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Tracing Equity

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Tracing Equity: Realizing and Allocating Value in Chapter 11

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Law and economics scholars have long argued that efficiency is best served when a firm's capital structure is arranged as a single hierarchical value waterfall. In such a regime, claimants with seniority are made whole before the next-junior stakeholders receive anything. To implement this single waterfall approach, those scholars envision a property-based mechanism: a blanket lien on all of a firm's assets, and therefore all of its value (including as a going-concern). This view informs a number of academic proposals for contractual bankruptcy and relative priority. Coincident with this scholarship, lawyers, scholars, and judges have largely accepted at face value the proposition that Article 9 of the Uniform Commercial Code implements the single waterfall. In other words, they assume that the law allows a secured lender to write contracts that enable it to capture all of a distressed company's going-concern value. This assumption has placed "senior" secured lenders firmly in the driver's seat when a firm falls into distress. So-called "senior" creditors claim priority in all of the value and control over all of the cash. They often push aggressively for a quick sale of the firm as a going concern, or liquidation of its assets, followed by distribution of all of the sale proceeds to the secured lender.

In this Article, we illustrate that neither Article 9 nor the federal Bankruptcy Code, in fact, implements the single waterfall. Instead, both maintain a distinction between claims with priority based on a property interest in the firm's assets and claims to the residual value of the firm. Whenever the firm continues in operation, there will always be two value waterfalls—one tied to assets, and the other not. The second waterfall consists of unencumbered assets, as well as the going-concern and other value of the firm that Chapter 11 preserves. The key legal (and often forgotten) concept that maintains this distinction is "equitable tracing"—required by both Article 9 and Chapter 11. The terms "equitable

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principles" in Article 9 and "equities of the case" in Chapter 11 refer to equitable tracing principles that, in turn, inform secured creditors' "fair and equitable" baseline entitlement under a Chapter 11 plan.

On the petition date, the value of the firm is therefore divided into two categories: value traceable to encumbered assets and other value. This relationship must then be managed over time, as the value of the firm changes. To accomplish this, Chapter 11 treats realization of value as a two-step process that we call "Equitable Realization." Equitable Realization uses tracing principles to allocate a firm's value between asset-based and firm-based claimants and to preserve that allocation over time. First, it fixes the relative positions of secured and unsecured claims when a bankruptcy petition is filed. Second, it delays the fixing of the value of secured claims until collateral is sold or a Chapter 11 plan is confirmed. The value of the secured creditor's collateral may increase, but the secured creditor's entitlement to any bankruptcy-created value extends only to "identifiable proceeds"—value that can be traced to assets encumbered on the petition date. As a result, increases in going-concern value of the company in this period, and other bankruptcy-created value more generally, are not within a lender's collateral package. Any going-concern value created or preserved by Chapter 11 is allocated to the bankruptcy estate for the benefit of all stakeholders—workers, retirees, customers, and more.

We then address whether Article 9 and the Bankruptcy Code took the right approach by choosing Equitable Realization over the single waterfall. Many scholars, all the way back to Grant Gilmore, have questioned the wisdom of the single waterfall. Joining and expanding on those scholars' concerns, we explain the benefits of Equitable Realization and how the concept resonates with a large family of corporate and commercial law rules that guard against undercapitalization and judgment proofing. Equitable Realization not only implements the Bankruptcy Code's core goal of equitable treatment of creditors, but, by properly identifying firms' residual claimants, limits a firm's ability to externalize risk and increases the prospect of reorganizing troubled companies.

The last task of this Article is to test our insights against the value-allocation proposals in the Final Report of the American Bankruptcy Institute Commission to Study the Reform of Chapter 11*, as well as priority-related proposals in academic scholarship. Many of the Commission's proposals are consistent with Equitable Realization. But one proposal in particular, redemption option priority, allocates too much to secured creditors relative to our interpretation of current law.*

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> [W]hy on earth should the fruits of a known insolvent's labors feed the assignee while all the other creditors starve?........[D]oes it make any sense to award everything to a secured party who stands idly by while a doomed enterprise goes down the slippery slope into bankruptcy? [1]
>
> —Grant Gilmore

Introduction

In General Motors' historic bankruptcy, investment bank J.P. Morgan learned a hard lesson about the effect of property law on contractual priority. Although the debtor promised the creditor an asset-based loan, with priority in particular assets, failure to provide public notice of the $1.5 billion secured loan transaction left J.P. Morgan largely unsecured.[2] While the contract between J.P. Morgan and General Motors said one thing, Delaware lien law dictated a different result. When there is not enough value to go around, private agreements between the debtor and a creditor about priority (contracts) affect other creditors (third parties) and are therefore governed by property law. Federal bankruptcy law derives rules about the enforceability of obligations and their priority from state and other nonbankruptcy law and then uses those entitlements to allocate the value realized in bankruptcy in a

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

2. *In re* Motors Liquidation Co., 777 F.3d 100, 105 (2d Cir. 2015). As the case has developed, the ultimate fate of the lenders appears likely to turn on how much of the lenders' collateral can be characterized as "fixtures." Tiffany Kary, *GM Creditors' $1 Billion Fight Hangs on Fixture Definition*, BLOOMBERG (June 6, 2017), https://www.bloomberg.com/news/articles/2017-06-06/key-to-gm-creditors-1-billion-fight-lies-in-fixture-semantics [https://perma.cc/4DEQ-V2WP].

manner that is "fair and equitable."[3] These legal allocations may not, however, match the hopes of particular creditors.

The distributional stakes are high, and contested by claimants with varying levels of power, including private equity funds, tort claimants, inventory suppliers, customers, governmental units, workers, and retirees. A central goal of bankruptcy law is to ensure that disappointment is shared in a manner that is fair but that also facilitates value maximization. Value allocation also implicates governance; distributional rights determine who has decision-making power in a Chapter 11 bankruptcy case and can decide the fate of the firm, hopefully to maximize value.

The normative stakes are high as well. Douglas Baird, Thomas Jackson, Alan Schwartz, and others have long argued that economic efficiency is best served when the capital structures of companies are arranged as single, hierarchical value waterfalls.[4] The mechanism that these scholars advocate to implement this contractual waterfall—a blanket lien on all of a firm's assets—is, necessarily, property based. Otherwise, the subordination/priority would not bind third parties, such as employees, trade creditors, and tort claimants.

This view influenced the comprehensive revision to Article 9 of the Uniform Commercial Code in 2000.[5] Lawyers, scholars, and judges have, since then, largely accepted at face value the notion that a secured lender can write contracts that enable it to capture all of a distressed company's going-

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3. 11 U.S.C. § 1129(b) (2012).

4. *See* Douglas G. Baird & Thomas H. 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, 106–08 & n.40 (1984) ("Bankruptcy is, in short, a mechanism to make disparate owners act as one owner would act, and thereby to reduce the costs such dispersion would otherwise bring."); *id.* at n.52 ("Secured credit is to unsecured credit what unsecured credit is to equity interests "); Alan Schwartz, *A Theory of Loan Priorities*, 18 J. LEGAL STUD. 209, 211 (1989) ("[T]he optimal priority contract ...... would rank the initial financer first ...."); *cf.* Alan Schwartz, *The Fairness of Tender Offer Prices in Utilitarian Theory*, 17 J. LEGAL STUD. 165, 167–68 (1988) [hereinafter *Fairness*] (noting that the single-owner standard is widely accepted by courts and legal commentators). In Douglas G. Baird, *The Rights of Secured Creditors after* ResCap, 2015 U. ILL. L. REV. 849 (2015), Baird recognizes the asset-based nature of the secured claim but continues to assume the possibility of a blanket lien on going-concern value. *Id.* at 860 (The debate over "[w]hether one looks at a secured creditor as holding the discrete parts worth less than the going concern or whether it enjoys a right to the first cashflows of the firm . . . will undoubtedly continue. Both sides cling to their views as if they were articles of religious faith.").

5. The assumption was that the positive externalities associated with reduced cost of credit would outweigh any negative externalities imposed on nonconsensual or nonadjusting creditors. *See* Steven L. Harris & Charles W. Mooney Jr., *How Successful Was the Revision of UCC Article 9: Reflections of the Reporters*, 74 CHI.-KENT L. REV. 1357, 1359 (1999) (suggesting that the Article 9 revision was motivated by "increase[d] awareness that the principal beneficiaries of secured credit" are borrowers *and* third parties); Lois R. Lupica, *The Impact of Revised Article 9*, 93 KY. L.J. 867, 870 (2004–2005) (explaining that purported efficiency grounds justified the expanded rights of secured creditors in the Article 9 revision).

concern value.[6] Lynn LoPucki, Elizabeth Warren, Lucian Bebchuk, and Jesse Fried—and, before them, Grant Gilmore—questioned the wisdom of this view, but not the efficacy of the chosen mechanism or the comprehensiveness of Article 9 as adopted.[7]

In this Article, we question not only the wisdom of the "single waterfall," but the accuracy of the view that it exists under current law. We first argue that both Article 9, as revised, and the Bankruptcy Code retain the distinction between asset-based claims of priority and value-based claims against firm value that cannot be traced to encumbered assets. We then join the single-waterfall skeptics as a normative matter, and reconceptualize this view—that asset-based priority must be traceable to pre-petition assets—as part of a broad family of laws that encourage adequate capitalization through a combination of governance rules and liability rules, but also through limitations on limited liability (veil piercing), and limitations on property rights (avoidance). Our positive argument proceeds as follows. First, we explain how the Bankruptcy Code allocates realized value and uses the term "equity" to police the line between asset-based claims and value-based claims.[8] Next, we show that equity has a temporal dimension; Chapter 11

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6. As we discuss later, the American Bankruptcy Institute Commission Report assumes a single waterfall when it seeks to allocate the reorganization value of a firm. D.J. BAKER ET AL., AM. BANKR. INST., COMMISSION TO STUDY THE REFORM OF CHAPTER 11: 2012–2014 FINAL REPORT AND RECOMMENDATIONS 213 (2014), http://commission.abi.org/full-report [https://perma.cc/X24X-LL3N] [hereinafter ABI FINAL REPORT] ("The absolute priority rule codified in section 1129(b) . . . continues the basic tenet that . . . secured creditors have a right to receive payment in full prior to junior creditors and interest-holders receiving any value."). Many commentators make the same assumption. *See* Douglas G. Baird, *Priority Matters: Absolute Priority, Relative Priority, and the Costs of Bankruptcy*, 165 U. PA. L. REV. 785, 797 n.39 (2017) ("As a matter of black-letter law, of course, unsecured claims are supposed to receive nothing if the secured creditors cannot be paid in full."); Anthony J. Casey, *The Creditors' Bargain and Option-Preservation Priority in Chapter 11*, 78 U. CHI. L. REV. 759, 763–64 (2011) ("[T]he 'absolute priority rule' provides that assets in bankruptcy must be distributed in strict adherence to the contractual priority that exists for liquidation outside bankruptcy. Thus, senior secured creditors must be paid in full before junior creditors recover a penny.").

7. Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857, 859 (1996); Gilmore, *supra* note 1, at 627; Lynn M. LoPucki, *The Unsecured Creditor's Bargain*, 80 VA. L. REV. 1887, 1939–40 (1994); Elizabeth Warren, *Making Policy with Imperfect Information: The Article 9 Full Priority Debates*, 82 CORNELL L. REV. 1373, 1390–91 (1997).

8. Much has been written about "equity" in the Bankruptcy Code and its impact on the treatment of creditors' claims. *See, e.g.*, Alan M. Ahart, *The Limited Scope of Implied Powers of a Bankruptcy Judge: A Statutory Court of Bankruptcy, Not A Court of Equity*, 79 AM. BANKR. L.J. 1, 1 (2005) ("[A] bankruptcy judge has scant prerogative to invoke inherent powers, formulate federal common law or imply private rights of action under the Bankruptcy Code."); Marcia S. Krieger, *"The Bankruptcy Court Is a Court of Equity": What Does That Mean?*, 50 S.C. L. REV. 275, 297 (1999) (discussing the history of the characterization of bankruptcy courts as "courts of equity"); Adam J. Levitin, *Toward a Federal Common Law of Bankruptcy: Judicial Lawmaking in a Statutory Regime*, 80 AM. BANKR. L.J. 1, 2–5 (2006); *see also* United States v. Sutton, 786 F.2d 1305, 1308 (5th Cir. 1986) ("While the bankruptcy courts have fashioned relief under [11 U.S.C.] Section 105(a) in a variety of situations, . . . [t]hat statute does not authorize the bankruptcy courts to create substantive

cases unfold over time and absolute value and relative allocation of value may change over the course of a case. We show how the Code's mechanism for value tracing and the Code's timing rules for realization interact over the course of a Chapter 11 case to freeze the relative position of asset-based and value-based claims as of the moment the bankruptcy petition is filed. This implements a concept we call "Equitable Realization." We then consider the implications of this concept for creditors when they claim to hold blanket liens encumbering the value of the firm as a whole.

Our interpretive argument rests on the meaning of the term *equity* as it is used in both Article 9 of the Uniform Commercial Code and the Bankruptcy Code with regard to collateral tracing. We discuss the use of this term in three statutory provisions:

- First, to confirm a Chapter 11 plan of reorganization over the objections of a class of impaired claims, the plan must be "fair and equitable" to the dissenting class;[9]
- Second and third, both Article 9 of the Uniform Commercial Code and the Bankruptcy Code invoke the term *equity* when a secured creditor's collateral has become commingled with other assets of the estate.[10]

Article 9, by its terms, mandates the application of "equitable principles" to determine the portion of commingled assets that should be treated as identifiable proceeds of the secured party's collateral.[11] Similarly, the Bankruptcy Code authorizes a court to use the "equities of the case" to limit a secured creditor's entitlement to identifiable proceeds.[12] These tracing principles, as interpreted and applied by courts, maintain an equitable distribution of firm value as it changes over time during a Chapter 11 case.

Our interpretation of equity as tracing is far from a "roving commission" to do justice.[13] Drawing from the language of the statute, and the history of bankruptcy law, our interpretation has bite that prior commentators have not sufficiently appreciated. It mandates a particular approach to allocating value among stakeholders in Chapter 11 cases. We show that the pool of assets entitled to asset-based priority is fixed on the petition date. Therefore, to the extent Chapter 11 creates or preserves the going-concern value of a firm, such value is not allocated to the secured lender, even one claiming a blanket lien

rights that are otherwise unavailable under applicable law, or constitute a roving commission to do equity.").

9. 11 U.S.C. § 1129(b)(2) (2012).

10. The likelihood of commingling collateral and noncollateral is high when the security agreement includes an extensive list of tangible and intangible personal property interests as collateral.

11. U.C.C. § 9-315(b)(2) (2014).

12. 11 U.S.C. § 552(b).

13. *See Sutton*, 786 F.2d at 1308.

on all of the firm's assets. That value is allocated to the bankruptcy estate and, consequently, to the parties with a claim to the firm's value.

Having established that a single waterfall cannot be created through security interests under current law, we had to ask whether that is a problem that needs to be fixed. The debate over the efficiency of secured credit, and the related debate over a carve-out for nonconsensual creditors, ended at an empirical standoff in the 1990s.[14] Secured credit has both positive and negative externalities of relative sizes that have yet to be measured. The effort of creditors to obtain blanket liens, however, requires consideration here because the principle that a firm should not do business without maintaining capital reasonably sufficient to pay its debts has deep roots in tort, property law, and corporate law.[15] Reserving the going-concern increment for those harmed by the failure to maintain adequate capital sounds both in efficiency and in equity. It prevents secured credit from being used as a contractual end run around this legal norm.[16]

The timing has never been better for our consideration of these questions. The American Bankruptcy Institute (ABI) Commission on the Reform of Chapter 11 recently published an extensive report on the current state of Chapter 11 (the "ABI Commission Report" or the "Report").[17] The Report—a monumental example of cooperation amongst restructuring professionals and the academy—reveals agreement that the corporate-bankruptcy system is not working nearly as well as it should. In large part, the dysfunction stems from the control exercised by asset-based lenders that goes beyond what the original Bankruptcy Code drafters anticipated. Many of the Report's proposals relate to secured creditor entitlements, and often (but not always) seek to cabin those entitlements—an approach that has generated strenuous opposition.[18]

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14. As Janger has discussed elsewhere, the debate over the efficiency of secured credit foundered on the inability to measure and compare the relative size of secured credit's positive externalities (reduced credit cost) and its negative externalities (risk alteration and distorted investment incentives). *See* Edward J. Janger, *Predicting When the Uniform Law Process Will Fail: Article 9, Capture, and the Race to the Bottom*, 83 IOWA L. REV. 569, 606 & n.149, 608 (1998); *see also* Paul M. Shupack, *Solving the Puzzle of Secured Transactions*, 41 RUTGERS L. REV. 1067, 1068 (1989); *infra* section II(B)(3).

15. The scope of the debts to be protected under this principle (e.g., nonconsensual debt, ordinary trade debt, employment claims) is a separate question, but unless tort claims and the like are given priority, blanket liens will violate this principle whenever a firm becomes insolvent.

16. While in theory a firm that has encumbered all of its assets could be adequately capitalized, the value of the firm must exceed the amount of the debt secured by the lien. Reductions in the equity cushion shift all risk to operating and nonconsensual creditors.

17. *See* ABI FINAL REPORT, *supra* note 6.

18. *See* LOAN SYNDICATIONS & TRADING ASS'N, THE TROUBLE WITH UNNEEDED BANKRUPTCY REFORM: THE LSTA'S RESPONSE TO THE ABI CHAPTER 11 COMMISSION REPORT 13–37 (2015) (calling the ABI Report's approach "well-intentioned," but "misguided"). This resistance is neither new nor limited to the United States. For an assessment of the various ways secured creditors resist reforms perceived as restricting their scope and power in the UK, see Adrian J. Walters, *Statutory Erosion of Secured Creditors' Rights: Some Insights from the United Kingdom*,

The ABI Commission Report offers a vehicle to test our view of the realization rules and entitlements currently embedded in the Bankruptcy Code. We agree with much of the Chapter 11 Commission's articulation of problems in the current system. But the proposals lack a consistent conception of realization and entitlement, probably because of negotiation to achieve agreement about the reform package as a whole. In particular, some proposals cling to the assumption that a secured creditor can use its asset-based claim to become the residual owner of a firm—a view that this Article illustrates is neither justified by current law, nor inherently desirable.[19]

This Article proceeds in three parts. In Part I, we develop the concept of Equitable Realization in bankruptcy. We identify the moment(s) in time when the Bankruptcy Code fixes: (1) the relative positions of claimants against the estate and its assets, and (2) the value of those claims for distributional purposes (value realization). In addition to distinguishing between unsecured and secured claims, we show how fixed- and floating-lien collateral are treated differently as a practical matter.[20] In the process, we explain how the Bankruptcy Code seeks to ensure the equitable treatment of all creditors but does so differently depending on type. This analysis also specifies the allocation of bankruptcy-created value. The allocation we describe is facially similar to proposals for an option-preservation priority and a relative priority described in recent articles by Anthony Casey and Douglas Baird. However, failure to distinguish asset-based priority from claims against the value of the firm leads their proposals to considerably understate the extent to which bankruptcy-created value is allocated to the bankruptcy estate.

2015 U. ILL. L. REV. 543, 546–47 (2015). The Reporters to pre-revision Article 9 also lamented this fact and noted its long historical provenance in the Official Comment 2 to former 9-204:

> The widespread nineteenth century prejudice against the floating charge was based on a feeling, often inarticulate in the opinions, that a commercial borrower should not be allowed to encumber all his assets present and future, and that for the protection not only of the borrower but of his other creditors a cushion of free assets should be preserved. That inarticulate premise has much to recommend it. *This Article decisively rejects it not on the ground that it was wrong in policy but on the ground that it was not effective.*

U.C.C. § 9-204 cmt. 2 (1999) (emphasis added).

19. *Accord* Edward J. Janger, *The Logic and Limits of Liens*, 2015 U. ILL. L. REV. 589, 592 (2015).

