav. Ass'n, 730 F.2d 236 (5th Cir. 1984); *In re* Taddeo, 685 F.2d 24 (2d Cir. 1982). *But cf. In re* Seidel, 752 F.2d 1382 (9th Cir. 1985) (no deacceleration on debt maturing prior to bankruptcy).

74. For a case discussing the various approaches to the adequate protection concept, see *In re* American Mariner Indus., Inc., 734 F.2d 426 (9th Cir. 1984); *see also* Baird & Jackson, *supra* note 61; Nimmer, *Secured Creditors and the Automatic Stay: Variable Bargain Models of Fairness*, 68 MINN. L. REV. 1 (1983).

75. Courts and commentators may not agree, however, over the method of measuring the full appraised value during the period when the debtor retains possession of the property. *See supra* note 74.

76. 75 F.2d 941 (2d Cir. 1935). In *Murel*, Judge Learned Hand found that a stay against a foreclosure action should not be granted where the debtor had proposed a reorganization plan insufficiently protective of a mortgagee's rights. The mortgagee maintained only a small equity cushion, and the plan proposed no amortization for a period of 10 years.

77. *See id.* at 942. In light of *Murel*'s murky holding (the case tells us only that a rather weak plan was insufficient) and procedural posture (the court ruled on a request for relief from a stay, though Judge Hand clearly had his eye on the feasibility of the proposed plan, *see supra* note 76), Congress, courts, and commentators may have placed too much reliance on *Murel* in deriving standards of adequate protection in other contexts. The argument that the adequacy of protection at the confirmation stage, when the secured creditor is locked into a plan, should be firmer than at some preliminary stage, such as when relief is sought from § 362(a)'s automatic stay, merits consideration.

thy of solution, then one must rethink much of the rest of the Bankruptcy Act's treatment of secured creditors' state law possessory rights.[78]

C. *Section 1111(b),* Pine Gate, *and Bankruptcy Policy*

Assessing section 1111(b) as a matter of bankruptcy policy requires discussion of three related matters. First, one must identify a justification for the decision to honor secured credit outside of bankruptcy. Unless we understand why secured credit is desirable in the nonbankruptcy setting, where secured credit originates, evaluating the wisdom of modifying secured creditors' rights in bankruptcy is difficult. Second, assessing section 1111(b) requires some sense of why Congress provides for bankruptcy reorganizations, where the election operates. Reasonable persons may differ about the wisdom of reorganization laws.[79] Third, having identified reasons for secured credit and reorganizations, one must resolve the tension between nonbankruptcy law's need to honor secured credit and reorganization law's need to modify it. In many cases, a reorganization requires diluting one creditor's interests in the hope of securing benefits for other creditors. Section 1111(b) and *Pine Gate* present one facet of this larger problem.

The analysis below reaches the predictable conclusion that the policy bases for secured credit and bankruptcy reorganizations support contrasting views of security. This section then suggests possible approaches to reconcile this conflict. Debate over section 1111(b), however, probably is not the ideal forum in which to address this matter.

1. The Bases for Secured Credit and Reorganizations

There are in the literature several useful discussions of why secured credit exists.[80] Discussion here is limited to two of the

78. Section 722 would be particularly vulnerable since it allows a Chapter 7 debtor to redeem collateral by paying its value to the secured creditor. This procedure bears a striking similarity to what the court did in *Pine Gate.* For a discussion of the limits on this right of redemption, see *In re* Bell, 700 F.2d 1053 (6th Cir. 1983).

79. Some Western countries do not even have reorganization laws. England, for example, has no reorganization mechanism corresponding to Chapter 11. For a discussion of the treatment of security interests under French bankruptcy law, see Haimo, *A Practical Guide to Secured Transactions in France,* 58 TUL. L. REV. 1164, 1193-97 (1984).

80. *See, e.g.,* Chan & Kantas, *Asymmetric Valuations and the Role of Collateral in Loan Agreements,* 17 J. MONEY, CREDIT & BANKING 84 (1985); Jackson & Kronman, *Secured Financing and Priorities Among Creditors,* 88 YALE L.J. 1143 (1979); Schwartz, *Security Interests and Bankruptcy Priorities: A Review of Current Theories,* 10 J. LEGAL STUD. 1

leading rationales: (1) secured credit's ability to cater to various levels of risk aversion among lenders and the different costs of security among debtors,[81] and (2) secured credit's ability to exploit the relative advantages some creditors enjoy in monitoring debtor behavior.[82] Under the differing risk aversion view, those who want to make riskier, unsecured loans may do so and those who want more protection through security may obtain that protection. Borrowers as well obtain a wider range of credit choices through the availability of secured credit. Under the differing monitoring costs view, the benefits of secured credit accrue from allowing those with a relative cost advantage in monitoring a debtor's behavior to exploit that advantage and pass on the lower costs.

If risk aversion, differences in demand for secured credit among debtors, and differences in creditors' monitoring costs constitute the strongest rationales for secured credit, then *Pine Gate* and the security-as-priority view have a real cost. The *Pine Gate* rule will drive some of the most strongly risk averse lenders from the market because the rule does not honor their views of how and when to dispose of collateral.[83] Consequently, some debtors who have a stronger relative preference for secured credit will be unable to obtain it. Under *Pine Gate*, the benefits accruing to creditors from the ability to exploit lower monitoring costs also will diminish. Superior monitoring provides less assistance when a bankruptcy proceeding may remove some of the property being monitored from the creditor's grasp. Section 1111(b) cushions these effects.

The dominant justification for reorganizations is to preserve a going concern value that would be lost through piecemeal liquidation.[84] The precise lines of reasoning underlying the justification

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(1981); White, *Efficiency Justifications for Personal Property Security*, 37 VAND. L. REV. 473 (1984).

81. The risk aversion hypothesis has generated the most controversy among commentators. *See supra* note 80. Professor Schwartz recently has taken the debate one step further by suggesting justifications for secured credit that are supersets of the risk aversion hypothesis. *See* Schwartz, *The Continuing Puzzle of Secured Debt*, 37 VAND. L. REV. 1051, 1068 (1984) (suggesting that we need to ask why some lenders or debtors want secured credit more than others). To the extent that the discussion herein depends on a precise justification for secured credit, the discussion must be regarded as tentative.

82. *See* Jackson & Kronman, *supra* note 80, at 1158-61.

83. If secured credit does rest on honoring the different risk preferences of creditors, then it may not be satisfactory to substitute a package of rights to future value for the secured creditor's right to immediate repossession. *Contra* Baird & Jackson, *supra* note 61.

84. *See, e.g.*, J. TROST, G. TREISTER, L. FORMAN, K. KLEE & R. LEVIN, *supra* note 7; Baird & Jackson, *supra* note 61, at 117.

may differ. Some may believe that creditors would bargain for a reorganization system in advance to maximize the return to creditors as a group.[85] Under this view, only the presence of multiple actors prevents the automatic preservation of going concern value that would be achieved if a firm had a single owner and no creditors.[86] Others think it unfair that secured creditors, whose priority interest is honored, should also be able to prevent preservation of going concern value.

If one accepts this value maintenance justification for reorganizations, many bankruptcy reorganizations must temper state law rules that allow repossession by secured parties who are not fully repaid. Debtors in reorganization usually cannot pay significant creditors in full. If the collateral is important to achieving the reorganization goal of maximizing value, then honoring a state law repossession rule may frustrate the bankruptcy proceeding's purpose. More importantly, one cannot predict in advance whether honoring an in rem interest will prevent a reorganization from preserving an entity's going concern value. Bankruptcy judges need discretion to resolve these matters on a case-by-case basis.[87]

2. The Traditional Bases for Reconciliation

The leading arguments for secured credit support an in rem view of security,[88] and the leading rationale for Chapter 11 reorganizations supports *Pine Gate* and the priority view. These underlying rationales, as developed to date, are therefore unlikely to lead to a clear basis for choosing between the *Pine Gate* approach and that of section 1111(b). In the end, one must analyze the relationship between nonbankruptcy security law and reorganization theory. The principles that govern their relationship may be used to choose between the two views of security.

Bankruptcy law should not tinker unnecessarily with state law rights.[89] The bundle of state law rights presumptively worthy of

85. *See, e.g.*, Jackson, *supra* note 9.

86. *Id.*

87. The need to modify state law in rem interests does not, standing alone, make a case against § 1111(h) because § 1111(b) allows modification of those interests. The need to modify state law interests, however, suggests that the *Pine Gate* creditors' in rem view of security cannot be the sole guide to sound bankruptcy treatment.

88. Arguments favoring secured credit also would support the priority view. The point is that a secured crediter plausibly may claim to attach importance to rights represented by both the in rem and priority views.

89. *See* Baird & Jackson, *supra* note 61; Eisenberg, *Bankruptcy Law in Perspective*, 28 UCLA L. REV. 953, 959-76 (1981); Jackson, *Avoiding Powers in Bankruptcy*, 36 STAN. L.

respect includes in rem rights in collateral. The right to be free from judicial reexamination of a lender's assessments of a collateral's value and the right to optimal timing and manner of sale can be important. These rights often provide incentives to keep a debtor out of bankruptcy or to push a debtor into bankruptcy.[90] Some financing sellers, particularly small sellers without large loan portfolios, simply might refuse to sell property unless assured of full payment or return of the specific property sold.[91] Unnecessary modification of these state law rights would create perverse incentives for some creditors and debtors to opt for bankruptcy merely to avoid the effects of the state rule.

If state security law is an appropriate starting point for articulating secured creditors' rights in bankruptcy, then more work is necessary before one can reconcile the Bankruptcy Act's effect on secured creditors with stated justifications for reorganizations. Most efforts to justify reorganizations rely principally on the rationale that reorganizations try to preserve the excess of going concern value over liquidation value, or on some other statement of a value maximizing principle. Proponents do not take the further necessary step of supporting the specific inroads made on secured creditors' rights in the reorganization's quest for additional value. These rationales do not explain, for example, why secured creditors receive no compensation for the extra risks that their coerced participation in a reorganization imposes.[92] Rationales based on value maximization do not explain how to allocate the risks inherent in achieving the maximized value.

The creditors' bargain model assumes that creditors, secured and unsecured, will find it advantageous to agree upon a collective proceeding in which to deal with financially troubled debtors. It is not clear, however, that secured creditors would or should agree in advance to the treatment of secured credit in the current bankruptcy system. Although secured creditors might find the idea of a

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REV. 725 (1984); Jackson, *supra* note 9, at 883-87.

90. *But see* Baird & Jackson, *supra* note 61, at 112-14.

91. For a factual situation in which this might have been the case, see *In re* Hobson Pike, 3 BANKR. CT. DEC. (CRR) 1205 (Bankr. N.D. Ga. 1977) (farmers who sold farmland and retained mortgage may have thought they could recover property if debtor did not fulfill purchase obligation). *But see supra* note 5 (noting limits on creditors' ability to foreclose under state law).