20. A floating lien is known as a security interest in after-acquired property in the parlance of Article 9 of the Uniform Commercial Code. U.C.C. § 9-204. Article 9 permits parties to sign an agreement whereby a security interest will become effective against property the debtor does not yet own when the debtor acquires it in the future. *Id.* Absent floating liens, lenders and borrowers would have to execute and authenticate new agreements every time the debtor obtained a new property interest that the lender expected to encumber. Floating liens are often associated with property interests that turn over quickly, such as accounts receivable or inventory. *See* Stoumbos v. Kilimnik, 988 F.2d 949, 956 (9th Cir. 1993) (explaining that cases "discuss cyclically depleted and replenished assets such as inventory or accounts receivable").

Part II sets forth a normative argument for Equitable Realization. We show that this approach to value allocation combats judgment proofing, thereby limiting externalities, promoting good governance, and vindicating policies served by tort, contract, property, and corporate law. Indeed, even if Article 9 had validated blanket liens, it could not have created the "single waterfall." The anti-judgment proofing principle is often enforced by property based remedies that limit the ability of consensual lienors to obtain full priority over other creditors.

In Part III, we test drive our articulation of the positive law against recent proposals for Chapter 11 reform, primarily drawn from the ABI Commission Report.

I. The Concept of Realization and an Introduction to Questions of Timing

Among other things, Chapter 11 of the Bankruptcy Code seeks to accomplish two related goals: value maximization and fair distribution of that value. Fair distribution requires precision with regard to the scope of any claim of priority, and value maximization is not instantaneous. Value allocation therefore requires management of the relationship between high-priority and low-priority claims over time. Attention must, accordingly, be paid to the moment in time when those baseline entitlements become fixed—the moment of realization—to ensure that risk is borne by the appropriate party and benefits accrue to those risk-bearers.

In this Part, we examine how Article 9 and the Bankruptcy Code work together to manage the scope of security interests over time. We develop four propositions that appear obvious to us, but others might see as controversial or even revolutionary. If one pays close attention to state lien law and its integration into the Bankruptcy Code, (1) secured creditors' claimed blanket liens do not encumber as much property as is commonly assumed;[21] (2) the scope of collateral encumbered by a secured creditors' lien (blanket or not) is fixed on the petition date; (3) secured creditors' minimum distributional rights are also fixed on the petition date; but (4) their maximum (asset-based) distributional rights are determined upon disposition of their collateral.

A. Value Allocation and Timing: The Stakes

This is not the first time that we have wrestled with the relationship between time, leverage, opportunism, and the assertion of a single-priority waterfall in Chapter 11 cases. Our inquiry began when we observed the opportunistic use of leverage, principally by senior creditors, to hurry a case

21. Melissa B. Jacoby & Edward J. Janger, *Ice Cube Bonds: Allocating the Price of Process in Chapter 11 Bankruptcy*, 123 YALE L.J. 862, 920–25 (2014) [hereinafter *Ice Cube Bonds*]; Janger, *supra* note 19, at 591.

through bankruptcy. Even before the much-discussed Chrysler and GM bankruptcies, many Chapter 11 cases had devolved into quick foreclosure-sale devices, used for the benefit of creditors asserting that a blanket lien entitled them to capture all of the value of the debtor firm.[22] We wrote that, for at least a decade, bankruptcy debtors had been routinely alleging that the firm was quickly losing value—a "melting ice cube"—to justify hurry-up going-concern sales without the procedural protections of a Chapter 11 plan. We argued that this strategy, when successful, placed increased risk of an erroneous valuation on the bankruptcy estate rather than on the proponent and beneficiary of the expedited sale. We further contended that the sale proponent often exploited the crisis to distort state-law entitlements and the Bankruptcy Code's distributional scheme.[23] We proposed a procedural device—the Ice Cube Bond—that would permit quick sales, while preserving issues of valuation and distributional priority (entitlement) for resolution through the plan process.[24]

A common response to our proposal was premised on the aforementioned single waterfall: why worry about unsecured creditors and other stakeholders when there's almost always an undersecured creditor with a "blanket lien" that encumbers all the assets?[25] In other words, if a dominant secured creditor is entitled to all of the value of the debtor, that creditor alone should have the right to dictate how to deal with the firm. What started as an inquiry into procedure became substantive, forcing us to consider how the Bankruptcy Code and the underlying state-law architecture allocate value amongst claimants against, and contributors to, a firm.

This widespread assumption that a blanket lien creates a single distributional waterfall led us to ask two questions: (1) exactly what assets or value does a secured creditor claiming a blanket lien actually encumber under state law, and (2) when does a secured creditor's allowed secured claim become realized (fixed) for various purposes under bankruptcy law? These two questions help us determine entitlements to any bankruptcy-created

22. Melissa B. Jacoby & Edward J. Janger, *Bankruptcy Sales*, *in* HANDBOOK ON CORPORATE BANKRUPTCY (B. Adler ed., forthcoming 2018) [hereinafter *Bankruptcy Sales*]; *Ice Cube Bonds*, *supra* note 21, at 901–02, 934; Janger, *supra* note 19, at 611–12. Jay Westbrook's important empirical work reminds us that quick secured-creditor-dominated sales are only part of a complete picture of Chapter 11. *See* Jay Lawrence Westbrook, *Secured Creditor Control and Bankruptcy Sales: An Empirical View*, 2015 U. ILL. L. REV. 831 (2015) (analyzing a cross section of Chapter 11 cases from 2006); *see also* Lynn M. LoPucki, *The Nature of the Bankrupt Firm: A Response to Baird and Rasmussen's* The End of Bankruptcy, 56 STAN. L. REV. 645 (2003) (disputing the scope of sale cases and demonstrating data showing the continuation of reorganization plans in Chapter 11).

23. *Ice Cube Bonds*, *supra* note 21, at 895.

24. *Id.* at 926, 931.

25. A blanket lien is the colloquial name for a security interest that purports to cover all or substantially all of the assets of a firm. Our prior work illustrates a variety of reasons for skepticism about the existence of blanket liens. *Ice Cube Bonds*, *supra* note 21, at 923; Janger, *supra* note 19, at 595.

value—value generated or preserved, after the petition date, solely by the existence of the federal bankruptcy process.[26]

The answers to these two questions are (1) a secured creditor's collateral is fixed on the petition date; and (2) the value of an allowed secured claim is fixed upon the disposition of the collateral. This timing rule has implications for the allocation of enterprise value that is preserved, or even created, by the federal bankruptcy process; it belies the single waterfall assumption.

Conventional wisdom suggests that secured-creditor entitlements can be coextensive with the bankruptcy estate, and that undersecured creditors often hold the fulcrum security in a Chapter 11 bankruptcy.[27] We show that the conventional wisdom is wrong as a matter of positive bankruptcy and non-bankruptcy law in that it ignores the distinction between asset-based claims and firm-based claims. The Bankruptcy Code embraces this distinction and contains a sophisticated and calibrated scheme to manage the relationship between these types of claims.

Simply put, prior to bankruptcy, a secured creditor could not realize on the enterprise value of a firm by exercising asset-based rights. Extra value that bankruptcy makes available by allowing the business to continue to operate, thereby facilitating a going-concern sale or recapitalization, is not necessarily tied to the encumbered assets and should be allocated to the value-based waterfall.

B. *Realization, Timing, and Equity*

Chapter 11 of the Bankruptcy Code demands that, in the absence of acceptance by all impaired classes, creditors and shareholders be treated in a manner that is fair and equitable. The concept of equity is inextricably linked to the concept of realization. In finance, realization occurs when an asset of uncertain value is converted into cash or a receivable of fixed value—usually when title to the asset is transferred from a seller to a buyer.[28] The moment of realization can be important for a variety of reasons. For example, capital gains are taxed at the moment of realization. A secured creditor realizes on the value of its collateral when it receives payment from a foreclosure sale. In a bankruptcy case, realization occurs when the value of the allowed secured claim is fixed.

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26. *See* Ronald J. Mann, *Bankruptcy and the Entitlements of the Government: Whose Money Is It Anyway?*, 70 N.Y.U. L. REV. 993, 1040 (1995) ("[T]he government's role in creating and preserving those gains gives it an entitlement to some share of any gains from reorganization.").

27. *See* ERIC E. SAGERMAN ET AL., CREDITORS' RIGHTS IN BANKRUPTCY § 17.17 (2d ed. 2016).

28. One dictionary definition of realization can be found here: *Realization*, BUSINESSDICTIONARY, http://www.businessdictionary.com/definition/realization.html [https://perma.cc/QFW5-D2AS].

Once a claim's value is fixed, the creditor is insulated from risk that the value of its investment might decrease, but also no longer benefits from a subsequent increase.

In Chapter 7 value realization is accomplished through liquidation. The filing of a Chapter 11 case complicates the relationship between realization and allocation, because the two cannot be addressed simultaneously. Chapter 11 cases take time, and realization of value can happen in a number of ways. Delayed realization is a key (and desirable) feature of reorganization. Chapter 11 is meant to stop a run on the firm's assets, fix a business, allow markets to stabilize, and then to realize the value of the firm through an orderly process of sale or recapitalization. Over time, and by design, the value of the firm, and the value of its constituent assets, will change, hopefully for the better. In a world where one wishes to buy low and sell high, both timing of realization and control over timing matter. We next disentangle how Chapter 11 allocates value by more precisely identifying the moments at which value is realized for asset-based and firm-based claims.

1. Timing of Realization Under State Law.—Outside of bankruptcy, the effect of timing on the interaction between realization and equal treatment gets relatively little attention for two reasons. First, secured lenders, at least, can control the timing of realization by choosing when to foreclose after a debtor defaults. And, second, because the typical remedy is liquidation, there are not as many decisions to make.[29]

If a business borrows money secured by collateral and later defaults on its obligations, the default triggers the secured party's right to liquidate assets—to realize the value of its collateral.[30] If the collateral is personal property governed by Article 9 of the Uniform Commercial Code, the secured party is supposed to exercise its judgment to dispose of the property at a reasonable time and in a commercially reasonable manner.[31] For real estate, nonuniform state law fixes the foreclosure timeline, but the lender can determine when to initiate the process.

For unsecured creditors to obtain interests in and realize on specific assets of a firm, the process is more cumbersome. They must become judgment creditors, levy on the debtor's assets, and sell them at a sheriff's

29. Some state laws provide for assignments for the benefit of creditors, including some that seek to replicate tools of federal bankruptcy law. Andrew B. Dawson, *Better than Bankruptcy?*, 69 RUTGERS U. L. REV. 137, 142 (2016). We do not address those laws in detail here—in part because, to the extent that these ABC statutes allow a secured creditor to capture value that is not traceable to their collateral, they may be subject to fraudulent conveyance challenge. Moreover, these laws may raise constitutional objections.

30. U.C.C. § 9-601 (2014).

31. *Id.* §§ 9-610, 9-611; *see also id.* § 9-627 (describing how to determine whether the conduct was commercially reasonable). For ways in which the revisions to Article 9 enhanced lenders' foreclosure rights, see Lupica, *supra* note 5, at 882 (observing that "collection and foreclosure remedies have been enhanced, both procedurally and substantively").

sale or whatever equivalent process state law establishes.[32] Either way, the sale is what fixes the value of asset-based claims. If the firm is wound up under state law and there are unencumbered assets, the residual value of the firm would be distributed to the unsecured creditors who would share pro rata. If they were paid in full, the remaining value would be distributed to the shareholders. In other words, the value of claims and interests in the firm would be realized upon disposition of the firm's assets.

It must be realized, however, that state-law remedies have limits. State law determines what assets are subject to levy. Article 9 enforcement rights are articulated on an "asset-by-asset basis,"[33] and commentators have questioned whether secured creditors are even entitled to repossess or foreclose on intangible property.[34] Even for tangible property, secured creditors may be hesitant to engage in self-help repossession due to concerns about breaching the peace.[35] That leaves them to pursue judicial processes, such as replevin or claim and delivery, the procedures of which may vary state by state.[36]

In addition, a secured creditor's foreclosure rights are limited to its own collateral.[37] Even if an asset could be sold for significantly more if coupled with noncollateral, the Article 9 process offers no such option. For real estate, even an unopposed foreclosure can be cumbersome, expensive, and time-consuming.[38] Selling multiple lots as a package would be out of the question. Having a mix of assets also means that different procedures apply, especially if the procedures are governed by more than one state's law. If the debtor is a company with many types of assets dispersed across multiple jurisdictions, the compulsory state-law options for realizing value are likely to be inefficient, expensive, and slow. The value realizable under state-law

32. LoPucki, *supra* note 7, at 1939–40.

33. Juliet M. Moringiello, *False Categories in Commercial Law: The (Ir)relevance of (In)tangibility*, 35 FLA. ST. U. L. REV. 119, 125 (2007).

34. *See, e.g.*, *id.* at 125–27 (reviewing doubts about remedies for intangible collateral expressed in scholarship and case law); *id.* at 127 ("Article 9 provides no foreclosure remedy to a creditor holding a security interest in intangible property that is not a payment right, or a 'true' general intangible."); *id.* at 129 (discussing critiques of various states' garnishment laws that are sometimes used to enforce rights against intangible property, focusing on differences between those of Illinois and Massachusetts).

35. *See* U.C.C. § 9-609 cmt. 3 (2014) (explaining that "breach of peace" was left undefined and that secured parties are responsible for their own actions and those of their agents engaged in taking possession of the collateral).

36. For the relevance of assignments for the benefit of creditors, see Dawson, *supra* note 29, at 142.

37. *See* Janger, *supra* note 19, at 603–04 (illustrating the limited rights of creditors with an example).

38. *See* Melissa B. Jacoby, *The Value(s) of Foreclosure Law Reform*, 37 PEPP. L. REV. 511, 513–18 (2010) (reviewing standard critiques of state real property foreclosure-law processes). Although most reviews of foreclosure law focus on homes, many critiques, particularly those regarding valuation and timelines, apply to commercial property.

processes will not include or approximate the going-concern value of the firm.[39]

2. Timing of Realization Under Federal Bankruptcy Law, and Chapter 11 in Particular.—In a Chapter 7 bankruptcy case, the story is similar, except that the assets of the debtor can be addressed together and sold in a manner that maximizes value. Unsecured claimants of an insolvent company are treated as claimants against the residual value of the firm.[40] Assets are sold and their value is realized upon sale. The sale price of the collateral fixes the amount of that creditor's allowed secured claim.[41] The sale price of unencumbered property determines the amount available for unsecured creditors. The legal priority of claims against encumbered assets and the residual unencumbered value of the firm, respectively, determines how to distribute that value.[42]

As suggested above, Chapter 11 complicates the story by changing both the timing and manner of value realization. In Chapter 11, assets need not be sold piecemeal or at all.[43] Stakeholders in a firm can realize the value of their interests in the enterprise in other ways, such as reorganization or a going-concern sale of the entire enterprise. Both mechanisms allow creditors to realize the going-concern value of the firm, and neither would be possible (or at least would be greatly complicated) under state law.[44] Flexibility is crucial. An enterprise can be sold even if it bundles one secured creditor's collateral with that of another, or with unencumbered assets.[45]

Without a sale of a discrete asset at a legally determined time, however, the question of value disaggregation and allocation can be difficult. That complexity is magnified by the fact that the value of the firm and its constituent assets may change over time. Failure to disentangle these two

39. In some jurisdictions, an assignment for the benefit of creditors may allow for a sale of substantially all of a debtor's assets. Usually, such assignments are liquidations, and the procedures do not provide for assumption and assignment of contracts or sales free and clear. Nonetheless, it is sometimes possible to conduct a going-concern sale under state law. This does not, however, resolve the question of priority of distribution. The secured creditor is still entitled only to value that can be traced to its collateral. Carly Landon, *Making Assignments For the Benefit of Creditors as Easy as A-B-C*, 41 FORD. URB. L.J. 1451, 1476 (2014) ("California has a complex priority scheme that includes giving priorities for unsecured claims for up to $4,300 for each individual priority for consumer deposit claims, and priority treatment of claims for wages, salaries, commissions, and employee benefit contributions.").

40. *See* COLLIER ON BANKRUPTCY ¶ 726.01 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2009) (discussing the importance of the Code's priority scheme).

41. 11 U.S.C. §§ 363, 506 (2012).

42. *Id.* § 726.

43. *See* COLLIER ON BANKRUPTCY, *supra* note 40, ¶ 1100.01 (asserting that Chapter 11 provides an opportunity for debtors to continue to operate and reorganize rather than simply liquidating the business).

44. *Ice Cube Bonds*, *supra* note 21, at 894.

45. *Id.* at 875–76.

questions—timing of valuation and value allocation—explain much of the conceptual chaos and controversy in modern bankruptcy.

The fault for this confusion does not lie in the positive law, but in a failure to apply it precisely. The Bankruptcy Code has well-articulated realization rules that, when properly applied, simplify, or at least clarify, many of Chapter 11 bankruptcy's hardest questions about the timing of valuation. We start first with principles that are frequently overlooked.

C. The Equitable-Snapshot Principle and Equitable Realization: How They Work

Confusion about the scope of so-called blanket liens and an imprecise understanding of the timing of realization in Chapter 11 obscure an architectural principle in the Bankruptcy Code that we call Equitable Realization. In this section we show how the Bankruptcy Code uses Equitable Realization to clarify both the scope of a secured creditor's claim to priority, and the time when the amount of its claim is fixed.

Equitable Realization bifurcates the process of value allocation to allow for delayed realization of value. An "Equitable Snapshot" establishes the relative position of creditors as of the petition date. The Snapshot fixes, as of the petition date, the relative positions of unsecured creditors in relation to one another for purposes of *pari passu* distribution. It also establishes the relationship between secured (asset-based) and unsecured (firm-based) claims by fixing the pool of collateral that is encumbered.

Chapter 11 delays realization of the value of the claims themselves until the value of the estate (or the collateral) can be maximized. We call this Value Realization. Full realization of value does not occur until later disposition of collateral or the entire estate through a sale or plan. That value is allocated by reference to the Equitable Snapshot taken on the petition date. In between the Snapshot and Value Realization, *equitable tracing preserves the relationship between asset-based and value-based claims against the estate*.

This two-step realization process fixes the scope of a secured creditor's lien on the petition date. The secured creditor receives any appreciation of its original collateral during the case until disposition through sale or plan. Upon Value Realization, the priority claim associated with that asset has been fixed, even though the lien will continue in identifiable proceeds subject to tracing. Bankruptcy-created value not traceable to the disposition of a specific encumbered asset is allocated to the estate, not to a lienholder–even one claiming to hold a blanket lien.

State law does not give secured lenders' deficiency claims priority over other claims to this unencumbered value. Bankruptcy does not change that outcome. These creditors may have deficiency claims that share pro rata with other unsecured claims, but otherwise do not stand in the firm-based priority line. Thus, an undersecured creditor cannot use its secured claim to become the sole residual owners or so-called fulcrum security of the entire company.

1. Distinguishing Firm-Based and Asset-Based Claims: The "Fair and Equitable" Standard(s).—In the real multiple-waterfall world, Equitable Realization is necessary because a firm creates and faces two broadly different types of stakeholders: those with claims against the firm's assets, and those holding rights to the firm's residual value. For solvent entities, equity holders have the residual claim to the firm's value after debt has been paid.[46] All creditors take priority over equity holders, but not all creditors are created equal as against each other. Some creditors may have claims against distinct assets of the firm that others do not. Asset-based claims are often voluntary, based on an enforceable contract under which the debtor grants a security interest or mortgage in specific collateral. Others are involuntary, arising because an unsecured creditor pursued its collection rights through becoming a judgment lien creditor in court or through specific statutes. Asset-based creditors take priority over non-asset-based creditors only to the extent of the specific assets that their liens encumber. Their priority is realized by foreclosing on and selling assets within the scope of their lien.

When a firm becomes insolvent, these differences among creditors matter.[47] A firm need not prove it is insolvent to file a voluntary bankruptcy petition,[48] but most firms are insolvent when they file.[49] Secured creditors continue to hold rights against specific assets of the firm.[50] Unsecured creditors get whatever is left over.[51] They have claims against the residual value of the firm.[52] Their once-fixed claims become variable, subject to fluctuations in the value of the firm. In short, in bankruptcy, the unsecured creditors' claims are value-based—against the value of the firm not represented by encumbered assets—while the secured creditors' claims are asset-based—against particular assets owned by the firm.