92. Professors Baird and Jackson have argued that to avoid this problem of insufficient compensation, adequate protection under § 362 should be *fully* compensatory and should include compensation for extra risks. *See* Baird & Jackson, *supra* note 61.

collective proceeding attractive,[93] on closer examination they would find that the current collective proceeding imposes distinctly unattractive burdens on them. Bankruptcy provisions such as the automatic stay and the trustee's power to use or sell collateral impose costs and risks on secured creditors without giving them any payoff other than allowing them to recover what they would have recovered under state law in the absence of a bankruptcy proceeding. Indeed, the benefits of the bankruptcy provisions affecting secured creditors usually rest with unsecured creditors. For secured creditors, bankruptcy imposes risks without corresponding rewards.[94]

Another justification for reorganizations asserts the unfairness of allowing highly ranked secured creditors to hinder an effective reorganization. This rationale also fails to explain why secured creditors should bear the risk of reorganization without receiving any compensation for taking the risk. The best that secured creditors can hope for is the prebankruptcy status quo, in which they would have received the value of their collateral. In our system the existence of a potential benefit to others from compromising a party's entitlement generally is not, standing alone, a sufficient justification for the compromise.

Surprisingly few commentators discuss this deeper problem

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93. *See* Jackson, *supra* note 9. Professor Jackson's model seems premised on the assumption that the details of secured creditors' treatment will be designed to insulate them from harm in the reorganization proceeding. *See id.* at 868-71; *see also* Baird & Jackson, *supra* note 61.

94. Shifting bankruptcy risks to junior interests, as Professors Baird & Jackson have proposed, *see* Baird & Jackson, *supra* note 61, may not be satisfactory from the viewpoint of a creditors' bargain model. Secured creditors need some positive incentive to agree to a collective proceeding when they would otherwise rank first. Furthermore, if one justifies secured credit on the basis of the differing risk aversion among lenders, then recasting their bargains may go to the very heart of the basis for secured credit. The administrative difficulty of calculating the incentives for a secured party may be a reason for not compensating the secured party for this added risk.

It is also unclear whether unsecured creditors would agree in advance to our current system of honoring secured credit in bankruptcy and honoring other techniques, such as use of state spendthrift trusts, *see* 11 U.S.C. § 541(c)(2)(1982), letters of credit, *see* Baird, *Standby Letters of Credit in Bankruptcy*, 49 U. CHI. L. REV. 130 (1982), and escrows, *see* Gulf Petroleum, S.A. v. Collazo, 316 F.2d 257 (1st Cir. 1963), that effectively allow avoiding participation in what is usually described as a collective proceeding. The Bankruptcy Act does contain countermeasures that deal with other efforts to avoid entanglements with bankrupts. *See* 11 U.S.C. §§ 362; 365(b), (c), (e), (f); 542; 543 (1982). The net effect of this odd collection of avoidance and anti-avoidance rules is that risk aversion may be honored in some instances and not honored in others. Perhaps the bottom line is that "those creditors with sophisticated planning ability, and with the expertise and funds to set up escrows and letters of credit, [and secured transactions], will avoid entanglement in bankruptcy, and less sophisticated creditors, particularly small trade creditors, will routinely be entangled in bankruptcy proceedings." T. EISENBERG, *supra* note 15, at 549.

involving reorganization theory and secured credit—that one cannot terminate analysis merely because a set of rules seeks to maximize value. Perhaps the issue has been obscured because much of the focus on the treatment of secured creditors centers on constitutional matters.[95] If a question about a provision's constitutionality is raised and dismissed, some may assume that the provision is sound on all grounds. Perhaps the issue has been obscured because the principle of maximizing overall values, without focusing on who pays the cost, is so seductive. Or perhaps it is because the rhetoric of bankruptcy law assures that secured creditors will receive adequate protection or the "indubitable equivalent" of their interest,[96] a promise that sounds as though the secured creditors have nothing to worry about, however different reality might be.[97]

3. A New Basis for Reconciliation

Are there new lines of reasoning to support bankruptcy law's inroads upon secured credit? One possible approach rests on questioning the traditional barrier between secured and unsecured credit. In this perspective, one could change the analytical starting point from asking whether bankruptcy law should differ from state law in treating secured credit to asking whether bankruptcy law should be more solicitous of secured creditors' rights than of unsecured creditors' rights.

Bankruptcy law often disregards important aspects of state law treatment of creditors' status. Bankruptcy law's treatment of secured credit deviates from this general approach. For example, bankruptcy will not necessarily preserve whatever state law contractual advantages an unsecured creditor may enjoy as the result of financial covenants in a loan agreement. A state law judgment creditor who has not levied may have a significant advantage under state law over other creditors merely by being closer to being able to levy. The creditor, however, will find that advantage eliminated in bankruptcy. Similarly, under state law a creditor may enjoy an advantage over competitors by having delivered a writ of execution to the sheriff, or by having less knowledge of competing claims. In general, bankruptcy law has a levelling effect on subtle differences in creditors' positions that state law, if allowed to run its course

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95. *See supra* note 69.

96. *See* 11 U.S.C. §§ 361(3), 1129(b)(2)(A)(iii) (1982).

97. One of the few discussions that recognizes the deeper problem resolves the issue by arguing that the essence of the secured creditors' bargain rests in the priority achieved and not in any in rem interest obtained. *See* Baird & Jackson, *supra* note 61.

uninterrupted by a bankruptcy proceeding, would respect.[98] By classifying claims as secured or unsecured, bankruptcy law requires all-or-nothing treatment of rights that state law would address as if on a continuum.

One might question, therefore, whether secured credit is sufficiently different in kind from other credit to justify sheltering secured credit from bankruptcy's levelling effect. Grants of security are, after all, merely additional terms in a contract. An unsecured lender has inchoate rights in a debtor's nonexempt property. Although these rights usually depend on obtaining and enforcing a judgment, they also include other property-specific attributes, such as the ability to bring fraudulent conveyance and bulk transfer challenges against certain transfers. Through financial covenants and other contractual terms, some unsecured lenders have enhanced inchoate claims to a debtor's property.

Security agreements, though they theoretically confer rights in specific property, are merely another version of enhanced rights. The secured creditor's idealized status often is tarnished by reality. A secured party must observe limitations on breaches of the peace, limitations on the time and place of sale, and limitations on the amount of value that may be realized from collateral. State laws imposing significant restrictions on secured creditors' rights to realize upon their collateral highlight the continuity between secured and unsecured forms of debt.[99] Furthermore, secured creditors' rights are subordinate to those of a large class of claimants—buyers in the ordinary course of business[100]—and secured creditors have uncertain rights as against some lien creditors.[101]

These factors suggest that the difference between secured and unsecured forms of debt is more one of degree than of kind. If this is true, then the pertinent question is not whether bankruptcy law should depart from state law treatment of security, but whether bankruptcy law should depart from state law treatment of unsecured credit without also doing so for secured credit.

One cannot respond to this argument simply by asserting the

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98. For a normative defense of the levelling effect, see Jackson, *supra* note 89, at 732-35.

99. *See supra* note 5.

100. *See* U.C.C. § 9-307(1) (1972).

101. *See, e.g.*, Frisch, *The Priority Secured Party/Subordinate Lien Creditor Conflict: Is "Lien-Two" Out in the Cold?*, 33 BUFF. L. REV. 149 (1984); Justice, *Secured Parties and Judgment Creditors—The Courts and Section 9-311 of the Uniform Commercial Code*, 30 BUS. LAW. 433 (1975).

need to preserve the efficiencies or other benefits of secured credit. Financial covenants and other terms of unsecured credit agreements cater to the same concerns and needs as secured credit does. Unsecured credit terms cater to variations in risk aversion, to differences in monitoring costs, and to other factors that support the nonbankruptcy existence of secured credit. Even though unsecured debt contract provisions may promote efficiency or reduce monitoring costs, bankruptcy generally disregards them and discharges the underlying debt, cutting off unsecured lenders' inchoate interests in a debtor's property.

Why are these efficiencies not worth preserving while those attending secured credit are worth saving? One answer may be that the costs of preserving in bankruptcy the relative nonbankruptcy advantages of unsecured creditors would be high. The near infinite gradations of unsecured creditor status under state law may be ignored if honoring them in bankruptcy would require resolution of many priority contests that would not have arisen under state law because creditors probably would have achieved clearer state law status before actual disputes arose. This kind of concession to reality, however, if applied to secured creditors, further clouds the distinction between secured and unsecured debt. The problems of locating, identifying, repossessing, and realizing the value of collateral are not trivial. The greater these practical obstacles, the more a secured party begins to look like an unsecured party.

In short, the line between secured and unsecured creditor status is less clear than it first appears. Justifying separate treatment for one bundle of property rights likely presents no simpler a task here than in determining what constitutes a taking under the fifth amendment.[102] Bankruptcy law's inroads upon secured credit, through *Pine Gate* and statutory provisions, may be viewed as cushioning the drastically different treatment bankruptcy generally accords secured and unsecured credit.

Even if secured credit differs sufficiently from unsecured credit to warrant separate treatment in bankruptcy, administrative concerns may justify not compensating the secured party for all of the additional burdens that attend prohibiting foreclosure in ac-

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102. *See, e.g.*, Michelman, *Property, Utility, and Fairness: Comments on the Ethical Foundations of "Just Compensation" Law*, 80 HARV. L. REV. 1165 (1967). One might take the analogy to the takings prohlem even further. An in rem view of security emphasizes the physcial "taking" of a secured creditor's interest, and the physical taking has long heen one of the central factors in constitutional taking doctrine. The priority view, on the other hand, deemphasizes the physical aspect of the issue.

cordance with state law. Providing a crude measure of protection under the lahel "adequate protection" may be more efficient than calculating and valuing the added risk imposed on a secured party. The general goal of bankruptcy law would be to leave the secured party unaffected by the bankruptcy proceeding.[103]

Finally, the existence of federal reorganization law effectively limits the states' authority to enact reorganization measures.[104] How would states deal with secured credit absent federal reorganization law? If federal law did not already undertake the difficult task of modifying secured creditors' rights, states might have to rethink their entire secured credit structure. Perhaps one should view current federal bankruptcy law as striking the balance state law would strike if state law could encompass reorganizations. From that perspective, the entitlements at stake under state law might not be those we are used to considering.[105]

4. Section 1111(b) as a Minor Detail

However promising these and other avenues of analysis might be—and none of them necessarily would lead to the specific collection of bankruptcy rules that now affect secured credit—assessment of section 1111(b) probably need not reach such depth. If one were rethinking such basic matters as the scope of the automatic stay, the standards of adequate protection, or the standards governing cram down, a return to first principles might be unavoidable. With respect to the costs imposed by *Pine Gate* and the wisdom of a marginal provision such as section 1111(b), the ultimate wisdom of honoring state law rights cannot be assessed in a vacuum. As described above, bankruptcy law affects secured creditors' interests in many ways unrelated to section 1111(b) and *Pine Gate*.[106] Other bankruptcy inroads upon security already will have driven from the market those marginal secured lenders worried about *Pine Gate*. Given what is already done to secured creditors' in rem rights in the name of fostering effective reorganizations, the question whether *Pine Gate*'s further alteration of state law rights represents sound bankruptcy policy has a

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103. *See* Jackson, *supra* note 9, at 870 n.62.