The Bankruptcy Code shows its respect for the difference early in the case. For example, it gives secured creditors, but not unsecured creditors, a right to adequate protection and the power to lift the automatic stay if adequate protection is not provided.[53] But if adequate protection is provided,

46. CONTESTED VALUATION IN CORPORATE BANKRUPTCY: A COLLIER MONOGRAPH ¶ 9.04[1] (Robert J. Stark et al. eds., 2011).

47. Our discussion primarily focuses on Chapter 11. As we note later, in Chapter 7, like under state law, proceeds from the sale of specific assets are distributed to entities with liens on those assets. Leftover value is distributed to claimants against the firm.

48. *See* 11 U.S.C. § 109(d) (2012) (enumerating the eligibility requirements for Chapter 11 bankruptcy, which do not include insolvency).

49. *See* Thomas E. Plank, *The Security of Securitization and the Future of Security*, 25 CARDOZO L. REV. 1655, 1729 (2004).

50. 11 U.S.C. §§ 361, 362(d), 506, 1129(b)(2)(A).

51. *Id.* §§ 1129(a)(7), 1129(b)(2)(B).

52. *Id.* § 1129(b)(2)(B).

53. *See id.* §§ 361, 362(d)(1).

incumbent management continues to operate the firm and maximizes its value for the benefit of the residual claimants.

But it is when value is being distributed, that the distinction matters most, and where it is necessary to map pre-bankruptcy entitlements onto distributions. When a class of creditors rejects a proposed Chapter 11 plan, we encounter a statutory use of the term "equity" to define creditors' statutory entitlements. The overarching requirement for this so-called cramdown of a dissenting class is that the plan be fair and equitable.[54] The fair and equitable standard is not discretionary. It mandates in precise detail the mapping of pre-petition entitlements onto plan distributions. In successive subsections of § 1129, the entitlements of secured creditors ((b)(2)(A)), unsecured creditors ((b)(2)(B)), and interests ((b)(2)(C)) are described.[55] The standard for secured claims is asset-based, guaranteeing the creditor a lien and a distribution equal to the value of its collateral,[56] while the provisions that apply to unsecured creditors and interests—the so-called absolute-priority rule—are firm-based, ensuring creditors' priority over equity and mandating respect for any distributional priority among shareholders.[57]

It is here that another single waterfall colloquialism causes confusion in the literature and in practice. The fair and equitable standard is sometimes shorthanded as the "absolute-priority rule." There are, however, really two distinct standards. For secured creditors, their payment priority is based on, and limited to, the value of their collateral on the effective date of the plan—not the value of the firm.[58] Therefore, when collateral is worth less than the

54. *See id.* § 1129(b)(1). In addition, a nonconsensual plan must not discriminate unfairly against a dissenting class. *Id.*

55. *Id.* § 1129(b)(2).

56. *Id*. § 1129(b)(2)(A). Under this section, the secured creditor may insist on retaining a lien (limited to the value of the collateral on the effective date of the plan) and payments (with a present value equal to the value of the collateral on the effective date of the plan).

57. *Id.* § 1129(b)(2)(B)–(C). This is the well-known absolute-priority rule that requires distributional priorities to be respected. Senior unsecured creditors must be paid in full before junior unsecured claimants, and debt takes priority over equity. Distributional priorities among shareholders must similarly be respected.

58. *Id.* § 1129(b)(2)(A). That section provides:

> With respect to a class of secured claims, the plan provides—
>
> > (i) (I) that the holders of such claims *retain the liens* securing such claims, whether the property subject to such liens is retained by the debtor or transferred to another entity, *to the extent of the allowed amount* of such claims; and (II) that each holder of a claim of such class *receive* on account of such claim 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* . . . .

Id. (emphasis added). Crucially, the "allowed amount" refers to the allowed secured claim as determined, for an undersecured creditor by 11 U.S.C. § 506(a)(1), which provides:

> 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

amount of debt owed to an asset-based creditor, that creditor becomes both an asset-based and a firm-based creditor: it has an allowed secured claim plus an unsecured deficiency claim.[59] Nothing in state law or the Bankruptcy Code gives a deficiency claim priority over the claims of other unsecured creditors in the value of the firm, and to do so would be neither fair nor equitable.[60] As a claimant against the residual value of the firm, the holder of the deficiency shares equally with other unsecured creditors, while remaining senior to holders of equity interests.[61]

2. *Timing of Realization.*—These examples from the front (adequate protection) and back (cram-down) of a Chapter 11 case reveal the importance of distinguishing between asset-based and firm-based claims over time. The assets may be worth different amounts at the end of the case than at the beginning. The same is true of the value of the firm. Moreover, the two need not move in tandem. Statutory use of the term "fair and equitable," referenced above, enlists Equitable Realization to reconcile mandatory distributions at the end of the case with the Snapshot at the beginning, in the service of the two core bankruptcy principles: value maximization and equitable treatment. To vindicate both principles, Chapter 11 distinguishes between the petition date and the disposition date. This is where Equitable Realization comes into play. On the petition date, the Bankruptcy Code takes an Equitable Snapshot that fixes the relative position of creditors. The relative positions of claimants are frozen when the bankruptcy petition is filed. On the disposition date, the Bankruptcy Code establishes the value of the particular claim either through sale or under a plan. For value-based claims, Value Realization occurs upon disposition of the residual estate, either through a plan or through sale of the firm as a going concern.

3. *Fixing the Relative Position of Creditors Through Equitable Realization.*—In Chapter 7, the Equitable Snapshot takes care of itself. Bankruptcy law stops the so-called race to the courthouse among creditors by implementing a principle of equal treatment. A Chapter 7 trustee usually sells property promptly, and the Equitable Snapshot and the realization of value merge as a practical matter.

> the value of such creditor's interest or the amount so subject to setoff is less than the amount of such allowed claim.

Id. § 506(a)(1). If the creditor makes the § 1111(b)(2) election, the lien is not stripped, but the distributional priority is still limited to the value of the collateral on the effective date of the plan. This is discussed below. *See infra* note 78 and accompanying text.

59. *Id.* § 506(a); U.C.C. §§ 9-610, 9-626 (2014).

60. Richard Squire, *The Case for Symmetry in Creditors' Rights*, 118 YALE L.J. 808, 846–48 (2009).

61. That deficiency claim does not, however, make the undersecured creditor the residual owner of the firm.

In Chapter 11, however, Value Realization is delayed, and the entitlements of asset-based claims and firm-based claims may shift relative to each other, even as the value of the estate increases. The petition date provides a point of reference—again, an Equitable Snapshot of those entitlements. Through Equitable Realization, Chapter 11 then fixes the relative position of pre-petition claimants, though not their claims' monetary value. We next explore how the Code implements Equitable Realization for firm-based and asset-based claims, respectively.

a. Firm-Based Claims.—Section 502 of the Bankruptcy Code establishes that an unsecured creditor's claim is determined by that creditor's nonbankruptcy entitlement on the petition date and excludes interest that would otherwise accrue after the bankruptcy filing.[62] The value of the assets to be distributed is unknown, but the relative position and proportional entitlement of each unsecured creditor is fixed. Each nonpriority unsecured creditor will be entitled to a pro rata share of whatever is distributed to firm-based claimants.

b. Asset-Based Claims.—Secured creditors base their assertions of priority on a property interest in particular assets of the debtor. The property interest in the collateral, rather than amount of the debt, fixes secured creditors' position as of the date of the petition.[63] After the petition is filed, a pre-petition secured creditor cannot assert an entitlement to entirely new collateral.[64] This result—locking in place the secured creditor's relative asset petitions vis-à-vis each other and the unsecured creditors—flows from four key Bankruptcy Code provisions related to equitable treatment:

- First, § 552(a) invalidates after-acquired property clauses in security agreements.[65] This provision cuts off floating liens as of the bankruptcy filing. For example, a security interest in a debtor's accounts receivable, including after-acquired accounts, does not extend to accounts receivable generated after a petition is filed. This provision is one of the most explicit examples of the lock-in concept.
- Second, § 552(b) complements § 552(a) by preserving the interest that the secured party had in its original collateral. If the secured creditor's original collateral is sold or otherwise disposed of, the security continues in identifiable proceeds to the extent consistent

62. 11 U.S.C. § 502(b)(2) (excluding unmatured interest). The reason for this piece of the rule is generally said to be that allowing post-petition interest would alter the relative position of creditors over time. Patrick Darby, Southeast *and* New England *Mean New York: The Rule of Explicitness and Post-Bankruptcy Interest on Senior Unsecured Debt*, 38 CUMB. L. REV. 467, 475–76 (2007).

63. 11 U.S.C. §§ 361, 362(d), 506(a).

64. 11 U.S.C. § 552(a). For now we leave to the side the question of a pre-petition secured lender's picking up new collateral by extending new credit post-petition. *See infra* note 207 and accompanying text.

65. 11 U.S.C. § 552(a).

with the equities of the case.[66] As we discuss later, state law protects secured creditors against diminution of their collateral by encumbering other property interests of the debtor if they are identifiable proceeds of that creditor's collateral.[67] Bankruptcy law honors that concept, but "the equities" reference explicitly recognizes that the interest in proceeds should not fundamentally alter the relative position of creditors. In other words, it does not permit the secured creditor's interest in "proceeds" to expand such that it encompasses all of the unencumbered value of the debtor.

- Third, § 549 gives the trustee the power to avoid and unwind any unauthorized transfer of property of the estate that arises after the date of the filing of the petition.[68] This power further polices the Snapshot principle by ensuring that the debtor does not transfer the estate's property rights to a creditor.
- Fourth, and relatedly, § 551 preserves any avoided transfer for the benefit of the estate,[69] preventing junior claimants from improving their priority post-petition. Again, this preservation maintains the relative positions of creditors.

In other words—and this point is key to much of the analysis that follows—the assets to which secured creditors' interests extend are identified, and the implications for intercreditor priority are frozen, as of the petition date. *This is so even if the amount of debt chargeable against particular collateral or the value of the collateral changes, and even if the collateral itself is sold.*

4. Summary.—So far, this discussion should be uncontroversial. The collateral pool available to the secured creditor on the petition date establishes the scope of asset-based priority, and the rules for unsecured claim allowance establish the relative position of unsecured creditors as of the petition date. The unsecured creditors cannot change their relative pro rata share of the unencumbered value that remains. And, while the value of encumbered collateral and the value of the firm may change, a secured creditor cannot increase the value of its claim by expanding the assets that form the basis for the claim.

D. *Timing of Value Realization: Relatively Easy Questions*

Once the assets subject to liens have been identified, and the relative positions of unsecured creditors have been fixed as of the petition date, it is

66. *Id.* § 552(b).
67. U.C.C. §§ 9-102(a)(12), 9-203 (2014).
68. 11 U.S.C. § 549(a).
69. *Id.* § 551 ("Any transfer avoided under section . . . 549 . . . of this title . . . is preserved for the benefit of the estate but only with respect to property of the estate.").

necessary to determine the value of these claims. The pace and duration of modern Chapter 11 cases vary greatly, so the timing of valuation must accommodate that variability.[70] In this subpart we seek to determine the moment of value realization for unsecured creditors and creditors with fixed collateral. We then turn to creditors with floating liens.

1. Realization on the Value of Fixed Collateral: Adequate Protection and Option Value.—For some types of secured loans, the encumbered collateral remains constant throughout the life of the loan or the case. Examples include manufacturing equipment and real estate. For these kinds of collateral, the timing rules are simple, but Value Realization still happens in two stages. The secured creditor is entitled to at least what it would have received had the collateral been sold outside of bankruptcy on the petition date.[71] That entitlement is embodied in the concept of adequate protection, which protects against a decline in the value of collateral during the period when the secured creditor is prevented from exercising state-law collection rights.[72] Courts disagree on whether the value entitled to adequate protection should be measured on the petition date or on the date the creditor requests adequate protection, but the key point is that, for downside purposes, the secured creditor's claim is fixed as of the petition date at the value of the collateral that could have actually been realized.[73]

The Bankruptcy Code could have treated the petition date as a firm realization event for secured creditors for all purposes, but its rules are more complex. The Value Realization on that date is only partial—for downside purposes. If the secured creditor's collateral is sold on a stand-alone basis at a later date (the sale having been delayed in the interest of reorganization) and the collateral has increased in value since the petition date, the secured creditor is entitled to the upside. Realization happens upon sale,[74] and to the extent that the secured creditor is forced to wait to receive its collateral, it is entitled to the value of that option.

70. *See Ice Cube Bonds*, *supra* note 21, at 904–05 ("Judges are faced with the Hobson's choice of permitting a potentially opportunistic sale or possibly overseeing the destruction of value by insisting on the diagnostic process that would reveal the truth. Although the purchaser might be bluffing about time being of the essence, the risk associated with calling that bluff is considerable.").

71. *Id.* at 925.

72. *See* 11 U.S.C. § 361 (defining ways to provide adequate protection when it is lacking).

73. *Id.* § 361, 362. For a discussion of the importance of using "realizable" value as the measure of adequate protection, see text accompanying note 189. The importance of using a realizable value standard is explored in more detail in Janger, *supra* note 19, at 602 ("[E]xtending the . . . rights embodied in 'adequate protection,' or the 'allowed secured claim,' beyond . . . realizable value gives the holder . . . the power to bargain for . . . greater value than . . . would have [been] achieved using . . . prebankruptcy state law ").

74. 11 U.S.C. § 363.

In a traditional reorganization, valuation of assets remains an issue because the debtor retains the collateral rather than selling it.[75] In this context, the Bankruptcy Code provides that Value Realization occurs on the date a confirmed Chapter 11 plan becomes effective; the secured creditor is entitled to the value of its collateral as of that date.[76] In short, secured creditors realize the value of their collateral on plan confirmation or collateral disposition.[77]

There is an important exception to this principle, but it is an exception that proves the rule. Under § 1111(b), if the debtor is retaining collateral under the plan of reorganization, the secured creditor is similarly permitted to delay Value Realization beyond the confirmation date of the plan. The creditor may make this election because it believes that its collateral is appreciating in value and is likely to be sold by the debtor before its lien is satisfied. But delayed Value Realization comes at a cost; the creditor must waive its right to a deficiency claim.[78] Thus, absent an § 1111(b) election, plan confirmation serves as a realization of the value of the secured claim. If secured creditors wish alternative treatment, they must give up any claim to the residual value of the firm beyond their collateral.

There is nothing "inequitable" about allocating to the secured creditor an increase in the value of its collateral upon disposition because there is no change in the relative position of creditors or between secured creditors and the bankruptcy estate. Tracing is not an issue because the identity of the collateral has remained constant. While the secured creditor's right to liquidate its collateral upon default is cut off at the bankruptcy filing, adequate protection ensures that the creditor is not harmed by the delay imposed by the automatic stay. But, if the collateral has increased in value as of the effective date of the plan, then absent the bankruptcy the creditor could have realized on that increased value by liquidating at that point—timing would have been at the creditor's option. The realization rules are, therefore, equitable, reflecting the asset-based nature of the claim and both protecting the creditor's downside as of the petition date, and preserving the right of the secured creditor to realize the value of its collateral when sold.

75. Instead, the debtor continues to operate the business, 11 U.S.C. § 1108, and to use and sell collateral in the ordinary course of the business. 11 U.S.C. § 363(c).

76. 11 U.S.C. § 1129(b)(2)(A).

77. *Id.*; 11 U.S.C. § 363; *see* Janger, *supra* note 19, at 601–02 (discussing the importance of focusing on realizable or realized value).

78. Even if a secured creditor elects alternative treatment under § 1111(b)(2), the secured creditor is guaranteed only the value of the collateral on the effective date of the plan. 11 U.S.C. § 1111(b); *see, e.g.*, *In re* Transwest Resort Props., Inc., 801 F.3d 1161, 1165 & n.3 (9th Cir. 2015) (lender retains lien of $247 million on property worth only $92 million, but forgoes deficiency claim). Moreover, even though, over the course of the case, the secured creditor's lien may have attached to proceeds, the tracing rules and the "equities," discussed later, prevent the security interest from expanding to cover the value of the firm.

2. Value Realization for Firm-Based Claimants (Unsecured Creditors).—Unsecured creditors come in all shapes and sizes, but have in common that they lack property rights in any particular asset of the debtor unless and until they go through the state-law collection process and become judgment lien creditors. Unsecured creditors short of that stage are left with a claim against the residual unencumbered assets—the residual value—of the firm.[79] In bankruptcy, realization does not occur for unsecured creditors until they receive a distribution, whether through a confirmed Chapter 11 plan or after liquidation of unencumbered assets.

Again, the potential outcomes of Chapter 11 add complexity to an otherwise simple story. If a firm is liquidated in Chapter 7, the residual value of the firm will be distributed as cash generated by the sale of assets.[80] In reorganization, however, the distribution can take any number of forms—from cash to debt instruments to stock.[81] If the plan issues debt instruments, value will be uncertain until the debt is repaid. If stock is distributed, the value of the distribution will remain uncertain until the stock is sold. But overall, the secured creditor, as an asset-based claimant, is a fixed claimant with regard to the value of its collateral as of the petition date, but is entitled to any upward variation in the value on its collateral during the case. Unsecured creditors are entitled to the residual value of the firm, whatever that may be. These residual firm-based claimants bear the downside risks and are entitled to the benefits of increases in value of the firm during the Chapter 11 case, at least to the extent that the increase is not attributable to appreciation of the value of encumbered assets themselves.

In the next subpart, we show that current practices, premised on the notion that undersecured, so-called blanket lien creditors are entitled to all residual firm value, do not comply with either the basic structure and principles of state law or the Bankruptcy Code.

E. Value Realization: Harder Questions—Floating Lien Collateral and Tracing

Article 9 of the Uniform Commercial Code allows a secured creditor to write a security agreement that will encumber property a debtor does not yet own. A lien on after-acquired property[82] is often referred to as a floating lien. The right to encumber identifiable proceeds of collateral also is a form of

79. 11 U.S.C. § 726(a). If that residual value is sufficient to pay unsecured creditors in full, then holders of equity "interests" will be treated as the residual claimants. 11 U.S.C. § 1129(b)(2)(C). This doesn't happen all that often.

80. Id.

81. *Id.* § 1123(a)(3).

82. U.C.C. § 9-204 (2014); *see also supra* note 20 and accompanying text (defining after-acquired property).

floating lien.[83] This is where the statutory uses of the term "equity" encounter our architectural principle of Equitable Realization. The complexity of a timing rule for realization on floating lien collateral arises from the nesting of federal and state definitions of several statutory terms: proceeds, equitable principles, and the equities. We must therefore consider how our understanding of Article 9 intersects with § 552 of the Bankruptcy Code. The two together fix the *value* of a secured creditor's claim with regard to post-petition collateral (preserved as an interest in proceeds), for both upside and downside purposes, when the original collateral is sold.

1. Identifiable Proceeds Under Article 9 and the Concept of Equitable Tracing.—An Article 9 security interest in after-acquired property "attaches" to (i.e., becomes effective against) property only if the contract between the parties so provides, and only at the point the debtor acquires rights in it.[84] As noted, assets also float into the lien and become collateral if they are identifiable proceeds of collateral, even if the contract between the parties does not say so. Thus, if a debtor sells inventory for cash, that cash will become collateral as proceeds (assuming it can be traced).[85] Article 9's proceeds doctrine thereby prevents the harm to a secured creditor that otherwise might arise if a debtor sold a creditor's collateral without permission. It preserves the benefit of the secured creditor's bargain.

The comprehensive revision to Article 9 of the Uniform Commercial Code in 2001 expanded the definition of proceeds to include "whatever is collected on, or distributed on account of, collateral" and "rights arising out of collateral."[86] Although it has always been true that an interest in proceeds

83. The term "floating lien" is used to refer to a security agreement that covers property that was acquired by the debtor after the agreement was entered into. Article 9 specifically authorizes such liens. U.C.C. § 9-204(a). If a security agreement covers proceeds (which most security agreements do, pursuant to § 9-203(f)), then the proceeds will "float" into the lien. *See id.* § 9-203(f) ("The attachment of a security interest in collateral gives the secured party the rights to proceeds ").

84. *Id.* §§ 9-203, 9-204. At that point, the secured creditor benefits from the "first to file or perfect" rule, providing that priority relates back to the date on which the secured creditor filed an authorized financing statement that covers the collateral. *Id.* § 9-322(a).

85. *Id.* §§ 9-203(f), 9-315(a). If the debtor sells collateral to a buyer in the seller's ordinary course of business, the buyer purchases the collateral free and clear of the security interest. *See id.* § 9-324(a) (providing that, as a general rule, a "perfected purchase-money security interest in goods other than inventory or livestock has priority over a conflicting security interest in the same goods"); *id.* § 1-201(b)(9) (defining "ordinary course of business"). If the secured party authorizes any other sale free and clear of the security interest, the security interest does not continue with the property into the hands of the buyer. *Id.* § 9-315(a). These scenarios cover many, if not most, commercial situations.

86. *Id.* § 9-102(a)(64) (defining proceeds as "whatever is acquired upon .... disposition of collateral [or] ......on account of[] collateral," and "rights arising out of collateral," including "claims arising out of . . . loss, . . . defects ...... , or damage to[] the collateral" and "insurance payable by reason of . . . loss.......or damage to[] the collateral"); *see also In re* Bumper Sales, Inc., 907 F.2d

can expand the collateral beyond the scope of the original security agreement, these changes led some observers to worry that a secured creditor might button up virtually all of the assets owned by the debtor at any given moment.[87]

a. Defining the Scope of Proceeds.—Notwithstanding the intentions of the drafters or the worries of observers mentioned above, § 9-102(a)(64)'s definition of proceeds is not unlimited, and courts are hesitant to embrace an interpretation of this provision wholly untethered to the concept of disposition of collateral. First, the drafters did not abandon the requirement that proceeds be identifiable. Second, there are limits to what Article 9 security interests can cover. Third, and perhaps most notably, proceeds do not arise simply because business operations were conducted using the collateral.

For example, the U.S. Court of Appeals for the Sixth Circuit has held that accounts receivable are not proceeds of encumbered tractors and trailers used to provide the services that generated those accounts.[88] The court adopted the logic of the district court decision that, "in order for rights to 'arise out of collateral,' they must have been obtained as a result of some loss or dispossession of the party's interest in that collateral, not simply by its use."[89] The Sixth Circuit decision noted further that "[c]ases interpreting the UCC and the associated state statutes in other jurisdictions likewise uniformly support the proposition that revenues earned through the use of collateral are not proceeds."[90]

Also, the U.S. Court of Appeals for the Seventh Circuit has held that a negligence claim for failure to obtain business-loss insurance does not include proceeds of equipment (the original collateral).[91] The unanimous decision explained:

> [T]he claim against Rothschild *was* for failure to obtain business-loss insurance, and we do not see how compensation for that failure can be considered proceeds of collateral. The usual proceeds of collateral are the money obtained from selling it. By a modest extension, as we have just seen, they are money obtained in compensation for a diminution

1430, 1437 (4th Cir. 1990) ("[T]he UCC's definition and treatment of proceeds applies to Section 552 of the Bankruptcy Code."); Lupica, *supra* note 5, at 880–81.

87. Jonathan C. Lipson, *Remote Control: Revised Article 9 and the Negotiability of Information*, 63 OHIO ST. L.J. 1327, 1372–74 (2002) (discussing predicted implications of the expansion of proceeds definition); Lupica, *supra* note 5, at 881; G. Ray Warner, *Article 9's Bankrupt Proceeds Rule: Amending Bankruptcy Code Section 552 Through the UCC Proceeds Definition*, 46 GONZ. L. REV. 521, 528 (2011).

88. 1st Source Bank v. Wilson Bank & Tr., 735 F.3d 500, 501–02, 505 (6th Cir. 2013).

89. *Id.* at 504.

90. *Id.* at 504–05 (citing cases from Ohio, Nevada, and Arkansas).

91. Helms v. Certified Packaging Corp., 551 F.3d 675, 678 (7th Cir. 2008).

> in the value of the collateral. But replacing a business loss is not restoring the value of damaged collateral.[92]

The decision distinguishes between these circumstances and the circumstances under which a commercial tort claim would more likely fit the proceeds definition in § 9-102(a)(64).[93] Here, however, "the business losses exceeded the impairment of the value of the collateral ninefold."[94]

In the Gamma Center bankruptcy, a secured creditor claimed that receivables of a medical diagnostic center were proceeds of a nuclear-stress-test camera and related equipment.[95] The judge rejected the bank's effort to claim the accounts receivable as property "collected on account of" the collateral, namely the camera, in part because:

> [t]o the extent that the accounts receivable include the value of services rendered by the physicians, and are from an indistinguishable mixture of services and other assets of the business operation, they were not exclusively generated by the Camera. The record is also silent as to whether the Camera was the only camera or equipment that was used by Debtor's medical practice.[96]

Factual uncertainties aside, the court rejected the legal argument that accounts receivable should be considered proceeds of the camera in any event. Noting that "it strains the statutory language to conclude that Debtor's accounts receivable constitute something that is 'collected on' the Camera," the court held that "there is no right to payment that is generated by, or arises out of, the Camera itself."[97] The court likewise rejected the argument that accounts receivable and funds collected thereon were "products" of the camera.[98]

Even outside of bankruptcy, these summaries suggest, courts are understandably reluctant to expand proceeds doctrine, to the detriment of other stakeholders, beyond the value-tracing function the proceeds doctrine historically served.[99]

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92. *Id.*

93. *Id.* (describing a situation in which equipment damage was the cause of action, and the damage award restored the original value of the collateral, whereas with business-loss insurance, "[t]here is no necessary relation between the value of collateral and a business loss that results from its being destroyed or damaged").

94. *Id.* at 678–79.

95. *In re* Gamma Ctr., Inc., 489 B.R. 688, 695 (Bankr. N.D. Ohio 2013).

96. *Id.* at 695–96 (emphasis omitted).

97. *Id.* at 696. The court uses pre-2001 Permanent Editorial Board commentary, albeit commentary that sought an expanded definition, to bolster the court's position. *Id.*

98. *Id.* at 697.

99. For example, using the pre-2001 proceeds definition, the Iowa Supreme Court had held that the consumption of feed (the collateral) by pigs did not make the pigs proceeds encumbered by the security interest. Farmers Coop. Elevator Co. v. Union State Bank, 409 N.W.2d 178, 180 (Iowa 1987) (agreeing with the Colorado Court of Appeals that "[i]ngestion and biological transformation of feed is not a type of 'other disposition' within the contemplation of [former 9-306]. For UCC

b. Tracing Identifiable Proceeds.—Crucially, the broader definition of proceeds adopted in 2001 does not change the identifiability requirement in Article 9.[100] To be considered identifiable, the statute mandates that proceeds must be traceable.[101] The burden of establishing the entitlement to proceeds lies with the party asserting that entitlement.[102]

How does a secured creditor prove that proceeds are traceable if they are commingled with other property? The first step to answering that question can be found in § 9-315(b), which discusses two categories of identifiable proceeds:

> [UCC § 9-315](b) . . . Proceeds that are commingled with other property are identifiable proceeds:
>
> (1) if the proceeds are goods, to the extent provided by § 9-336; and
>
> (2) if the proceeds are not goods, to the extent that the secured party identifies the proceeds by a method of tracing, including application of equitable principles, that is permitted under law other than this article with respect to commingled property of the type involved.[103]

For proceeds taking a form other than goods (subsection (b)(2) above), Article 9 essentially incorporates legal or equitable tracing rules from elsewhere in state law.[104] The *Oriental Rug Warehouse*[105] case illustrates this principle. A consignment seller of rugs (deemed to be a secured creditor) sought to claim the debtor/consignee's inventory as proceeds of its collateral. The court explained that the secured creditor could have used the lowest intermediate balance rule to indicate the money in a bank account that was then used to buy more rugs. But, fatal to the claim to proceeds, the secured creditor had made no effort to connect the current inventory to the original collateral.[106]

Similarly, the Arkansas Supreme Court has held that crops are not identifiable proceeds of seeds and other farming supplies (the collateral).[107]

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purposes, the hogs are not proceeds of the feed."). For a discussion of disputes over the purpose of the proceeds definition under pre-2001 law, see Lipson, *supra* note 87, at 1377–78.

100. U.C.C. § 9-315(a)(2) (2014).

101. *Id.* § 9-315(b).

102. *Id.* § 9-103(g).

103. *Id.* § 9-315(b).

104. *In re* Patio & Porch Sys., Inc., 194 B.R. 569, 575 (Bankr. D. Md. 1996) (citing the use of the lowest intermediate balance rule as "well settled").

105. *In re* Oriental Rug Warehouse Club, Inc., 205 B.R. 407 (Bankr. D. Minn. 1997). Although the Oriental Rug Warehouse dispute was adjudicated in bankruptcy court, resolution of this issue turned entirely on state law. *See id.* at 411–14 (stating that U.C.C. § 9-306(4)(d) "eliminates the use of common law tracing theory" and substitutes relevant state law instead).

106. *Id.* at 413.

107. Searcy Farm Supply, LLC v. Merch. & Planters Bank, 256 S.W.3d 496, 502–03 (Ark. 2007). The transaction was in 2001 and, per the court decision, is governed by the version of Article 9 that became effective that year. *Id.* at 503.

The court noted that "[a]ppellants fail to cite any case law or statutory authority that defines crops as the identifiable proceeds of seeds, and without such authority, we decline to do so."[108] Insofar as the court found that a corn stalk is not traceable to the seed that was planted, the court's science may be bad, but the implication is that tracing requires more than a mere formal or logical connection as the value, especially to the extent that the corn traceable to the seeds (as opposed to land, water, and labor) is likely to be relatively small.

The rule for commingled goods in § 9-315(b)(1), excerpted earlier, offers some guidance. It refers to § 9-336, which contains complex rules for goods that are commingled.[109] Under that provision, the perfected security interest in goods continues in the commingled mass as a whole rather than just in the original collateral, but the secured creditor will share pro rata with a conflicting security interest that was perfected at the time the goods were commingled, in proportion to the extent they contributed to its value.[110] This section does not address the key issue with which we wrestle, how a secured creditor (asset-based claimant) fares against firm-based claimants, including judgment creditors, but it illustrates how the value of commingled proceeds can be assessed by reference to inputs. In the case of the corn, the seed would make up a relatively small portion of the value of the ripened stalk.

We explain below how an input-based approach should be used to value proceeds once the debtor files for bankruptcy, even if 100% of the inventory were encumbered under state law.

2. Floating Lien Collateral in Bankruptcy Under Equitable Realization.—To the extent the Article 9 tracing rule has a gap in guidance, § 552 of the Bankruptcy Code fills it by giving effect to Equitable Realization. Bankruptcy does not limit the scope of security interests in original collateral prior to the filing of the bankruptcy petition. However, once a bankruptcy petition is filed, § 552 of the Bankruptcy Code cuts off floating liens and limits a secured creditor's right to after-acquired property to identifiable proceeds of collateral encumbered on the petition date. Subsections 552(a) and (b) work together to address squarely the threat of collateral expansion relative to firm-based claimants that § 9-336 leaves unaddressed outside of bankruptcy. It is here that the term "equities of the case" comes into the picture.

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108. *Id.* at 502.

109. Under U.C.C. § 9-336(a), goods are commingled if they "are physically united with other goods in such a manner that their identity is lost in a product or mass." Goods that are physically united with other goods but maintain their identity are accessions, § 9-102(a)(1), and are governed by a separate priority rule found in § 9-335. *See also* Lipson, *supra* note 87, at 1375–78 (discussing commingled goods rules in Article 9).

110. U.C.C. § 9-336(c), (f).

To reconcile §§ 552(a) and (b), it is necessary to understand how equitable tracing is required to prevent an interest in proceeds under § 552(b) from frustrating the purpose of § 552(a) by swallowing the entire value of the firm. Consider a security interest in existing and after-acquired inventory outside of bankruptcy. The security interest encumbers new inventory when the debtor acquires rights in it. When the debtor sells that inventory, the identifiable proceeds of that sale become collateral.[111] If the secured creditor can show that those proceeds are used to buy more inventory, the security interest will encumber that new inventory. If the secured creditor can show the debtor used inventory-sale proceeds to buy equipment, then the security interest also encumbers that equipment as identifiable proceeds, even though the security agreement's collateral description does not include equipment.[112] If the debtor uses identifiable proceeds to buy materials for a work in progress, the value of which is also expanded through workers' labor, the secured creditor may try to assert an interest in the finished work.[113] Although entitled only to a single satisfaction of the debt, a well-advised lender can use an after-acquired property clause and the proceeds doctrine to assert a security interest over a substantial percentage of the assets of the business—at least until the debtor files for bankruptcy.

If this process were allowed to continue uninterrupted after a debtor filed for bankruptcy, the secured creditor might continue to assert an interest in more and more unencumbered assets of the bankruptcy estate in an effort to encumber all of the value of the firm as proceeds. Indeed, some secured creditor representatives argue that they are entitled to the encumbrance of any firm value created post-petition by the estate. We do not agree with this assertion in any event, but their position would be stronger if the Bankruptcy Code did not include § 552.

Section 552, instead, implements and preserves the Equitable Snapshot principle. A secured creditor's floating lien in bankruptcy is limited to the proceeds of collateral actually owned on the petition date subject to any further limitations imposed by the court based on the equities of the case.[114] The effect of § 552,[115] read together with Article 9, is to fix the collateral at the petition date and to fix its value (subject to adequate protection) upon disposition.

The legal principle that effectuates that timing rule is the concept of equitable tracing, found in both Article 9 and in the Bankruptcy Code. The

111. On the possibility that the security interest may continue in the original inventory even after it is sold to a third party, see *supra* note 85.

112. This example is arguably distinguishable from the facts of *1st Source Bank v. Wilson Bank & Tr.*, 735 F.3d 500, 504 (6th Cir. 2013), discussed *supra* note 88.

113. But only to the extent the encumbered assets to which it has an interest contributed to the final product. *See infra* notes 124–25 and accompanying text.

114. 11 U.S.C. § 552(b)(1) (2012).

115. As noted earlier, 11 U.S.C. §§ 549 and 551 amplify the effect. *See supra* notes 68–69.

value protected by the interest in proceeds is the value realized upon disposition of the original collateral, and not more. Thus, while the collateral securing the creditor's allowed secured claim may expand, the value of the claim will not once the original collateral is sold. The estate and firm-based claimants are entitled to any going-concern increment created by the Bankruptcy Code. Asset-based claimants (secured creditors) are not. Although we cannot promise that courts will consistently interpret the law along the lines we suggest, we contend it is the most accurate reading of the current Bankruptcy Code.

3. The "Equities of the Case" in Bankruptcy.—It is against this background that one must interpret the term "equities of the case" in § 552(b) of the Bankruptcy Code. Although § 552(a) stops floating liens from extending to after-acquired property once the debtor files for bankruptcy, the security interest continues to attach to identifiable proceeds, albeit with an important limitation:

> [I]f the security interest created by such security agreement extends to property of the debtor acquired before the commencement of the case and to proceeds, products, offspring, or profits of such property, then such security interest extends to such *proceeds*, products, offspring, or profits acquired by the estate after the commencement of the case *to the extent provided by such security agreement and by applicable nonbankruptcy law, except to any extent that the court, after notice and a hearing and based on the equities of the case*, orders otherwise.[116]

This language imposes multiple hurdles on a secured creditor seeking to identify property of the bankruptcy estate as proceeds of its collateral after a bankruptcy filing. First, as indicated by the language "to the extent provided by the security agreement and by applicable nonbankruptcy law," the secured creditor must show its interest would have attached under state law. As explained earlier, Article 9 honors the encumbrance only if the proceeds can be traced.[117]

In addition to Article 9's tracing requirement, § 552(b) contains its own tracing rule, allowing a court to limit an interest in proceeds "based on the equities of the case."[118] The somewhat sparse decisional law on the equities

116. 11 U.S.C. § 552(b)(1) (emphasis added).

117. *See In re* Oriental Rug Warehouse Club, Inc., 205 B.R. 407, 411 (Bankr. D. Minn. 1997) (explaining that to establish identifiable proceeds, "the secured party must 'trace' the claimed proceeds back to the original collateral"); U.C.C. §§ 9-315(a)(2), (b) (2014) (imposing the "identifiable" requirement and explaining identifiability); *supra* notes 96–98 and accompanying text. Although § 552 is less explicit on this point, provisions elsewhere in the Bankruptcy Code allocate to the secured party the burden of proof to show the validity, priority, and extent of such interest. *E.g.*, 11 U.S.C. § 363(p) (establishing this point for purposes of disputes over the use, sale, and lease of property of the estate).

118. 11 U.S.C. § 552(b)(1).

of the case is not uniform,[119] but it generally allows, and indeed requires, that a court determine the value of proceeds of pre-petition collateral that have become commingled with other assets and inputs of the bankruptcy estate that are not subject to the security interest. This provision could be rooted in a heightened sensitivity to state law's tracing requirement when a debtor is in bankruptcy, as well as the need for greater attention to relative inputs in this context.

The resulting limit on the scope of collateral is also situated in the concept of an allowed secured claim. Generally, the value of a secured party's collateral is determined when it is sold.[120] That determines the allowed secured claim, and therefore the amount of debt secured by the interest in proceeds.[121]

Courts have interpreted this provision as requiring value tracing to determine a secured creditor's entitlement. For example, when a restaurant's inventory was encumbered by a security interest and that restaurant served food to customers after being transformed in the kitchen, the restaurant's revenue was deemed to be untraceable—not a product of the creditor's collateral.[122] Value added by slicing, dicing, and cooking string beans, or by the wait staff carrying and serving, is not collateral. Similarly, where a farmer's cows were collateral, the resulting milk was deemed proceeds, but the secured creditor's interest in proceeds was limited to the amount attributable to the cow, and not to (1) feed, (2) farmer's labor, (3) the barn and pasture, etc., value added to milk by other inputs is not proceeds of the cow.[123] Value added to inventory as a result of store rent, advertising, and employee labor is not itself collateral. Court decisions along these lines reflect how the Bankruptcy Code takes tracing seriously, carrying forward the requirements state law already imposes, but adding an additional limit—§ 552(a) and (b)—to prevent collateral expansion.

What are the implications of this discussion, and the "equities of the case" language, for the timing of realization for floating-lien collateral? For downside purposes, the rule is the same as for fixed collateral; set the value of inventory and other floating collateral as of the petition date. What happens while the debtor uses inventory to continue to operate during the case? The lien attaches to any cash or accounts created as proceeds. At this point, one

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119. *In re* Terrestar Networks, Inc., 457 B.R. 254, 271–72 (Bankr. S.D.N.Y. 2011) (collecting cases); *Ice Cube Bonds*, *supra* note 21, at 921 n.213.

120. 11 U.S.C. §§ 363, 506(a).

121. *Id.* § 506.

122. *In re* Cafeteria Operators, L.P., 299 B.R. 400, 409–10 (Bankr. N.D. Tex. 2003).

123. *In re* Delbridge, 61 B.R. 484, 491–92 (Bankr. E.D. Mich. 1986) (holding that when a cow encumbered by security interest produces milk post-petition, the milk is proceeds of the lender's collateral in proportion to the extent that the cow's depreciation contributed value to the milk); *see also In re* Package Design & Supply Co., 217 B.R. 422, 425–26 (Bankr. W.D.N.Y. 1998) (describing the "paradigmatic" value-added argument as it relates to milk as proceeds).

of two things will happen. Particularly during bankruptcy, one would expect that the cash will remain traceable, the secured creditor's interest will remain protected, and there will be no valuation problem.[124] By contrast, if the proceeds are untraceable, then the secured party continues to be protected by the requirement of adequate protection, but only for the value of its collateral as of the petition date.[125]

To the extent that the value of the proceeds is greater than the price received for the original collateral, because of, say, value added by employees or by other assets, the equitable-realization principle would be violated by allowing the secured creditor to capture that excess, as it would reallocate unencumbered property to the secured creditor's lien. That, in our view, is what is meant by the equities of the case in § 552(b).