104. *See* International Shoe Co. v. Pinkus, 278 U.S. 261 (1929); T. EISENBERG, *supra* note 15, at 435.

105. It is difficult, however, to see why state control over reorganizations should make a drastic difference. The problem would then be how to coordinate a state's regular debtor-creditor with its reorganization law.

106. *See supra* notes 70-78 and accompanying text.

hollow ring. If all of the other measures affecting secured creditors may be justified in the name of whatever policies reorganization law serves, *Pine Gate* cannot be the only bankruptcy inroad on state law rights that crosses the line between sound and unsound policy.

V. Problems with the Section 1111(b) Solution

Pine Gate presents either one aspect of the general valuation problem in debtor-creditor law or a problem concerning the nature of security. In either case, the result in *Pine Gate* is at least as faithful to the needs, dominant goals, and general approach of our bankruptcy law as is section 1111(b). Even assuming that the valuation problem rationally may be confined to situations that section 1111(b) covers,[107] the solution that Congress chose is flawed. In enacting section 1111(b), Congress focused solely on how that section would affect debtors and undersecured creditors, neglecting the provision's effects on other creditors in a bankruptcy proceeding. In addition, Congress did not adequately tailor section 1111(b) to the problem that generated it. If the case for section 1111(b) rests on doubts about the valuation process, then it is reasonable to limit the provision's scope to cases in which doubts about valuation are a central concern. Section 1111(b) is not so limited.

A. Effects on Other Creditors

Viewed as a valuation matter, *Pine Gate* presents a problem between a debtor and its creditors. Those troubled by *Pine Gate* were most upset because a creditor did not receive full repayment even though the debtor might later enjoy the benefit of the value of collateral that could have been used to pay the creditor. In analyzing any response to *Pine Gate* that is not limited to remedying this perceived core anomaly, one must weigh the benefit of its contribution towards resolution of the *Pine Gate* problem against its side effects in other areas. Section 1111(b) seems to have more side effects than core effects.

Rather than draft a solution tailored to the *Pine Gate* situation, a single-asset reorganization involving nonrecourse debt,[108]

107. Perhaps data would support our systematic undervaluation analysis, *see supra* notes 55-60 and accompanying text, and dispel concerns about departing from bankruptcy's normal view of security as priority.

108. Reported cases to date suggest that undersecured creditors have employed the § 1111(b) election in factual settings that differ from that in *Pine Gate*; its reported use has not been limited to single-asset reorganizations. *See In re* Polytherm Indus., Inc, 33 Bankr.

Congress through section 1111(b) enacted a solution tbat fundamentally cbanges the way confirmation standards function in bankruptcy reorganizations. Section 1111(b) is not limited to cases in which a low valuation may redound to the debtor's benefit. The provision grants the undersecured creditor and the nonrecourse creditor additional leverage against all participants in a reorganization.

The claim that the section 1111(b) election provides undersecured creditors additional leverage requires discussion. The undersecured creditor should make the election only in limited circumstances[109] because the election in effect waives the undersecured creditor's normal unsecured claim for a deficiency. Unless a creditor expects the collateral to increase in value and the debtor to sell it, the election seems to require the undersecured creditor to sacrifice its undersecured claim for little in return.

How does the section 1111(b) election enhance the undersecured creditor's position vis-a-vis other creditors? One approach to this question requires stepping into the shoes of another creditor at the time of the negotiations over interests in the reorganizing entity. At the time creditors are sorting out interests no one knows whether the debtor's business will succeed or fail, or whether particular assets will increase or decrease in value. Each creditor must formulate its position in part on implicit or explicit assessments of the probabilities of success of the enterprise and of increases in the value of assets, as well as the probabilities of failure of the enterprise and of decreases in the value of assets. In the absence of the section 1111(b) election, other creditors could include in their calculus the probability of a postcashout increase in value of assets formerly subject to the undersecured creditor's interest. If a creditor makes the section 1111(b) election, assets that might have become available to other creditors will be unavailable because an increase in the assets' value is subject to the electing undersecured creditor's lien.

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823 (Bankr. W.D. Wis. 1983); *In re* White, 36 Bankr. 199 (Bankr. D. Kan. 1983); *In re* Southern Mo. Towing Serv., Inc., 35 Bankr. 313 (Bankr. W.D. Mo. 1983); *In re* Hallum, 29 Bankr. 343 (Bankr. E.D. Tenn. 1983); *In re* Griffiths, 27 Bankr. 873 (Bankr. D. Kan. 1983). *But see In re* Greenland Vistas, Inc., 33 Bankr. 366 (Bankr. E.D. Mich. 1983) (single-asset case); *In re* Landmark at Plaza Park, Ltd., 7 Bankr. 653 (Bankr. D.N.J. 1980) (same). Furthermore, the unreported effects of the § 1111(h) election are likely to he much more important. The existence of § 1111(b) influences starting points and bargaining positions in the negotiations that must accompany any reorganization with a chance of success. *See supra* notes 26-27 and accompanying text.

109. *See supra* notes 25-28 and accompanying text.

This advance absorption of one source of value in a reorganized entity will affect the other creditor's positions in the reorganized entity. At the time of negotiation, other creditors' risks are greater than they would be without the section 1111(b) election because their inability to benefit from increases in the value of the undersecured creditor's collateral reduces the present expected value of the interests available to them. In any reorganization in which a single undersecured creditor is not the only creditor, the effort to prevent the debtor from enjoying increases in the value of collateral has the residual, previously unnoticed effect of rearranging the status and bargaining position of the undersecured creditor vis-a-vis all other creditors.[110]

Considering a failed reorganization may illustrate more concretely section 1111(b)'s effects on other creditors. Assume that our undersecured creditor with a debt of $100 and collateral of $75 elects to be treated as fully secured because the creditor expects the collateral to appreciate in value. The creditor finds itself with a secured claim of $100, secured by a lien "to the extent of the allowed amount of such" claim.[111] The lien thus secured repayment of $100. Assume further that the debtor's reorganization plan is confirmed but that the reorganization effort fails soon after confirmation, before any payments have been made, and after the collateral has appreciated in value to $100.

Without the section 1111(b) election, the creditor could have been cashed out for $75 at the time of confirmation and unsecured creditors would have received the $25 in subsequent appreciation. With the section 1111(b) election, the electing creditor has a lien securing repayment of $100. It has captured for its benefit the $25 in appreciation that would have gone to unsecured creditors and not to the debtor.[112]

Section 1111(b)(1)(A)'s treatment of nonrecourse debt as recourse debt has a more obvious effect on creditors' bargaining positions. That provision may allow undersecured creditors, such as those in *Pine Gate*, to block confirmation of a debtor's reorganiza-

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110. In theory, those creditors able to do so will adjust their interest rates and lending practices to reflect § 1111(b)'s existence. Even with such adjustments, however, one would then have to justify the added complexity and uncertainty generated by § 1111(b).

111. 11 U.S.C. § 1129(b)(1)(A)(i)(I) (1982).

112. Although this illustration demonstrates that the § 1111(b) election often occurs at the expense of other creditors, it does so in a factual setting that presents the election in a relatively favorable light. Here the undersecured creditor expects the collateral to increase in value and, if allowed the benefit of its state law bargain, the creditor would have repossessed the collateral and waited for the increase to occur before selling the collateral.

tion plan. Conferring recourse status on a nonrecourse creditor creates an unsecured claim that may prevent confirmation of the reorganization plan. A creditor in such a class must then be cashed out through compliance with section 1129(b)'s fair and equitable standard.

But the nonrecourse-to-recourse solution works comfortably only in a situation in which no other creditors are in the picture. In a single creditor situation, preventing confirmation of a plan when the undersecured creditor believes its collateral has been undervalued may avoid a flow of value from the undersecured creditor to the debtor.[113] When other creditors are involved in the reorganization, the provision enhances the nonrecourse creditor's status at the expense of other creditors. In multiple creditor situations, therefore, the nonrecourse creditor and not the debtor benefits from the value freed by the nonrecourse aspect of the undersecured creditor's claim. Converting the undersecured creditor's claim to recourse status merely creates another claimant for the limited debt and equity interests in a reorganized entity.

This result is not theoretically appealing. Nonrecourse creditors are not strong candidates for special protection. The creditor who lends on a nonrecourse basis does so with knowledge of the consequences; most small or consumer creditors would not even know how to do so. Furthermore, the nonrecourse creditor's bargain includes an agreement to look solely to collateral for repayment. Fidelity to the state law bargain, which seemed to be the driving force behind the undersecured creditor's election under section 1111(b)(2), disappears as a consideration when recasting nonrecourse debt as recourse debt. By recasting that bargain, section 1111(b) alters state law—there is now no pure nonrecourse debt—without any clear benefit to the bankruptcy process.

B. Cases in Which Undervaluation is Not a Prime Concern

1. Reasonably Certain Valuations

Whatever one thinks of the valuation biases of bankruptcy judges, there are cases in which arriving at an accurate valuation is not difficult. Consider nonrecourse debt secured by a pledge of publicly traded securities. If the securities decline in value so that

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113. For a pre-§ 1111(b) situation in which the *Pine Gate* rule was applied when there were no other creditors, see *In re* Hobson Pike, 3 BANKR. CT. DEC. (CRR) 1205 (Bankr. N.D. Ga. 1977).

the creditor becomes undersecured, there is little reason to give the creditor an unsecured claim for the deficiency in bankruptcy or an opportunity to elect to be treated as fully secured. If the creditor believes the stock will increase in value, it may use the payments promised under the reorganization plan, which must equal the present value of the security, to purchase the stock on the open market.[114] In any case in which the valuation process is reasonably certain, section 1111(b) makes little sense.

2. The Substantially Undersecured Creditor

Examples illustrating section 1111(b)'s application usually present a "nice" relationship between the amount of the debt and the value of the security.[115] In these illustrations the creditor is undersecured, but the creditor is not drastically undersecured. Section 1111(b)'s authorization to treat the partially secured creditor as fully secured, even when the debt is nonrecourse, does not appear to be an extraordinary measure. Increasing the disparity between the amount of the debt and the value of the security, however, upsets this placid situation.