Other provisions of the Bankruptcy Code are consistent with this approach. Section 551 further implements the Equitable Snapshot by preserving the value of an avoided lien for the bankruptcy estate; an undersecured junior lien cannot get a windfall simply because a senior lien is avoided.[126] Sections 551 and 552 thus have an important interaction. Because § 552(a) invalidates after-acquired property clauses as of the bankruptcy petition date,[127] continued operation of an after-acquired property clause in a security agreement would be an unauthorized transfer in violation of § 549, which prohibits unauthorized post-petition transfers of property of the estate.[128] Nothing in the Bankruptcy Code authorizes new collateral (other than traceable proceeds under § 552(b)) to float into the pre-petition security interest. Thus, the collateral expansion would never become part of the "allowed secured claim," and any increase in value would be preserved for the benefit of the estate.[129]

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124. The most common methods would be through a lock box or segregated account, but recall that U.C.C. § 9-315(b)(2) deems even commingled proceeds identifiable through a rule such as the lowest intermediate balance rule, although the secured party bears the burden of that tracing.

125. *In re* Residential Capital, LLC, 501 B.R. 549, 592 (Bankr. S.D.N.Y. 2013); *cf. In re* Granda, 144 B.R. 697, 698–99 (Bankr. W.D. Pa. 1992) (distinguishing *United Va. Bank v. Slab Fork Coal Co.*, 784 F.2d 1188 (4th Cir. 1986), and concluding that "the contract had no intrinsic value when the bankruptcy was filed . . . and therefore, there [was] no value upon which Marine Bank [could] have a lien"); Kenneth Ayotte & David A. Skeel, Jr., *Bankruptcy Law as a Liquidity Provider*, 80 U. CHI. L. REV. 1557, 1591–92, 1606–08, 1613 (2013) (discussing the liquidity-enhancing effect of § 552, noting that "[t]he focus in the case law on fairness and preventing windfalls obscures the true efficiency benefit of the equities-of-the-case exception, which is the prevention of debt overhang," and concluding that "courts should apply the exception more expansively" in some cases).

126. 11 U.S.C. § 551.

127. *Id.* § 552(a).

128. *Id.* § 549.

129. This interpretation gives meaning to the reference in § 551 to § 506(d), though one might have to overlook the Supreme Court's tortured (and widely criticized) reading of that section in another context, in *Dewsnup v. Timm*, 502 U.S. 410 (1992).

4. Summary.—We have developed an asset-based version of the Equitable Realization as it applies to secured creditors with floating liens. It comes largely from a careful reading of §§ 549, 551, and 552 of the Bankruptcy Code, along with § 9-315(b) of the Uniform Commercial Code. A floating-lien creditor's entitlement to adequate protection of the value of its interest in collateral is fixed on the petition date. To the extent that there is appreciation of original collateral, the secured creditor is entitled to such appreciation up to the earlier of disposition of the collateral or the effective date of the Chapter 11 plan. The secured creditor is not, however, entitled to the value of proceeds unless the creditor can satisfy the state law and bankruptcy law tracing requirements. And, once collateral is sold, the allowed secured claim is fixed at the sale price. *Therefore, even if a secured creditor claims a perfected security interest in all of a debtor's hard assets on the petition date, the creditor is not entitled to claim post-petition income from operations unless it can be traced to a post-petition disposition of original collateral, owned on the petition date.*

F. Bankruptcy-Created Value

Chapter 11 is designed to preserve value that would otherwise be destroyed by liquidation. In *Ice Cube Bonds*, we explained that federal bankruptcy laws create or preserve enterprise value in a variety of ways that are not available under nonbankruptcy law.[130] Federal bankruptcy law respects properly executed security interests and, as prior sections discuss, sets forth different distributional rules for asset-based and firm-based claims. As such, the Bankruptcy Code distinguishes between the preserved value that inheres in the firm's encumbered assets and value that does not. Other elements of value are left to be allocated, via negotiation, through the Chapter 11 plan confirmation process.[131] Here, we review forms of bankruptcy-created value and discuss the existing statutory allocation of that value based on our analysis earlier in this Article.

1. The State-Law Baseline.—As both a legal and practical matter, bankruptcy law exists against the background of the value that could be realized under state-law compulsory remedies. As noted above, those procedures are individualistic, limited in scope, and in many cases cumbersome.[132] Even if creditors write contracts that seek blanket liens, we see little evidence that they are able to comprehensively foreclose on such

130. *Ice Cube Bonds*, *supra* note 21, at 919–20.

131. *Id.* at 916.

132. *Id.* at 893–94; *see also* Jacoby, *supra* note 38, at 513–18 (reviewing critiques of state real property foreclosure law processes).

interests unless the debtor simply hands over the keys.[133] To the extent that federal bankruptcy law allows creditors to realize more than they would if limited to state-law remedies, the excess is value created or preserved by the federal bankruptcy mechanism itself.

2. Potential Contributors to the Bankruptcy Premium

a. The Going-Concern Premium.—Federal bankruptcy law enhances state-law remedies in a variety of ways. If an operating business is worth more than the sum of its parts, Chapter 11 makes it possible to preserve that value for any and all stakeholders. When used to sell assets, nationwide service of process and the ability to sell assets free and clear of claims and interests are just the beginning of the advantages offered by the federal bankruptcy system.[134] Because the entire bankruptcy estate is under the jurisdiction of a single court, it is possible to bundle assets in packages that maximize value, in stark contrast to compulsory sales governed by state law. In bankruptcy, one can have a sale of encumbered plus unencumbered assets, a sale of two properties encumbered by different lenders, or, as has become increasingly common, a sale of the entire firm as a going concern. The ability that bankruptcy law offers to capitalize on asset synergies, reorganize, sell off business units, or sell the whole enterprise is the going-concern premium.[135]

b. The Speed Premium.—In addition, going-concern sales in bankruptcy can happen quickly. We have criticized opportunistic hurry-up sales.[136] In some situations, though, value can be preserved best by moving expeditiously. Again, bankruptcy allows this to happen where state process would not.[137]

c. The Governance Premium.—Outside of bankruptcy, general default by a debtor can trigger an involuntary liquidation—sometimes at fire-sale prices. The timing of the sale is not driven by value maximization.[138] The

133. Even then it is not so simple. For example, if they used a so-called "deed-in-lieu" transaction, the doctrine of equitable merger would allow junior interests to ride through. *See infra* text accompanying note 166.

134. *Ice Cube Bonds*, *supra* note 21, at 919–22.

135. One could separately characterize the ability to capitalize on asset synergies—where two assets sold together are worth more than the same assets sold separately—as an "assemblage" premium. Here, for simplicity's sake, we conceptualize that as part of the going-concern premium given that bankruptcy law increases value by creating the opportunity to keep assets together.

136. *Ice Cube Bonds*, *supra* note 21, at 895.

137. *Id.* at 910–11.

138. Although Article 9 of the Uniform Commercial Code tries to deal with this issue by requiring that the timing of the sale be commercially reasonable, U.C.C. §§ 9-610, 9-627 (2014), a secured lender's incentive on timing may not align with what would maximize the value of the firm as a whole, and a court would not rule on the transaction's compliance with the law unless challenged *ex post*. In addition, Article 9's flexibility cannot solve the problem if a lender is trying to sell a mix of real-property collateral, Article 9 collateral, and collateral excluded from both regimes.

ability to operate the business in Chapter 11 creates the going-concern premium described above. Law and economics scholars have traditionally viewed Chapter 11 as giving the decision to a class of residual owners whether, when, and how to reorganize or liquidate.[139] In this regard, Chapter 11 also allows the stakeholders to postpone realization, whether through reorganization (perhaps business conditions will improve) or sale (perhaps stabilizing the business will increase its sale price).[140] In that respect, the Governance Premium is a limited option. It gives stakeholders the opportunity to determine how to dispose of the firm within the confines of the case. In the absence of federal bankruptcy law, the value of that limited option would be lost, particularly if the debtor was already in default.[141]

3. Value Allocation, Tracing, and Timing: A Review.—The Equitable Snapshot principle and Equitable Realization serve important roles in allocating value in a bankruptcy case. Unsecured creditors' pro rata share is fixed on the bankruptcy petition date, but the value of the firm remains variable. Secured creditors' relative asset positions, vis-à-vis each other and vis-à-vis the bankruptcy estate as a whole, are also fixed on the petition date even as the value of their collateral remains variable. Any increase in bankruptcy-created value not tied to specific collateral is allocated to the estate.

Implementation of Equitable Realization for secured creditors, thus, has three components: value, timing, and tracing. Secured creditors' downside risk is fixed at the realizable value of their collateral on the petition date by their entitlement to adequate protection. Secured creditors can capture the upside if the value of their original collateral increases during the case. A slightly different timing rule is necessary for collateral that is liquidated during the case. In that instance, value is determined at the time of, and by, the sale. The security interest continues in identifiable proceeds of the collateral received as the purchase price, but the creditor's allowed secured

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139. *See, e.g.*, Lynn M. LoPucki, *The Myth of the Residual Owner: An Empirical Study*, 82 WASH. U. L.Q. 1341, 1341–42 (2004) (highlighting law and economics scholars' idea to give residual owners, who have an economic interest in the firm, responsibilities concerning the fate of the bankrupt firm). This construct has long been understood to be imperfect. The first objection is empirical. Particularly in large public company bankruptcies, it will not be clear exactly which class of claims or interests is the residual owner and, thus, in the optimal position to make the best decisions on the fate of the company. *Id.* at 1361. The second objection is doctrinal. The Bankruptcy Code gives a new set of governance rights to creditors, such as in the form of voting, that do not exist under state law. *See, e.g.*, 11 U.S.C. §§ 1126, 1129 (2012) (setting forth voting requirements and plan-confirmation requirements that depend on creditor support). But, at least formally, the law still leaves significant control in the hands of debtor management to propose whether to reorganize, liquidate, or something in between. LoPucki, *supra* note 7, at 1368. The fact that secured creditors might use contracting devices and financial incentives to sway debtor management in its exercise of governance rights is a different issue.

140. *Ice Cube Bonds*, *supra* note 21, at 920.

141. *Id.* at 920–21.

claim, and hence its interest in any proceeds, is fixed by the price realized on disposition of its collateral.

4. Equitable Realization and the Single Waterfall.— The implications of this analysis are far reaching for those who would claim that value should be distributed in bankruptcy according to a single waterfall. A careful analysis of the way in which the Bankruptcy Code administers the line between secured claims and unsecured claims—asset-based and firm-based priority—ensures that any time that a debtor delays realization in Chapter 11 there will be two value waterfalls, one for value traceable to assets owned on the petition date, and the other for going-concern and other bankruptcy-created value. Indeed, this will be true even if a secured creditor asserts a blanket lien on the firm's assets. Indeed, it would be true even if it were actually possible to encumber all of the firm's "value" as of the petition date.

II. The (Positively) Normative Case for Equitable Realization

In Part I, we showed that existing law distinguishes between asset-based claims and firm-based claims against an insolvent debtor—even when the debtor and its secured lenders intend otherwise. Part III will explore how the ABI Commission Report, while not entirely consistent on this point, recommends that this distinction be maintained, and even reinforced. Here, in Part II, we confront the prescriptive question of whether this interpretation and outcome is desirable. In other words, should the secured creditor's priority be limited to the realized or realizable value of its assets? And, consequently, should the going-concern or other bankruptcy-created increment of value be allocated to the estate and treated, in effect, as equity, owned by the firm-based claimants? More importantly, should such an equity cushion be mandatory—imposed even if a careful secured party perfectly executes a comprehensive security interest and meticulously tracks identifiable proceeds?

We conclude that secured creditors *should not* be able to encumber all of a company's value.[142] Limiting the scope of entitlements of asset-based creditors reflects and instantiates the long-standing principle, manifested in current tort, property, corporate, and commercial law, that a debtor ought to maintain adequate capital to satisfy its obligations, whether they arise as a matter of contract, tort or otherwise; if they do not, complicit owners may

142. As the text indicates, we write here to justify the limits that exist under current law. But this position connects us to a conversation that one of us has been through before. *See* Janger, *supra* note 14, at 606 (reviewing the "efficiency of secured credit" debate to that point). The conversation has deep historical roots, going back at one level to the year 1603 and *Twyne's Case*, (1601) 76 Eng. Rep. 809, 816; to Grant Gilmore, Gilmore, *supra* note 1, at 624–28, and, more recently, to reform proposals to limit the scope of security interests floated when Article 9 was being revised in the late 1990s. Elizabeth Warren, *Making Policy with Imperfect Information: The Article 9 Full Priority Debates*, 82 CORNELL L. REV. 1373, 1388–89 (1997).

lose the benefit of limited liability,[143] the officers might be liable for breach of fiduciary duty,[144] and, as we will discuss below, asset-based claimants may have their liens or other property rights invalidated. Maintaining the distinction between asset-based and firm-based claims enforces this principle when the debtor becomes insolvent. The implicit and explicit inalienability rules we observe above, and the principles justifying these rules, share a common anti-judgment-proofing theme from which we derive the normative case for limiting the scope of security interests. Those rules and principles reinforce our view that, as a positive matter, current law already imposes such limits, even outside of bankruptcy. Perhaps more significantly, the rules and principles (that exist outside of lien law) suggest that changing the law to permit encumbrance of a firm's entire value is not so easy as adding a few discrete amendments to either Article 9 or the Bankruptcy Code.

Legal remedies outside of bankruptcy law are calibrated based on the assumption that the debtor is solvent.[145] Contracting parties are entitled to the benefit of their bargain and tort claimants are entitled to compensation for harm. In this regard, the limits of property law must be evaluated more broadly in the context of debtor–creditor law, corporate law, and basic principles of contract and tort damages. Insolvency law must address the moral hazard that emerges in, and on the precipice of, bankruptcy, due to insufficient "skin in the game." But insolvency law is not the only game in town. In our view, two sets of legal principles operating well beyond the insolvency sphere push back against judgment proofing and the resulting moral hazard.[146] Our case for limiting the scope of blanket liens fits comfortably within these normative principles, and gives them effect in bankruptcy—when it matters.

One set of policies aims to prevent externalities both within and outside of a firm, including a requirement that an operating entity maintain reasonable capital (externalizing risk) and a prohibition on contractual

143. *See, e.g.*, Trs. of the Nat'l Elevator Indus. Pension v. Lutyk, 140 F. Supp. 2d 447, 458 (E.D. Pa. 2001) ("Whether a corporation is grossly undercapitalized for the purposes of the corporate undertaking is of particular importance in a veil-piercing analysis . . . ."); West v. Costen, 558 F. Supp. 564, 586 (W.D. Va. 1983) ("[U]ndercapitalization is a ground for piercing the corporate veil . . . .").

144. Albeit subject to the business judgment rule.

145. This point is implicit in the "make whole" goals of contract and tort damages. *See* U.C.C. § 1-305 (2014) (calling for the Code's remedies to be "liberally administered to the end that the aggrieved party may be put in as good a position as if the other party had fully performed"); RESTATEMENT (SECOND) OF TORTS § 903 (AM. LAW INST. & UNIF. LAW COMM'N 1979) (defining "compensatory damages" with reference to restoring the damaged person to his or her original position).

146. *See* Lynn M. LoPucki, *The Death of Liability*, 106 YALE L.J. 1, 4–5 (1996) (showing that modern technology and lending practices, including secured credit, facilitate judgment proofing and undercut the effectiveness of traditional liability rules); Gilmore, *supra* note 1, at 627 (advocating the financing assignee be incentivized to "investigate, supervise, and control" its transactions); Janger, *supra* note 14, at 606 (reviewing the "efficiency" literature).

claimants agreeing to "squeeze out" claimants absent from the negotiating table (altering risk or subordinating particular claimants within the firm). A second set of policies, rooted in corporate finance and corporate governance theory, seek to limit principal–agent problems through implementing governance by the residual claimant (an agency principle). Again, bankruptcy law's governance and distributional principles do not create these concepts anew; they emanate from, and are embodied in, *non-bankruptcy* law. Bankruptcy law enforces them to a greater extent than is commonly realized by distinguishing between asset-based and value-based claims in the way we established in Part I.

A. Externalities, Agency, and the Judgment-Proof Problem: The Normative Case for Limiting Liens

1. Externality: Undercapitalization, Wrongful Trading, Deepening Insolvency.—A family of existing doctrine imposes a duty on a firm to maintain reasonable capital. Sometimes the doctrine does so by imposing liability, while other times it invalidates transfers of property. One principle behind these rules is that a firm's owners should bear the risk of its activities vis-à-vis both consensual and nonconsensual creditors. Moreover, the owner should not be able to manipulate asset allocations or capital structure to shift risk from equity to debt. Insolvency and undercapitalization undercut that risk-bearing goal.

We start with what has been recently renamed the Uniform Voidable Transactions Act but was long known as fraudulent transfer law.[147] Transfers of property (including the creation of a security interest) can be avoided if made with the actual intent to hinder, delay, or defraud creditors.[148] A transfer of property also may be avoided, even in the absence of ill intent, if at the time of or after the transfer the debtor has "unreasonably small capital" and the transfer is for less than reasonably equivalent value.[149] As a practical matter, financial vulnerability operates as a limit on the free alienability of property—including granting a security interest. If you are in serious financial trouble, "[you] must be just before you are generous."[150] The fraudulent conveyance concept has been part of the law for hundreds of years, both implicitly and explicitly.[151] It sets a baseline and longstanding principle

147. Kenneth C. Kettering, *The Uniform Voidable Transactions Act; or, the 2014 Amendments to the Uniform Fraudulent Transfer Act*, 70 BUS. LAW. 777, 778–79 (2015).

148. UNIF. VOIDABLE TRANSACTIONS ACT § 4(a)(1) (UNIF. LAW COMM'N 2014).

149. *Id.* § 4(a)(2), § 4 cmt.5.

150. Bentley v. N.Y. Life Ins. Co., 488 N.W.2d 77, 81 (S.D. 1992) (Henderson, J., dissenting) (describing the phrase as an "old legal maxim").

151. Transferring property while insolvent was always a "badge of fraud." *See* Twyne's Case (1601) 76 Eng. Rep. 809, 816; 3 Co. Rep. 80 a, 82 b (declaring that all feoffments, gifts, and grants to delay, hinder, or defraud creditors shall be void); UNIF. FRAUDULENT CONVEYANCE ACT § 7

in favor of solvency as a prerequisite to free alienability of property rights, including security interests. As such, it has powerful implications for our analysis of the scope of secured creditors' rights in bankruptcy.

More generally, capital requirements are pervasive. Banks are subject to capital rules.[152] Accounting rules require officers and directors to maintain reasonable reserves against anticipated liabilities, and officers and directors are subject to a duty of reasonable care in this regard.[153] The duty is stated starkly outside of the United States. In the U.K., officers and directors must refrain from "wrongful trading"—continuing to do business while insolvent.[154] In civil-law countries, officers and directors may be found criminally liable if they fail to commence a bankruptcy case in a timely fashion; firms must immediately commence a public proceeding when they become insolvent.[155]

As these examples suggest, while some countries implement the concept as a rule, U.S. law lacks an explicit duty to commence insolvency proceedings. The principle is instead implemented through theories such as equitable subordination and fiduciary duties.

Equitable subordination empowers courts to subordinate the claim and invalidate the lien of a creditor that has engaged in some form of inequitable conduct plus advantage taking.[156] Classic examples occur when an insider of an insolvent firm loans money to the firm rather than making an equity contribution. Again, the theory is that an owner of an insolvent company ought to be contributing equity to keep the firm in business rather than subordinating or diluting existing creditors without consulting them. If a loan

(NAT'L CON'F OF COMM'RS ON UNIF. STATE LAWS 1918) (stating that conveyances made with actual intent to hinder, delay, or defraud creditors is fraudulent). Constructive fraud has been with us for close to 100 years. For more history, see generally Jonathan C. Lipson, *Secrets and Liens: The End of Notice in Commercial Finance Law*, 21 EMORY BANKR. DEV. J. 421, 437–39 (2005).

152. *See* Julie Andersen Hill, *Bank Capital Regulation by Enforcement: An Empirical Study*, 87 IND. L.J. 645, 647 (2012) (explaining that banks are required by law to maintain specific ratios of capital to assets).

153. *See, e.g.*, DIV. OF SUPERVISION AND REGULATION, BD. OF GOVERNORS OF THE FED. RESERVE SYS., COMMERCIAL BANK EXAMINATION MANUAL § 5000.1 (2013) ("A board of directors has the responsibility for maintaining its bank on a sufficiently capitalized basis.").

154. *See, e.g.*, Grant v. Ralls [2016] EWHC (Ch) 1812, [14] (Eng.) (describing a party's argument that since the justice had found that trading occurred after there was no reasonable prospect of avoiding insolvency that there had been "wrongful trading").

155. For a helpful discussion of the duties of officers and directors when a firm is in the zone of insolvency, see U.N. COMM'N ON INT'L TRADE LAW, UNCITRAL LEGISLATIVE GUIDE ON INSOLVENCY LAW—PART FOUR: DIRECTORS' OBLIGATIONS IN THE PERIOD APPROACHING INSOLVENCY, at 9, U.N. Sales No. E.13.V.10 (2013), http://www.uncitral.org/pdf/english/texts/insolven/Leg-Guide-Insol-Part4-ebook-E.pdf [https://perma.cc/N7HS-TMLM].

156. *See In re* AutoStyle Plastics, Inc., 269 F.3d 726, 744 (6th Cir. 2001) (discussing the three-part standard for establishing equitable subordination). *See generally* Juliet M. Moringiello, *Mortgage Modification, Equitable Subordination, and the Honest but Unfortunate Creditor*, 79 FORDHAM L. REV. 1599, 1621–38 (2011) (reviewing the history of equitable subordination doctrine use in bankruptcy and its implications for current lending arrangements).

facilitates actions that harm the other creditors, courts have, in effect, converted those debts to equity, subordinating the obligation to other creditors.[157] Indeed, while it remains controversial, some courts have found an independent cause of action under a theory of deepening insolvency, where a creditor prolongs the debtor's obligations for the purpose of recovering its own claim to the detriment of others.[158]

As noted above, common to these doctrines is the principle that a party capturing the benefits of ownership should bear the risk.[159] The corporate form limits liability, but capital must be adequate. Owners and favored creditors should not be able to gamble with investors' (and nonconsensual creditors') money without internalizing the cost of resulting harms. Capitalization rules guard against owners imposing risks on consensual creditors as well as on nonconsensual creditors by elevating their own interests (or the interests of preferred creditors) over those claimants for whom repayment is already in jeopardy. Regarding consensual creditors, these rules protect the contractual priority of debt over equity. With respect to nonconsensual creditors, they guard against owners imposing risk beyond the boundaries of the firm. Taken together, these remedies guard against judgment proofing, "moral hazard created by insolvency," and, in Lynn LoPucki's terms, the "death of liability."[160]

By functionally establishing a requirement of adequate capitalization,[161] and enforcing it with lien avoidance or subordination, the above-mentioned doctrines recognize that in insolvency situations, nonconsensual liability should have priority over certain property interests. In this regard, Lynn LoPucki has argued for a "tort-first regime."[162] To the extent that adequate capitalization includes the ability to pay operating creditors as well, the point may not be so limited. Indeed, the legal doctrines we have described above

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157. *See Autostyle Plastics*, 269 F.3d at 744.

158. Some courts recognize a "deepening insolvency" cause of action or theory of damages, alleging that creditors prolong a corporation's insolvency by permitting the corporation to continue to incur bad debt. *See, e.g.*, Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 344 (3d Cir. 2001) (defining deepening insolvency as "the fraudulent expansion of corporate debt and prolongation of corporate life."). Courts are split on whether to recognize an independent cause of action or a measure of damages based on deepening insolvency. *See, e.g.*, *In re* CitX Corp., 448 F.3d 672, 677 (3d Cir. 2006) ("Although we did describe deepening insolvency as a 'type of injury,' and a 'theory of injury,' we never held that it was a valid theory of damages for an independent cause of action." (citations omitted)); *Official Comm. of Unsecured Creditors*, 267 F.3d at 344 ("We conclude that 'deepening insolvency' constitutes a valid cause of action under Pennsylvania state law "); *In re* Amcast Indus. Corp., 365 B.R. 91, 119 n.19 (Bankr. S.D. Ohio 2007) ("While declining to recognize deepening insolvency as a valid cause of action, the court believes that the concept may be useful as a measure of damages for breach of fiduciary duty or commission of an actionable tort."). Some courts have rejected the theory entirely. *See, e.g.*, *In re* Glob. Serv. Grp., 316 B.R. 451, 458 (Bankr. S.D.N.Y. 2004).

159. *See supra* section I(D)(2).

160. LoPucki, *supra* note 146, at 6–7.

161. Indeed, functionally a tort of undercapitalization.

162. LoPucki, *supra* note 32, at 1913.

do not single out tort claims, nor do they constitute a clean and simple capital requirement. Nonetheless, they protect debt claims generally against judgment proofing, and are similar to proposals by Bebchuk and Fried,[163] and separately by Elizabeth Warren,[164] that secured creditor collateral be limited to preserve an equity cushion. We approvingly suggest, indeed we claim, that existing law (including Equitable Realization) already imposes such a cushion.[165]

2. Intrafirm Externality: Anti-Roll-Up, Merger.—A second family of doctrines deals more directly with externalities within a firm. Under the doctrine of merger, if a secured creditor becomes the owner of liened property through a deed in lieu of foreclosure, the lien merges into the "fee" interest, and the right to foreclose on the lien is extinguished.[166] Thus, if other liens exist on the property, the merger "elevates" these subordinate liens.[167] The problem with this doctrine for the secured creditor is that gaining title prevents the foreclosure of any junior interests encumbering the property.[168] If the debtor offers the secured creditor a deed in lieu of foreclosure, and the

163. Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857, 866 (1996).

164. Warren, *supra* note 142, at 1388–89.

165. Barry Adler has argued in favor of both torts-first priority and blanket liens, suggesting that one solves the problem of the other. *See* Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 STAN. L. REV. 311, 340 (1993) ("Ideally, nonconsensual claimants would have highest priority in any sort of firm."); Adler, *supra* note 6, at 814 (arguing that nonconsensual claimants ideally would have higher priority—or, torts-first priority—to overcome inefficient administrative and monitoring costs, but that these gains would not overcome the efficiency of robust priority for secured creditors; knowing this, bankruptcy law should not hinder debtors from granting blanket liens). We agree, but suggest that a requirement of adequate capitalization might work as well. *See* Bebchuk & Fried, *supra* note 163, at 861 & n.14, 911–12; Kenneth N. Klee, *Barbarians at the Trough: Riposte in Defense of the Warren Carve-Out Proposal*, 82 CORNELL L. REV. 1466, 1469–71 (1997).

166. 4 POWELL ON REAL PROPERTY § 37.32[1] (Michael Allan Wolf ed., 2016); *see also id.*:

> There is a merger whenever the mortgagor transfers its equity of redemption to the mortgagee, as in the case of a settlement involving transfer of a deed to the property as a substitute for foreclosure, commonly called a "deed in lieu of foreclosure" .... The doctrine of merger arises from the fact that normally there is no purpose in separately recognizing two parts of the entire bundle of ownership rights when all of these rights are held by one owner. Accordingly, the law courts have followed the rule of extinction of the lesser right whenever the requisite facts are present.

The question of whether a merger occurs depends on the intent of the parties. *In re* Apex Carpet Finishers, Inc., 585 F.2d 1323, 1325 (5th Cir. 1978); Downstate Nat'l Bank v. Elmore, 587 N.E.2d 90, 94 (Ill. App. Ct. 1992).

167. POWELL ON REAL PROPERTY, *supra* note 166 § 37.32[2].

168. *See* John A. Walker, Jr., *Simple Real Estate Foreclosures Made Complex: The Byzantine Tennessee Process*, 62 TENN. L. REV. 231, 261 (1995) ("[I]f the mortgagee accepts a deed in lieu of foreclosure and there is a junior lien on the property, the mortgagee may well be confronted by the merger doctrine."). Some courts have questioned whether the result of merger is desirable, in that it may prevent the fee owner from foreclosing junior liens. Ann M. Burkhart, *Freeing Mortgages of Merger*, 40 VAND. L. REV. 283, 301–02 (1987). But, as discussed above, there is a strong case that the effect of the doctrine is to protect the equitable interests of the junior claimants.

creditor takes the offered title, a junior interest (whether a consensual secured claim or judgment lien) will survive, and the secured creditor will lose the ability to foreclose on the junior interest.[169]

Looking at the doctrine from another perspective, however, shows its virtue and relevance to our discussion. Merger protects junior lien holders whose interests might "be in the money" from a deal between the senior creditor and the debtor that squeezes out the junior creditor's interest without compensation or process. Indeed, the doctrine serves the same function for competing secured creditors that the absolute-priority rule accomplishes for unsecured creditors and equity holders.[170]

The doctrine has stark implications when considering the entitlements of creditors claiming blanket liens against a company in bankruptcy. Outside of bankruptcy, the doctrine of merger requires that the lender foreclose to address the junior lien. In modern bankruptcy, though, blanket-lien creditors often assert the right to control the bankruptcy process, sell the debtor's assets free and clear of junior interests or credit bid and take title to them free of junior interests.[171] They seek, in effect, to use the bankruptcy-sale process to override the doctrine of merger. Such an override should not be permitted lightly. The merger doctrine calls into question whether a blanket-lien creditor should be permitted to foreclose those junior liens without complying with the process for confirming a Chapter 11 plan.

Another doctrine addressing intrafirm externality is the doctrine of true sale, or sale intended as security. Under this doctrine, a sale of an asset will be treated as a mortgage or secured transaction, regardless of what the parties labeled the transaction, if, in substance, the transaction was entered into for the purpose of securing a debt obligation.[172] The true-sale doctrine, and the associated right of redemption, protects the debtor's equity from a secured

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169. *See* PATRICK J. ROHAN, REAL ESTATE FINANCING: TEXT, FORMS, TAX ANALYSIS § 31.40 (2016):

> [T]he deed in lieu [of foreclosure] does not cut off junior liens. The mortgagee becomes owner, but the property remains subject to the junior lien. The mortgagee may also need to defend against junior mortgagee assertions that the merger doctrine applies, *i.e.*, that the fee title and mortgage have merged in the mortgagee, thus putting the junior mortgagee in first priority.

170. If there is equity in the property, the junior lienholder is protected by its ability to bid at the foreclosure sale and by outbidding the senior foreclosing creditor.

171. *See Ice Cube Bonds*, *supra* note 21, at 869–70, 917.

172. *See* Kenneth C. Kettering, *True Sale of Receivables: A Purposive Analysis*, 16 AM. BANKR. INST. L. REV. 511, 512 (2008) ("This paper analyzes the doctrine of true sale as it relates to sales of receivables—or, to say the same thing in another way, the doctrine that calls for a court in some circumstances to recharacterize a sale of receivables as a loan secured by those receivables."); John A. Pearce II & Ilya A. Lipin, *Special Purpose Vehicles in Bankruptcy Litigation*, 40 HOFSTRA L. REV. 177, 197–99 (2011) (discussing how courts determine whether a transfer of a financial asset is a "true sale" or a loan); *see also* Edward J. Janger, *The Death of Secured Lending*, 25 CARDOZO L. REV. 1759, 1762–67 (2004) (discussing the importance of the true-sale doctrine in connection with asset-backed securitization).

creditor who might try to short-circuit the procedural protections of foreclosure law and use a default as an opportunity to grab property value beyond the amount of the debt. In addition to protecting the debtor, the doctrine preserves assets for junior claimants, including unsecured creditors, in the event of the debtor's insolvency.

Some readers might not be satisfied with these externality-based reasons for limiting a debtor's ability to fully encumber its value. If a debtor can sell property for any price to raise money, why can't the debtor fully encumber its later value? Two responses come to mind. First, the implications of a debtor's decision-making process at the moment of borrowing are different for a sale and for a secured transaction. A debtor engaging in a true sale of an asset transfers any upside (option value), as well as any downside risk associated with the asset, to the buyer. A debtor engaging in a borrowing transaction and thus encumbering an asset with a security interest retains any value of the property in excess of the secured debt. And, even if the secured creditor is undersecured, the debtor also retains the option value—the possibility that the value will increase—on the collateral until it is sold. However, when the collateral is sold, if there is a deficiency, that claim shares with the unsecured creditors. Secured credit (or a sale intended as security) distorts investment incentives in ways that true sales do not. Debtors can conspire with secured creditors to have their cake (upside) and eat it too, while shifting downside risk onto other creditors.[173]

Conceptualized this way, the doctrine of true sale can be understood as a desirable creditor and stakeholder protection that limits negative externalities. In this respect it is consistent with the other commercial- and corporate-law doctrines and policies that justify restricting the ability of a debtor to precommit bankruptcy-created value to a secured creditor.

As already reviewed, fraudulent-transfer (now voidable-transactions) law also prevents property transactions from creating externalities.[174] If a debtor is insolvent or has unreasonably small capital, conveying an asset without receiving reasonably equivalent value shifts risk from one set of claimants to another, and the transaction can be avoided.[175] Although solvent individuals and entities generally can do what they want with their assets, creditors and courts have the power to police and claw back transactions of financially distressed debtors.

Taken together, the merger, true-sale, and fraudulent-transfer doctrines ensure that when an insolvent debtor conveys an interest in property, including a security interest, the transfer does not increase the risk faced by other creditors.

173. Danielle D'Onfro, *Limited Liability Property*, 38 CARDOZO L. REV. (forthcoming 2018) (manuscript on file with authors).

174. *See supra* notes 148–51 and accompanying text.

175. UNIF. VOIDABLE TRANSACTIONS ACT § 4(a)(2) (UNIF. LAW COMM'N 2014).

3. Value Maximization: Governance/Principal–Agent.—The preceding discussion shows that maintaining a distinction between asset-based claims and firm-based claims forces the firm to internalize externalities and preserves intrafirm priorities. The distinction has important governance implications as well. Corporate finance theory tells us that decision-making authority ought to be situated with the residual claimants.[176] Decision makers need to have capital at risk. In a hierarchical capital structure, the junior-most claimant will garner the benefits of success and bear the costs of failure.[177] This is sometimes referred to as the single-owner theory of corporate governance.[178] When a company becomes insolvent, unsecured creditors can, and often do, become the residual claimants.[179] The absolute-priority rule in Chapter 11 enforces that concept, as do various nonbankruptcy legal doctrines discussed above. In that regard, it becomes especially important to maintain the distinction between asset-based and firm-based claims, the former of which is never residual with respect to the firm.

The key point, embodied in the concept of the allowed secured claim, is that a property-based claim is not variable. It is tied to the value of the collateral but does not change with the value of the firm. A deficiency claim may be variable, but is treated like any other unsecured claim. As such, the secured portion of the undersecured creditor's claim should not be entitled to firm governance rights. More importantly, the secured creditor should not be able to piggyback its secured claim onto its deficiency claim, lest it exercise more power than its at-risk portion warrants.

B. *The Puzzle of Secured Credit Revisited—Liens versus Blanket Liens*

1. Secured Credit Efficiency: The Early Debate.—This analysis raises a larger question: why does the U.S. legal system allow and incentivize secured lending at all? Is asset-based lending efficient?[180] We ask this question for two reasons: (1) to justify some degree of asset-based lending; and (2) to

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176. *See* ADOLF A. BERLE JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 123 (1932) (explaining the principal/agent problem that arises with dispersed ownership of shares).

177. *See* Alan J. Meese, *The Team Production Theory of Corporate Law: A Critical Assessment*, 43 WM. & MARY L. REV. 1629, 1631 (2002) (explaining how the separation of ownership exposes shareholders to both costs and benefits).

178. *See id.* at 1631, 1634 (describing the single-owner approach as an account of corporate governance that implies a recognition that directors and managers run a corporation to maximize the wealth of a single owner).

179. Frederick Tung, *The New Death of Contract: Creeping Corporate Fiduciary Duties for Creditors*, 57 EMORY L.J. 809, 831–32 (2008).

180. This question has been called the "puzzle of secured transactions." Paul M. Shupack, *Solving the Puzzle of Secured Transactions*, 41 RUTGERS L. REV. 1067, 1068 (1989); *see also* Lois R. Lupica, *Asset Securitization: The Unsecured Creditor's Perspective*, 76 TEXAS L. REV. 595, 619–21 (1998) (reviewing literature considering secured credit efficiency).

determine whether efficiency justifications for secured credit might imply limitations to its scope.

The classic efficiency-based justification is that secured credit facilitates trading patterns that capitalize on monitoring advantages of particular lenders.[181] Such a rationale may justify priority for factors (buyers of receivables), equipment lenders, and other specialized secured lenders. Indeed, this explanation fits hand in glove with the secured credit system prior to the adoption of Article 9. The explanation does not, however, justify allowing a creditor to take a blanket lien on all of a debtor's assets, or on the overall value of a firm, particularly in today's secured credit system. We do not see why a blanket-lien holder would have a monitoring advantage over an unsecured lender—a point to which we return below.

Another efficiency-based justification for secured credit, and particularly blanket liens, takes us back to the alleged single waterfall and also falls short: to impose a hierarchical capital structure and allow a senior creditor to serve as a "sole owner" in the event of debtor insolvency.[182] To advocates of this position, the Bankruptcy Code's default rules are second-best options when compared to a prenegotiated bankruptcy scheme.[183] The link is perhaps best explained by Jay Westbrook's observation that any such prearranged bankruptcy scheme requires all of the value of the firm to be committed.[184] By necessity, this approach would harm nonconsensual creditors, later creditors, and probably employees. In addition, for the reasons we have discussed above, this sole-control-by-a-senior-creditor model flies in the face of nonbankruptcy liability, agency, and governance principles. Indeed, the very purpose of such schemes may lie not in value creation, but rather in risk alteration and negative externality.[185]

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181. *See* Thomas H. Jackson & Anthony T. Kronman, *Secured Financing and Priorities Among Creditors*, 88 YALE L.J. 1143, 1153–54 (1979) (arguing that the monitoring required for secured loans is likely less than for unsecured loans); Saul Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 YALE L.J. 49, 49, 56 (1982) (asserting that the required monitoring for secured debt largely solves freeriding); Robert E. Scott, *The Truth About Secured Financing*, 82 CORNELL L. REV. 1436, 1448 n.18 (1997) (portraying early work on agency costs in secured debt as focused on reduced monitoring costs); *see generally* Lupica, *supra* note 180, at 619–21 (framing and reviewing the arguments for and against the efficiency of secured debt since 1979).

182. This is the position taken by Baird and Jackson, as well as by Alan Schwartz. Douglas G. Baird & Thomas H. 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, 104–06 (1984); *Fairness*, *supra* note 4, at 166–67. It is important to recognize that a hierarchical structure can be accomplished without any secured credit. Secured credit is an exception to, rather than an essential feature of, this ideal hierarchical capital structure.

183. *See, e.g.*, Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, *in* CORPORATE BANKRUPTCY: ECONOMIC AND LEGAL PERSPECTIVES 395–407 (Jagdeep S. Bhandari & Lawrence A. Weiss eds., 1996).

184. Jay Lawrence Westbrook, *The Control of Wealth in Bankruptcy*, 82 TEXAS L. REV. 795, 799 (2004).

185. *See* Janger, *supra* note 14, at 604–06; Shupack, *supra* note 14, at 1069 (explaining "the creditor to whom the collateral is assigned will reduce the charges made for a loan" due to the

It also has been suggested that lenders are risk averse—absent security, credit might be constrained. Some argue that secured credit primes the pump and creates a positive externality in increased liquidity of debt and reduced credit cost.[186] Given the absence of data to determine the sizes of the negative and positive externalities of secured credit relative to each other and to other credit enhancements, we find it difficult to see this as anything but a subsidy-based argument rather than an efficiency argument. As such, the debate over the efficiency of secured credit remains at an uncomfortable equipoise.