Consider the undersecured creditor with a nonrecourse claim of $1,000,000 and security worth $100,000. Without section 1111(b) the creditor would have a secured claim of $100,000 and no unsecured claim. The unsecured creditors could approve the reorganization plan without this creditor's participation. If this undersecured creditor were the only creditor in its class, a reorganization plan could be confirmed over its objection by providing in the plan for payments to that creditor with a present value of $100,000. Moreover, the plan could be confirmed despite participation of junior interests in the proceedings.

Section 1111(b)'s conversion of nonrecourse debt to recourse debt changes this situation. The nonrecourse creditor now has an unsecured claim of $900,000 and a secured claim of $100,000. Approval of the plan over such a creditor's objection would require favorable votes by a substantial amount of other unsecured claims. Absent such class approval, junior interests could not participate

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114. The open market purchase may not provide the full equivalent of retaining an interest in the pledged securities. Cashing out the secured creditor would generate tax consequences and purchasing the stock in the open market would generate commission costs. But transferring the pledged stock to the creditor in satisfaction of the debt would also generate tax consequences and recovering pledged stock from a bankrupt entity may not be cost-free.

115. *See* Blum, *supra* note 6; Klee, *supra* note 7; Pachulski, *supra* note 7.

unless the plan provided for payment of the $900,000 claim in full. Section 1111(b), therefore, can transform a creditor who was merely a factor in the reorganization into the dominant factor, all in the name of preventing the debtor from enjoying the benefit of postvaluation appreciation of collateral.

3. Bargained-For Undersecurity and Nonconsensual Secured Claims

Problems with section 1111(b) transcend the confirmation and valuation processes. In some situations the provision makes almost no sense. First, consider a creditor who is undersecured not because of a decrease in the value of collateral that initially fully secured its loan. This creditor is instead undersecured either because the creditor was willing to take a chance or because the debtor drove a hard bargain and wanted to preserve some of the value of the collateral for possible later borrowing. Presumably this creditor is compensated for its greater risk through ability to charge a higher rate of interest than if fully secured.

Why should this creditor ever be able to treat its loan as recourse? Yet even if the parties agreed that equipment worth $75 will secure a loan of $100 (or perhaps the debtor has appraised the property more shrewdly than the creditor), section 1111(b) applies. In bankruptcy, the intentionally undersecured creditor finds itself with the option of being treated as fully secured.[116]

Second, consider a creditor who has a secured claim in bankruptcy arising from a transaction other than a grant of a consensual security interest. If, prior to bankruptcy, a debtor loses a contract action resulting in a $10,000 judgment, the judgment creditor, if it does nothing more, has an unsecured claim in bankruptcy, and section 1111(b) does not become relevant.

If, however, the judgment creditor takes the additional step of having the sheriff levy on $5000 of the debtor's property, the creditor has a lien on that property to secure payment of the judgment.[117] Under section 506(a), a $10,000 judgment creditor with a lien on $5000 worth of property has a secured claim of $5000 and

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116. Creditors may remain free to waive their § 1111(b) rights by contractual arrangement with the debtor. In any event, negotiating such a provision would probably add to the costs of credit transactions because creditors would not routinely include a provision limiting their rights in standard loan documents. Debtors would have to ask for the waiver and supply a *quid pro quo*.

117. *See* 11 U.S.C. § 101(31) (1982 & Supp. 1984).

an unsecured claim of $5000.[118] Since section 1111(b) is not limited to consensual secured transactions, it applies to all secured claims, this creditor becomes eligible to make the section 1111(b)(2) election to have its claim treated as if fully secured.

This undersecured creditor has no basis, however, for asserting reliance on in rem rights to sell the encumbered property. The creditor had the sheriff seize any available assets, and state law may require the sheriff to sell those assets.[119] It is difficult to imagine a justification for section 1111(b) in this situation. More importantly, if the creditor manages to levy on any substantial amount of assets, section 1111(b) enables the creditor to leverage that status into treatment of its entire claim as secured.[120] It is doubtful that Congress ever considered these consequences of section 1111(b).

C. Does Section 1111(b) Work?

By making the section 1111(b)(2) election, the undersecured creditor obtains the protection that section 1129(b)(2)'s fair and equitable standard affords for the creditor's full claim. The most specific portion of the fair and equitable standard states in part "that the holders of [secured] claims retain the lien securing such claims . . . to the extent of the allowed amount of such claims . . . ."[121] Under one interpretation of this language, the protection that sections 1111(b)(2) and 1129 provide is limited to assuring the undersecured creditor that it will receive payments equal to the total amount of its secured claim, with a present value equal to the value of the collateral. The lien that the creditor must retain pursuant to section 1129(b)(2)(A)(i)(I) secures only the right to this combination of payment characteristics.

As section 1129 currently reads, therefore, retention of the lien does not necessarily assure that the electing undersecured creditor will in fact enjoy the benefit of subsequent appreciation in the collateral. Section 1129 does not state that electing creditors retain their liens to secure receipt of an amount having a value, as of the date of confirmation of the reorganization plan, equal to the allowed amount of the fully secured claims.

118. *See id.* § 506(a) (1982).

119. *See, e.g.*, N.Y. CIV. PRAC. R. § 5233 (McKinney 1978).

120. Similarly, if state law provides a creditor with a valid statutory lien, *see* 11 U.S.C. § 101(45) (1982 & Supp. 1984), for any substantial part of the creditor's claim, § 1111(b) treats the full amount of the creditor's claim as if the claim were secured.