2. Secured Credit Efficiency: The Behavioral/Institutional Overlay.— Another reason to be concerned about asset-based lending, including all-asset lending, lies in concerns about bargaining *ex ante*. At the time of borrowing, the debtor may bargain away the value of the firm too cheaply.[187] The "puzzle of secured credit" literature largely preceded the institutional/behavioral concerns embedded in this point. The efficiency-based arguments for blanket liens assume that the parties know best at the time they make the deal.[188] Yet, more recent behavioral research suggests this is not always true.[189] Even in the absence of the distortions created by the ability to externalize risk, reallocate firm value, and distort governance structures, all described above, there are also informational and decisional costs associated with deciding at the time of borrowing to give the secured creditor complete control in the event of default.

The first problem is intertemporal externality. A firm's deals are done at one time, T1, but those deals' successes are measured at a later time, T2. The people who engineered a deal may no longer be responsible or even employed by the firm when the deal is evaluated *ex post*. Those who managed the deal may be compensated based on expectations shortly after the deal is executed and may not bear costs if the deal fails or generates losses down the road. Even if the same person is responsible at both times, intertemporal discounting may come into play. Firms, like people, may privilege the need

security interest); Ronald J. Mann, *Explaining the Pattern of Secured Credit*, 110 HARV. L. REV. 625, 633 (1997) (noting a grant of collateral can affect transaction costs and incentives).

186. Steven L. Harris & Charles W. Mooney, Jr., *A Property-Based Theory of Security Interests: Taking Debtors' Choices Seriously*, 80 VA. L. REV. 2021, 2022–24 (1994) (criticizing efficiency theories and arguing that secured transactions may be wealth enhancing).

187. For a discussion of individual decision-making, see Susan Block-Lieb & Edward J. Janger, *The Myth of the Rational Borrower: Rationality, Behavioralism, and the Misguided "Reform" of Bankruptcy Law*, 84 TEXAS L. REV. 1481, 1558–59 (2006).

188. Harris & Mooney, *supra* note 186, at 2049.

189. *Compare* Sanjai Bhagat & Roberta Romano, *Reforming Executive Compensation: Focusing and Committing to the Long-Term*, 26 YALE J. ON REG. 359, 363 (2009) (suggesting that firms should adopt incentivizing compensation packages for executives that nudge them to favor long-term interests), *with* Jesse M. Fried, *The Uneasy Case for Favoring Long-Term Shareholders*, 124 YALE L.J. 1554, 1557–58 (2015) (contending that executives favoring long-term interests are no better at promoting wealth creation than those favoring short-term interests and may paradoxically reduce the size of the pie).

to obtain credit now over the potential costs in future periods. Whether the problem is cognitive or institutional, the result is likely to be the same.

Bargaining dynamics also contribute to the problem. Some borrowers are at their lenders' mercy *ex ante*, particularly when a firm is initially capitalized. Keen to signal that it will be compliant, cooperative, low risk, and flush with optimism bias, the borrower might offer the initial lender the most powerful remedies permitted by law that the lender requests. Just as the dynamics of *ex ante* credit negotiations may lead a debtor to trade risk faced by future creditors for money now, the debtor may cede control too easily. In her important article, *The Logic and Limits of Contract Bankruptcy*, Susan Block-Lieb articulated these key informational and decisional costs the debtor faces at T1.[190]

In conclusion, deciding *ex ante* precisely what decisions will be made at the time of default may not be efficient. At the time of default, there may be more information about the business, the reason for default, and the possible options. Tying the debtor's hands earlier may impose significant costs later.

3. Operations vs. Assets.—Up to this point, we have (1) interpreted existing law to limit the scope of security interests when they leave a firm undercapitalized; (2) argued that limiting the scope of security interests may curb principal–agent problems; and (3) recognized that secured credit may generate negative externalities both inside and outside the firm. Together, these concerns justify limiting the scope of security interests. We need to go further, though, to support our claim that fixed-asset value and any appreciation during a bankruptcy case should be allocated to the secured creditor, but income and upside from operations should be allocated to the unsecured claims (including any deficiency claims).[191] The answer lies in updating the aforementioned monitoring story to justify the distinction between asset-based financial claims and claims rooted in the operation of the business.

First, in the real world, firms often have multiple stakeholders. In addition to financial creditors, there are suppliers, employees, tort claimants, taxing authorities, and many more. Picking up on the theme in the efficiency debates but taking it in a different direction, many of these parties are "closer to the ground" than financial creditors. In addition, maintaining relations with these stakeholders is critical to restructuring a distressed but viable company. Allocating a variable claim to these stakeholders gives them skin in the game and may serve the interests of the continued operation of the firm.[192] To the

190. Susan Block-Lieb, *The Logic and Limits of Contract Bankruptcy*, 2001 U. ILL. L. REV. 503, 522–23 (2001).

191. *See supra* Part I.

192. Commentators sometimes suggest that these stakeholders are indifferent to the restructuring because they routinely get paid, for business reasons, in any event. *E.g.*, Douglas G. Baird, *Priority Matters: Absolute Priority, Relative Priority, and the Costs of Bankruptcy*, 165 U.

extent that suppliers, employees, and others have continued transactions and interactions with the debtor, they may have considerable monitoring advantages as compared to financial creditors. Even nonconsensual claimants have incentives to monitor once they know they have a claim.

Second, blanket liens in particular turn the secured-lender-monitoring story on its head. To the extent lenders try to take blanket liens, they are not monitoring specific assets over which they have expertise. Moreover, in modern financial markets, the lender is more likely to be a syndicate of participants than a single entity.[193] Berle and Means wrote about disbursed shareholders, but in insolvency, Berle/Means shareholders have now been replaced by Berle/Means bondholders. To the extent there is an agency problem, it might be controlled better by unsecured creditors closer to the operational realities—suppliers and employees. The realities of modern finance alter the implications of the "comparative monitoring" rationale.

Although much more could be said, this relatively brief tour reveals a coherent set of justifications for both the Equitable Snapshot and Equitable Realization, as well as the inalienabilty rule that they enforce. Our assessment vindicates principles that encourage the proper capitalization of firms and reinforce incentives within the firm to maximize value. As with any debate about the efficiency of legal rules, empirical questions remain about whether the costs of this inalienability rule outweigh the benefits. And, though we cannot answer that question definitively at this time, we believe the burden should lie with those arguing for a change to the existing baseline—the advocates of the single waterfall.

III. Testing Recent Reform Proposals

Our analysis in Part I suggests that many complaints about contemporary Chapter 11 practices are a function of insufficient adherence to the principles and, indeed, plain language of the Bankruptcy Code and state law—a failure of advocacy, rather than a shortcoming in the law itself. Neither Article 9 nor the Bankruptcy Code support the common assumption that secured creditors are routinely the residual owner of bankrupt companies and thus have the unfettered right to "run the show." In Part II, we demonstrated the desirability of limiting the scope of security interests consistent with longstanding corporate and commercial principles and behavioral arguments. Here, in Part III, we turn to recent Chapter 11 reform proposals.

PA. L. REV. 785, 795–97 (2017). Even if that were true for the slice of corporate Chapter 11s on which Baird focuses (large cases that continue as a going concern), *id.* at 789, it does not reflect the fate of most Chapter 11 cases today.

193. William H. Widen, *Lord of the Liens: Towards Greater Efficiency in Secured Syndicated Lending*, 25 CARDOZO L. REV. 1577, 1581 (2004).

Our examination of creditor entitlements comes on the heels of a comprehensive study of Chapter 11 by a commission created by the field's largest professional organization.[194] The proposals in the ABI Final Report and the views we expressed in *Ice Cube Bonds* and here, in Part I, share common ground. But several of the Report's key recommendations addressing value allocation do not honor the distinction between asset-based and firm-based claims and lose track of the need to maintain the relative position of creditors over time through Equitable Realization. We discuss relevant proposals below.

A. Adequate Protection

The Report's recommendations regarding adequate protection are generally consistent with Equitable Realization. Indeed, they reinforce the importance of distinguishing asset-based from firm-based priority.

1. Foreclosure Value.—For secured creditors, Equitable Realization starts with fixing the value of the collateral as of the petition date for adequate protection purposes.[195] The standard developed in *The Logic and Limits of Liens* and in Part I of this Article is based on the value that was actually realizable in the absence of bankruptcy.[196] Consistent with this view, the Report recommends using foreclosure value of a secured creditor's collateral, for adequate-protection purposes, on the date the creditor seeks adequate protection.[197]

Notwithstanding our focus on the petition date above, we are not troubled by the proposal's use of the date on which the creditor seeks adequate protection. At least as to fixed assets, secured creditors have the power to choose the moment that collateral value will be realized for downside purposes, just as they would have been able to choose the moment to foreclose outside of bankruptcy. So, we see little problem with preserving this option in bankruptcy to the extent possible. Between the filing and the date adequate protection is sought, the value might go up or down.

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194. *About Us*, AM. BANKR. INST., http://www.abi.org/about-us [https://perma.cc/H3HK-EL3T] ("[ABI] is the nation's largest association of bankruptcy professionals, made up of over 12,000 members in multi-disciplinary roles, including attorneys, auctioneers, bankers, judges, lenders, professors, turnaround specialists, accountants and others.").

195. *See supra* section I(C)(2).

196. *See* Janger, *supra* note 19, at 606; *supra* section I(D)(1).

197. ABI FINAL REPORT, *supra* note 6, at 71. The Report distinguishes foreclosure value from going-concern value, as well as from liquidation value. *Id.* For personal property, foreclosure value is theoretically higher than liquidation value because Article 9 dispositions are supposed to yield prices greater than would be received in a distress sale. *See id.* at 71 ("The foreclosure value should be determined case by case based on the evidence presented at the adequate protection hearing, taking into account the realities of the applicable foreclosure markets and legal schemes."); U.C.C. §§ 9-610, 9-626 (2014) (describing flexible procedures for disposition after default).

For floating-lien collateral, the picture is more complicated than the Report appears to acknowledge.[198] To the extent the court grants adequate protection for collateral that has already been disposed of, the value has already been realized, and the allowed secured claim fixed. The option to sell has already been exercised. Therefore, the value entitled to adequate protection should be the sale price of the original collateral.[199] The Report does not specify this approach but says nothing inconsistent with this view.

There is one place, however, where the Report deviates from the concept of realizable value. If a creditor can establish that the collateral would have yielded more than the state-law foreclosure value upon disposition, then the Report proposes that this "value differential" can be claimed as the baseline for adequate protection.[200] That approach insufficiently appreciates the question of who should bear the risk of value changes during the case. The Report offers the following:

> In granting adequate protection to a secured creditor under section 361(3), the court should be able to consider evidence that the net cash value that a secured creditor would realize upon a hypothetical sale of the secured creditor's collateral under section 363 exceeds the collateral's foreclosure value (a "value differential"). If the court makes a finding based on the evidence presented at the adequate protection hearing that a value differential exists, the court should be able to premise adequate protection under section 361, in whole or in part, on such value differential.[201]

Taken literally, this language misconstrues the nature of adequate protection. The value-differential concept allows the secured creditor to ask, at the beginning of the case, to protect value that will not be realizable, if at all, until the end of the case. It is, of course, possible that collateral may appreciate, or, if the debtor reorganizes, the creditor may be entitled to the "reorganization value" of its collateral. In other words, the creditor might be able to argue that something greater than state-law foreclosure value would have been realizable in a going-concern sale or a Chapter 11 reorganization. This may well turn out to be true, as a factual matter, but they are not entitled to a guaranty of that amount as adequate protection. We do not object to allocating collateral appreciation to the secured creditor to the extent that it is actually realized as a result of the case, but there is no reason that the unsecured creditors should be forced to act as guarantors early in the case.[202]

198. Proceeds must be discussed separately, as the recommendation should apply only to original collateral and not to proceeds.

199. As we will discuss later, the sale price should also be the limit for distributional purposes.

200. ABI FINAL REPORT, *supra* note 6, at 67–68.

201. *Id.* (emphasis omitted).

202. Janger, *supra* note 19, at 590–91, 606.

2. Valuation for Adequate Protection vs. Valuation in Reorganization.— The report, like Equitable Realization, allocates appreciation of original collateral during the case to the secured creditor. The Report differentiates between valuation for adequate-protection purposes and distributional purposes. It calculates the latter slightly differently from the way we do. The Report recognizes that at the end of a case, the secured creditor should be able to insist on the "reorganization" or "going-concern" value of the collateral. In Part I, we focused on asset appreciation without specifying a valuation standard other than realizable value. The two approaches should, however, lead to the same result in practice.

The following thought exercise illustrates why the Commission's approach is plausible, if not mandated. If the collateral is sold piecemeal under ordinary commercial conditions, it will produce a market-based value. If, by contrast, the debtor is reorganizing, but it were possible to require that each item of collateral be auctioned individually, the debtor would bid on each piece of property deemed essential to the operation of the business. In each case, the maximum bid of the debtor should be the cost to replace, although, where the asset is firm specific, that might be quite a lot. Section 506(a) of the Bankruptcy Code currently states that determination of the allowed secured claim should consider the intended disposition of the collateral. If the debtor reorganizes without selling property that is collateral for a secured debt, the collateral is revalued as of the effective date, but necessarily based on an estimation of "realizable" or "reorganization" value. Under either formulation, it is appropriate to focus on the value of the collateral to the reorganizing debtor.

For some types of collateral, however, using reorganization value may be inappropriate. For example, creditors sometimes claim to have a security interest in goodwill.[203] For goodwill, or technical know-how, the realizable value at the petition date may very well be zero.[204] It is also hard to argue that goodwill on the post-petition sale date, existing only because bankruptcy law

203. Whether goodwill is a distinct property interest that a debtor can encumber and on which a lender can foreclose is a far-from-simple question. The Uniform Commercial Code has never defined property, leaving that question to other law. Moringiello, *supra* note 33, at 132. The North Carolina Supreme Court has held that goodwill is not a stand-alone property right that can be owned and sold apart from a property right "to which it is incident," such as a trademark. Maola Ice Cream Co. of N.C. v. Maola Milk & Ice Cream Co., 77 S.E.2d 910, 914 (N.C. 1953); *see also* Poore v. Poore, 331 S.E.2d 266, 271–73 (N.C. Ct. App. 1985) (permitting goodwill to be part of the valuation of a professional practice but finding that the professional association's goodwill had no significant value because its liabilities were approximately equal to the value of its assets, thus vacating the trial court's valuation); Craver v. Nakagama, 379 S.E.2d 658, 659–60 (N.C. Ct. App. 1989) (holding that, while goodwill is normally a valuable asset of a partnership, the goodwill of a "professional partnership whose reputation rests solely on the individual skill of the partners" cannot be distributed since its services are performed based on "the individual skill, judgment and reputation of the partner").

204. *In re* Residential Capital, LLC, 501 B.R. 549, 610–11 (Bankr. S.D.N.Y. 2013) (finding that the creditor failed to show that the goodwill on the petition date was worth more than $0).

postponed realization, is identifiable proceeds of the secured creditor's collateral.[205] More importantly, if the collateral was sold prior to the effective date of the plan, the value for distributional purposes should be the price actually realized when the original collateral was sold—not the reorganization value of the proceeds.[206]

3. Cross-Collateralization as Adequate Protection.—The Report further reflects the principle of Equitable Realization in its discussion of cross-collateralization in connection with debtor-in-possession financing. Courts will sometimes grant debtors' requests to give lenders post-petition liens on unencumbered and/or post-petition collateral as a form of adequate protection of their pre-petition secured loans. While the granting of a replacement lien is expressly contemplated as a form of adequate protection,[207] cross-collateralization creates problems if it increases the level of security on a pre-petition claim. Often called "Texlon-type cross-collateralization,"[208] this arrangement transfers value to the secured creditor to which it was not entitled on the petition date.

The Report proposes to limit the ability of a pre-petition secured creditor to cross-collateralize, "to the extent that such cross-collateralization would protect against the decrease in the value of the secured creditor's interest in the debtor's property."[209] This restriction correctly implements the Equitable Snapshot principle. The scope of the post-petition lien would be limited to the amount necessary to protect the value of the pre-petition collateral. That refinement properly effectuates the view that the value of floating-lien collateral, for downside and upside purposes, should be fixed as of the petition date.

205. *Id.* at 612; *Bankruptcy Sales*, *supra* note 22 (discussing *In re Residential Capital (ResCap)* and entitlement to post-petition goodwill). In other words, to the extent goodwill is an interest in property at all, it may be realizable in bankruptcy only because bankruptcy provides a mechanism for preserving the business entity as a whole, and thus part of the bankruptcy premium rather than strictly collateral of the secured creditor. Janger, *supra* note 19, at 611–12 (criticizing the ruling in *Buffets Holdings*).

206. For thoughtful discussions of this question, see Ralph Brubaker, *The Post-RadLAX Ghosts of Pacific Lumber and Philly News (Part I): Is Reorganization Surplus Subject to a Secured Creditor's Pre-Petition Lien?*, Bankruptcy Law Letter at 1 (June 2014); Ralph Brubaker, *The Post-RadLAX Ghosts of Pacific Lumber and Philly News (Part II): Limiting Credit Bidding*, Bankruptcy Law Letter at 1 (July 2014).

207. 11 U.S.C. § 361(2) (2012).

208. This practice, which is named after the case in which it originated, refers to granting a lien to a pre-petition lender on assets that first arose post-petition in order to secure pre-petition debt owed to the lender. *See Ice Cube Bonds*, *supra* note 21, at 908; Gerald F. Munitz, *Treatment of Real Property Liens in Bankruptcy Cases*, 38 J. MARSHALL L. REV. 171, 198–99 (2004).

209. ABI FINAL REPORT, *supra* note 6, at 72.

B. *The Scope of Post-Petition Proceeds of Pre-Petition Collateral: Section 552(b), Tracing, and the Equities of the Case*

The Report offers a number of recommendations with regard to the attachment of a security interest to identifiable proceeds. As we reviewed in Part I, the Bankruptcy Code allows a secured creditor to encumber post-petition proceeds of pre-petition collateral to the extent it could have done so under state law, but courts may limit the encumbrance based on the equities of the case.[210] Although we have cited court decisions applying this rule, our sense is that this limitation is imposed relatively rarely and that secured creditors routinely seek to define their proceeds expansively. The Commission seems to share our concern that current practices undercut the existing statute and the principles supporting it. First, the Report notes a practice of secured creditors conditioning some benefit on the debtor in possession waiving the right to argue that proceeds should be limited by the equities of the case, contrary to § 552(b)(1).[211] The Report proposes invalidating such waivers.[212] We agree.

Second, the Report responds to concerns that imposing a high burden of proof on the debtor's use of the equities-of-the-case exception may prevent § 552(b) from striking the intended balance between the secured creditor and the estate. Specifically, the Report states that the debtor does not necessarily need to show an expenditure of other funds with regard to the collateral to limit the secured creditor's interest in proceeds.[213] The evidence can be in a variety of forms, "whether through time, effort, money, property, other resources, or cost savings."[214] Again, we agree.

Third, the Report considers the definition of proceeds as used in the Bankruptcy Code. The Bankruptcy Code does not define the term proceeds, and the Article 9 definition of proceeds at the time the Bankruptcy Code was drafted was more limited than it is today.[215] The Report indicates that, in light of diverse views on the matter, the Commission declined to propose a federal definition of proceeds for purposes of § 552, retaining the current Article 9 definition.[216] The downside of the Article 9 definition is its potential to strip value from firm-based claimants. As we already explored, however, that

210. 11 U.S.C. § 552(b)(1).

211. ABI FINAL REPORT, *supra* note 6, at 232. The Report also notes that such waivers may help explain why there is so little case law interpreting § 552(b)(1). *Id.*

212. *Id.* at230.

213. *Id.* at234.

214. Id.

215. Lupica, *supra* note 5, at 904–06 (discussing diverging court opinions on the definition of proceeds for bankruptcy purposes); Warner, *supra* note 87, at 521–22.

216. ABI FINAL REPORT, *supra* note 6, at 233; *cf.* Juliet M. Moringiello, *(Mis)use of State Law in Bankruptcy: The Hanging Paragraph Story*, 2012 WIS. L. REV. 963, 1003–08 (2012) (applying Supreme Court decisions in *Butner* and *Kimbell Foods*, and determining the Article 9 definition of "purchase money security interest" should not be used in Chapter 13 bankruptcy cases).

definition, as interpreted by courts, is far from limitless.[217] In addition, as we have seen, Article 9 proceeds doctrine requires identifiability and tracing and imposes those burdens on the secured party.[218] Those requirements, when combined with the Bankruptcy Code's equities-of-the-case limitation, can be interpreted consistently with the Equitable Snapshot principle set forth in Part I.

The associated commentary to the Commission's § 552(b) proposals contains helpful insights consistent with our approach to allocating entitlements and value among asset-based and firm-based claimants. Looking to the legislative history, the Report notes that Congress intended § 552(b) to "prevent windfalls" to the secured creditor and "to compensate the estate for use of unencumbered property or expenditures that enhanced the value of the secured creditor's lien and to protect the rehabilitative purposes of the Bankruptcy Code."[219] Further, it favorably cites the *ResCap* ruling that post-petition goodwill is not proceeds of pre-petition goodwill.[220] Overall, the Report's proceeds discussion is consistent with the Snapshot Principle and the tracing requirements described above, as well as with the Commission's position on cross-collateralization.[221]

Rigorous enforcement of the limits on a secured creditor's claim to proceeds under § 552(b) helps to ensure the secured creditor's interest remains stable post-petition and does not expand. The effect is to allocate virtually all going-concern surplus, created by the bankruptcy process itself, to the estate rather than to asset-based creditors. As Parts I and II illustrate, we think this is right as a matter of positive law,[222] as well as normatively.[223] But the Report does not explicitly acknowledge that impact. In addition, as we discuss later, it includes a proposal inconsistent with that outcome.[224]

C. Sales of All Assets Outside of a Chapter 11 Plan

The Report expresses considerable concern about the speed and prevalence of going-concern sales of substantially all of a debtor's assets through § 363 rather than a plan, and the implications for Chapter 11's traditional goals. On timing, the Report proposes a sixty-day moratorium running from the filing of the petition on all-asset sales absent a showing, by

217. *See supra* section I(E)(1)(a).

218. *See supra* section I(E)(1)(b) (discussing U.C.C. § 9-315(a)(2), (b)).

219. ABI FINAL REPORT, *supra* note 6, at 231.

220. *Id.* at 233 (citing *In re* Residential Capital, LLC, 501 B.R. 549, 612 (Bankr. S.D.N.Y. 2013)); *see also* sources cited in *supra* note 203.

221. *See supra* section III(A)(3) (discussing cross-collateralization in debtor-in-possession financing).

222. *See supra* Part I.

223. *See supra* Part II.

224. *See infra* subpart III(D) (discussing redemption option).

clear and convincing evidence, that a quicker sale is necessary.[225] On substance, the Report sets forth a list of requirements, drawn from the Chapter 11-plan process, necessary to obtain court approval of all-asset sales (§ 363x).[226] And the Report would prohibit the entry of dismissal orders following such sales that rearrange creditor entitlements inconsistently with the Bankruptcy Code.[227]

We share the concern that hurry-up sales have become unduly common in Chapter 11 in a wide range of cases, with deleterious consequences for both value maximization and distribution.[228] We are less certain that a still-flexible moratorium will effectively put the brakes on breathless proposals for quick sales. It would continue to put courts in the impossible position of calling the bluff of advocates for a speedy sale.[229] After all, in some subset of cases, the debtor really is a melting ice cube. In such circumstances, requiring an extensive process—proving necessity by clear and convincing evidence as well as all of the new § 363x requirements up front—may undercut the value-preservation goal. Similarly, the sixty-day limit can be manipulated by altering the timing of the request. For example, a short-fuse request for an all-asset sale made on the forty-fifth day after filing may raise many of the same issues as a similar motion made earlier in the case. Thus, we continue to see our *Ice Cube Bonds* proposal as more likely to bolster the objectives of Chapter 11.[230]

At the same time, the Report's proposed abolition of court orders dismissing Chapter 11 cases with various strings attached, often called structured dismissal orders. This is consistent with our Part I analysis. Indeed, the Supreme Court recently held that the Bankruptcy Code does not permit dismissal orders that contravene bankruptcy's priority rules without consent of the affected parties.[231] The Supreme Court did not, however, ban all structured dismissals. Especially when coupled with all-asset sales, structured dismissals may enhance the leverage of a dominant secured creditor to capture enterprise value to which it is not legally entitled.

225. ABI FINAL REPORT, *supra* note 6, at 83, 87.

226. *Id.* at 201.

227. *Id.* at 272 ("The Commissioners believed that the recommended principles for section 363x sales should render the use of structured dismissals unnecessary. Accordingly, the Commission recommended strict compliance with the Bankruptcy Code in terms of orders ending the Chapter 11 case.").

228. *Ice Cube Bonds*, *supra* note 21, at 895. Again, however, the overall frequency of Chapter 11 cases involving such sales should not be overstated. Westbrook, *supra* note 22, at 843 (in a sample of 2006 Chapter 11 filings, "[s]lightly less than thirty percent of the cases had *any* sales sufficiently important and out of the ordinary course to make an appearance in the court files" (emphasis in original)).

229. *Ice Cube Bonds*, *supra* note 21, at 886–89.

230. *Id.* at 926–35.

231. Czyzewski v. Jevic Holding Corp., 137 S. Ct. 973 (2017).

D. The "Redemption Option Value" Proposal and Its Limitations

Perhaps the most noteworthy portion of the Report is its proposal regarding redemption option value.[232] Consistent with our analysis in Part I, the redemption-option-value proposal is a remarkable and important recognition that even a creditor claiming a blanket lien on the debtor's assets does not own all of the enterprise value of a firm. According to the Report, plan confirmation should not deprive unsecured creditors of the value of an option on the future value of the firm. The option proposed by the Commission would be "in the money" if the business produces sufficient value to repay the secured creditor in full. The Report argues that this value should be protected through the creation of a redemption-option-preservation priority: [233]

> A distribution of redemption option value, if any, would be made to an immediately junior class to reflect the possibility that, between the plan effective date or sale order date and the third anniversary of the petition date (the "redemption period"), the value of the firm might have been sufficient to pay the senior class in full with interest and provide incremental value to such immediately junior class.[234]

We applaud this proposal for its recognition that a secured creditor asserting a blanket lien does not have a lien on the entire value of the firm. We are concerned, however, because it is premised on the single waterfall approach, and conflates asset-based and firm-based priority, ignoring the principle of Equitable Realization. If one accepts our analysis in Part I, then secured creditors' entitlements should be determined by reference to the value of assets that serve as collateral, not the going-concern value of the firm as a whole. Therefore the secured creditor's claim, and hence the strike price of the option, should be the value of the collateral on the effective date of the plan, not payment in full of the face amount of the secured creditor's debt.

Equitable Realization excludes from the secured creditor's entitlement the fruits of employees' post-petition labor, or increases in firm value due to operations rather than asset appreciation. As demonstrated in Part I, the Bankruptcy Code goes to great lengths to protect the secured creditor from being harmed by bankruptcy and gives the secured creditor the upside value on its assets, but only until they are disposed of during the case or under a plan. Section 1129(b)(2)(A), the back-end baseline, entitles the secured party to the value upon disposition of its pre-petition assets, or their appreciated value if still owned on the effective date of the plan.[235] The Code does not,

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232. *See* ABI FINAL REPORT, *supra* note 6, at 218 (describing the mechanics of the redemption-option-value proposal).

233. *Id.* (explaining the proposal). The proposal bears some similarity to option-preservation priority discussed earlier. Casey, *supra* note 6, at 764–65.

234. ABI FINAL REPORT, *supra* note 6, at 208 (emphasis omitted).

235. 11 U.S.C. § 1129(b)(2012).

however, allocate "going concern" or operations-based upside to an asset-based secured creditor.[236] As a consequence, the entire going-concern premium is, and should be, allocated to firm-based claimants, not the asset-based secured lender.[237]

The concept of redemption option value, therefore, gets it half right. It recognizes that, at any given moment in time, the value of an enterprise has two components: the current value of the firm (based on saleable-asset value or discounted cash flow) and the value of a bet that the value of the firm may increase in the future. This second element is sometimes called optionality or option value. Although it sometimes is shorthanded as upside, option value must also take into account the possibility that the value of the firm may go down and the option may be out of the money.

The Report is undoubtedly correct that redemption option value exists. This possibility can be quantified at the time of plan confirmation as the price of an option on the value of the firm.[238] A bankrupt company may return to health and be able to pay more of its creditors and debts. The Report overlooks, however, the existence of two forms of option value: asset-based (the chance that the value of encumbered assets may go up) and firm-based (the possibility that the value of the going-concern increment may increase). Under Equitable Realization, the secured creditor is entitled to asset-based but not firm-based option value. By allocating both asset-based and firm-based option value to the secured creditor, the Report sets the strike price of the redemption option too high—at the full amount of the secured creditor's debt.

Our disagreement with this approach goes to the heart of the "single waterfall" question. If there are two separate waterfalls, as we contend, then one must always ask: "How much of the firm's value is tied to assets, and how much to operations?" The Report's redemption option value proposal assumes that secured creditors encumber the whole firm's value, leaving only a sliver of this bankruptcy-created value for the estate.

This not only assumes that a blanket lien is possible, but also that the lien gives the secured creditor a priority claim to income from the debtor company's operations. Both assertions are inconsistent with the principles regarding timing and realization found in a careful reading of the Bankruptcy Code.

236. *Supra* subparts I(C), (D) (discussing state-law baseline combined with restrictions that inhere in §§ 549, 551, and 552 of the Bankruptcy Code).

237. *Supra* subpart I(E) (describing bankruptcy premia).

238. Bank of Am. Nat'l Tr. & Sav. Ass'n v. 203 N. LaSalle St. P'ship, 526 U.S. 434, 455 (1999) (noting in dicta that equity securities of an insolvent company still trade at a positive value).

Although the Commission models its formulation on the absolute-priority rule,[239] the absolute-priority rule applies to unsecured claims and their relationship with equity interests, not asset-based claims. For secured claims, the Bankruptcy Code gives a different meaning to the term "fair and equitable."[240] As observed in *Ice Cube Bonds*, that entitlement does not establish a distributional priority with respect to the value of the firm.[241] By treating the secured creditor's rights as a senior claim to firm value and confusing asset-based priority with firm-based priority, the Report's redemption option priority proposal would give unsecured creditors considerably less than they should receive under current law.

Indeed, where the concept of redemption appears in the current Bankruptcy Code, the approach is more consistent with Part I of this Article than the Report. An individual Chapter 7 debtor may redeem abandoned personal property from the secured creditor's lien by paying the current market value of the asset rather than the entire debt.[242] Similarly, a Chapter 13 debtor can redeem most collateral by paying the stripped-down value of the lien in installments.[243]

To put it another way, the Commission does not sufficiently distinguish the redemption option from the other forms of bankruptcy-created value that are not asset-based and that the secured creditor does not own.[244] Bankruptcy-created value—the product of giving the firm breathing space to determine how to maximize the firm's value—is related to, but distinct from, option value itself. Bankruptcy-created value is value that is created by the various aspects of the bankruptcy process. Optionality is but one component of firm value that is preserved by Chapter 11—the value of a right to delay realization of the firm's value until some date in the future. Selling the firm or one's interest in the firm, however, shifts that option value to the purchaser.

Bankruptcy preserves the firm's value of this option by delaying realization and permits it to be allocated over a number of different time frames. During the case, option value is preserved for the estate by delaying Value Realization. Crucially, disposition of the firm, either by selling the firm

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239. *See* 11 U.S.C. § 1129(b)(2)(B) (2012) (establishing the absolute-priority rule for unsecured claims).

240. *Id.* § 1129(b)(2)(A).

241. *Ice Cube Bonds*, *supra* note 21, at 921.

242. 11 U.S.C. § 722.

243. 11 U.S.C. § 1325(a)(4). The Bankruptcy Code contains exceptions to this rule, such as the "hanging paragraph" of § 1325(a), which exempts certain purchase money loans from this treatment, but the default position for the redemption price of a secured creditor's collateral is consistent across the Bankruptcy Code.

244. For example, if the value of the debtor is maximized via a going-concern sale, then the upside or optionality would be allocated to the purchaser. The purchase price should reflect the value of that upside. If creditors take stock as their distribution in a traditional reorganization, the option value stays with them as shareholders of the reorganized company. The redemption option value is part of the value of the firm.

or confirming a reorganization plan, allocates, but does not destroy, any future option value. The same can be said of disposition of an asset. A sale transfers the upside to the purchaser. The option is sold, not destroyed.

But different allocations of the upside can be built into any disposition. For example, selling the firm but taking part of the purchase price as stock leaves a portion of the upside with the seller. Reorganizing the firm through a plan of reorganization and distributing the firm's value as stock similarly allocates post-confirmation option value to the claimants who take their distribution in that form. Value is preserved in bankruptcy by keeping the firm in business or engaging in an otherwise value-maximizing disposition. But optionality is simply an incident of the going-concern premium and other forms of bankruptcy-created value. Valuing the possible options becomes an issue only when a party seeks to transfer or preserve the post-confirmation option value separately from the other value of the firm or assets.

This distinction is crucial to understanding how our analysis relates to the Commission's proposed option-preservation priority, as well as Anthony Casey's similar proposal, and Douglas Baird's proposal to use relative priority in nonconsensual Chapter 11 plans instead of absolute priority. All rest on the single waterfall approach that we reject. They are only necessary if one accepts that a senior secured lender can hold a blanket lien on all firm value, and therefore owns all of the postbankruptcy upside until paid in full.[245] Our discussion above demonstrates that secured claims have no place in the hierarchical firm-value waterfall under current law. Instead, the secured creditor is entitled only to the value of the assets encumbered on the petition date and any appreciation on those assets until disposition. Upside from continued operation of the firm goes to unsecured creditors (including the secured creditor's deficiency claim).

In other words, the distinction between asset-based claims and firm-based claims, embodied in the Bankruptcy Code's protection of firm value for the bankruptcy estate based on the equities of the case, and Article 9's equitable tracing requirement, render the Baird, Casey, and Report proposals largely irrelevant where secured creditors are involved. The secured creditor's entitlement is based on assets that actually exist, not on a guess about the future.

To the extent unsecured creditors wish to preserve optionality for themselves post-reorganization, they can take their distribution in stock in the reorganized company. If they wish to cash out the option value, they can

245. We are opining neither on the utility of option-preservation priority in the event of disputes between unsecured creditors and equity holders, nor on whether relative or absolute priority are correct approaches to drawing that line. Our point is that the concept is inapposite where secured creditors are involved.

take their distribution as debt. Again, nothing is destroyed. It is simply allocated.[246]

For us, the redemption option is the tail on the dog.[247] If, as we argue, secured claims are realized on the disposition date or the effective date of the plan, then the key exercise is calculating the value of the secured creditor's existing collateral, not the hypothetical value of a bet on the future value of the firm. The rest, including the upside, belongs to the bankruptcy estate. Allocation of bankruptcy-created value, including firm-based option value, is a governance question. The firm-based claimants must decide how they wish to realize that value; the court need not value it.[248]

Thus, although the redemption-option-preservation-priority proposal reflects an important recognition that a firm's enterprise value is not inexorably collateral of secured creditors, the resulting proposed allocation of value reflects a profound shift in favor of the secured creditor relative to the current Bankruptcy Code, and a crabbed view of unsecured-creditor entitlements.[249]

E. *Summary*

The ABI Chapter 11 Commission Report offers insight into the current operation of corporate bankruptcy and identifies serious problems in the current bankruptcy system, many of which coalesce around the theme of secured creditor overreach. Most of its proposals are consistent with our analysis and with Equitable Realization. Two places where the Report goes awry, however, are the value differential for calculating adequate protection and the redemption-option-preservation priority. They rest on continued conflation of asset-based and firm-based priority, and do not distinguish

246. The absolute-priority rule currently embedded in 11 U.S.C. § 1129(b)(2)(B)(ii) potentially allocates option value to dissenting classes of unsecured claims at the expense of equity. The so-called "new value corollary" of the absolute-priority rule allows existing equity holders to purchase the equity of the reorganized firm under certain circumstances. *See* Bank of Am. Nat'l Tr. & Sav. Ass'n v. 203 N. LaSalle St. P'ship, 526 U.S. 434, 449 (1999) ("Although there is no literal reference to 'new value' in the phrase 'on account of such junior claim,' the phrase could arguably carry such an implication in modifying the prohibition against receipt by junior claimants of any interest under a plan while a senior class of unconsenting creditors goes less than fully paid." (quoting 11 U.S.C. § 1129(b)(2)(B)(ii))). *But see id.* at 458 (holding that "plans providing junior interest holders with exclusive opportunities free from competition and without benefit of market valuation fall within the prohibition of § 1129(b)(2)(B)(ii)").

247. *See supra* subsection I(E)(2)(d) (distinguishing optionality in discussion of bankruptcy premia).

248. For example, if the value of the debtor is maximized via a going-concern sale, then the upside or optionality would be allocated to the purchaser. The purchase price should reflect the value of that upside. If creditors take their distribution in stock in a traditional reorganization, the option value stays with them as shareholders of the reorganized company. The redemption option value is part of the value of the firm.

249. *See supra* notes 56–57 and accompanying text (explaining how the fair and equitable standard for confirmation of a Chapter 11 plan over the objection of dissenting secured claimants is explicitly asset-based as distinguished from the absolute-priority iteration for unsecured creditors).

Equitable Realization on the petition date from Value Realization upon disposition of the collateral. The result is a windfall to secured creditors to the detriment of other creditors and stakeholders, as well as to the Chapter 11 process.

Conclusion

The single waterfall metaphor has dominated both the theory and practice of Chapter 11 for much of the last twenty years. Practitioners have assumed that it exists, and academics have argued that it is desirable. Challenging both assumptions, we have argued that the Bankruptcy Code and Article 9 of the Uniform Commercial Code should be viewed as creating a dual waterfall that distinguishes asset-based claims of priority from claims to the value of the firm. We further argued that delayed realization of value in Chapter 11 requires the Code to manage the relationship between these two types of claims over time and does so using tracing rules, through the process we call Equitable Realization.

This Article derived the principle of Equitable Realization from the terms “fair and equitable,” “equities of the case,” and “equitable principles,” as they are used in the Bankruptcy Code and Article 9. It explored the impact of these terms on secured creditors’ entitlements and the allocation of an insolvent firm’s going-concern value. In an exercise of purposive statutory interpretation, we merged a careful analysis of state law, as applied by modern courts, with a close reading of the Bankruptcy Code’s timing rules for realization of the value of those state-law rights.

This analysis allowed us to explain how the Bankruptcy Code implements the equitable treatment of creditors over time in Chapter 11. We described a two-step process. Equitable Realization locks in the relative positions of creditors as of the petition date, taking an Equitable Snapshot that freezes the relationship between asset-based claims and those with claims against the estate more generally. Value Realization happens upon disposition of the collateral or the estate. The result is an inalienability rule: the debtor cannot use pre-petition security interests to encumber bankruptcy-created value beyond that which is specifically tied to collateral owned on the petition date.

We then argued that Equitable Realization vindicates well-recognized efficiency goals underlying commercial and corporate law: (1) limiting the ability of firms to externalize risk; (2) restraining certain investors from shifting the burden of risk within a firm; (3) reducing agency costs and encouraging value-maximizing governance within a firm; and (4) facilitating efficient monitoring of the firm’s operations. Although the resulting inalienability rule may have countervailing costs, the burden of shifting the legal status quo always lies with those seeking legal change. We look forward to that conversation.

The final portion measured our analysis against the ABI Commission Report on the Reform of Chapter 11, and we found broad areas of agreement. Yet, our understanding of Equitable Realization led us to question the assumptions underlying the proposed option-preservation priority. Under our understanding of equitable value allocation, this proposal is unnecessary, given that option value already is included within the bankruptcy-created value allocated by the statute to firm-based claimants.

While our claims may seem technical, the implications of this Article are far reaching. A legal and normative mistake has dominated practice and the academy. A hierarchical capital structure, favoring early creditors over later, may make sense for financial creditors or single-asset firms. But when other firms head into a messy world to conduct business, all types of creditors of the operating entity should be able to assume that there will be capital available to pay their claims. The dual waterfall of Equitable Realization not only recognizes and preserves this objective, but has an important advantage over other proposals: it is already present under existing law, waiting to be recognized.