121. *Id.* § 1129(b)(2)(A)(i)(I) (1982).

If an undersecured creditor receives payments equaling the total amount of the enhanced secured claim, with a present value as of the effective date of the plan equal to the value of the collateral, then the section 1129(b) lien may not have an obligation left to secure. At that point the undersecured creditor has no interest in any appreciation in the collateral, or in the "true" value of the collateral to the extent it exceeds the initial valuation. Extinguishment of the lien after a stream of payments with the above characteristics may occur even though the creditor has not received any payments to reflect the difference between an erroneously low initial valuation of the collateral and a subsequent increase in value. The creditor may be cashed out without receiving anything for the higher value. A debtor, therefore, may achieve the economic equivalent of cashing out the undersecured creditor on confirmation by choosing an appropriate period of payments in light of the governing discount rate. In short, a result not unlike that reached in *Pine Gate* may remain possible through careful planning.[122]

An alternative view of section 1129(b)(2) may be more in keeping with the goals of section 1111(b)(2)—that the section 1129(b)(2) lien must secure whatever the undersecured creditor is entitled to receive under the reorganization plan. The lien would remain in existence despite the creditor's receipt of payments with a present value equal to the value of the collateral. The lien would remain until the creditor received all payments that the plan required. Although this alternative view may follow more faithfully the underlying rationale for section 1111(b), it is somewhat more difficult to reconcile with the description of the lien in section 1129(b)(2),[123] which reads in terms of the amount of the claim and not in terms of the obligations to be performed under the plan.

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122. To illustrate, assume that an undersecured creditor is owed $100 and has an interest in collateral worth $90. The creditor believes that the valuation of the collateral is low and, therefore, makes the § 1111(b)(2) election to avoid being cashed out for $90. The debtor proposes a plan that provides for payment to the creditor of $100 one year from the effective date of the plan. Assuming a discount rate of 10%, upon payment the creditor will have received payments totaling $100 (the allowed amount of the secured claim) with a value, as of the effective date of the plan, of at least $90. Upon such payment there is no underlying obligation left for the § 1129(b)(2)(A)(i)(I) lien to secure. The creditor has, in effect, been cashed out for payment of $90 on the effective date of the plan, the very result § 1111(b)(2) was designed to avoid. This result is possible only when there is a suitable relationship among the amount of the debt, the value of the collateral, and the discount rate.

123. Of course, it remains possible for a court to supplement § 1129(b)(2)'s illustrations of fair and equitable treatment.

VI. Conclusion

In discussing an area as technical as confirmation of reorganization plans, it is tempting to leap to illustrations of the detailed operations of the intricate provisions involved. Without such illustration few will understand the statutory provisions, because the provisions themselves are far from self-explanatory. Yet by the time one has worked through a detailed example or two, there may be little energy left to assess the less technical considerations underlying a particular provision. Having mastered a provision's operation, one may even have a vested interest in its survival.

Section 1111(b) and the related confirmation provisions contained in section 1129 are particularly ripe candidates for technical discussions that pretermit more fundamental inquiries. One is so grateful to have grasped how the provisions work—on a first reading it is difficult to believe that they mean what they say[124]—that one fails to proceed to critical assessment of the provisions. The provisions seem to have supplied writers with an irresistible impulse to discuss technical aspects of confirmation.

Because of the narrowing effect that technical provisions have on legal discussions, it is even more important for those who understand the technical provisions to discuss those provisions' role in the larger statutory and legal framework. Under almost any larger view not influenced by an overreaction to the result in *Pine Gate*, section 1111(b) does not coexist comfortably with the general goals of the reorganization process or with the general thrust of bankruptcy law. At a minimum, section 1111(b)'s complicating features are not worth their costs.

Section 1111(b), whatever its direct costs, may be most troublesome as evidence of another problem in bankruptcy law. Viewed in hindsight, with knowledge of the 1984 bankruptcy amendments,[125] section 1111(b) may be a precursor to the balkanization of bankruptcy law. Enactment of that provision was a triumph for one special interest group—nonrecourse real estate lenders—that secured passage of a provision of little if any value to the bankruptcy process as a whole. Other groups achieved similar success in 1978,[126] and the process showed signs of getting out of hand in the

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124. Professor White has termed § 1111(b)(2) "incomprehensible." J. White, Bankruptcy and Creditor's Rights 317 (1985).

125. *See* Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, 98 Stat. 333.

126. *See* 11 U.S.C. §§ 365(b)(3) (special protection for shopping centers against assumption of executory contracts), 1110 (special protection for security interest in aircraft

1984 amendments. Bankruptcy law now provides special treatment for, among others, holders of timeshare interests under timeshare plans,[127] farmers who sell grain,[128] United States fishermen,[129] and repurchase agreements.[130]

One hesitates to advocate the sort of know-nothing attitude that automatically condemns without detailed analysis each new complicating provision of the Bankruptcy Act. The basic needs of the bankruptcy process, however, mandate few of these provisions. One hopes that they serve some larger societal goals.

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and vessels) (1982).

127. *See id.* §§ 101(47), 365(h) (1982 & Supp. 1984).

128. *See id.* §§ 546(d), 557.

129. *See id.* §§ 507(a)(5)(B), 546(d).

130. *See id.* §§ 101(39), 546(f), 559. The 1984 amendments also provide even more special protection for shopping centers. Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, § 362(a), 98 Stat. 333 (amending 11 U.S.C. § 365 (1982)).