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DEATH AND RESURRECTION OF SECURED CREDIT

JAMES J. WHITE*

INTRODUCTION**

The Bankruptcy Reform Act of 1978 (the Code) posed palpable threats to secured creditors. It was drafted by a commission that was at least as concerned with the rights of debtors as with the rights of creditors. It was modified and adopted by a Congress that might have been the most liberal since World War II and signed into law by President Carter at the apogee of the left's power, two years before the Reagan election that marked the rise of the right and the beginning of the left's decline. The power of the left was exerted most forcefully on behalf of consumer debtors who are not the subject of this paper.

In matters of commercial debt and in contests between secured commercial creditors and unsecured commercial creditors, the distance between the congressional poles was much less than it was in the consumer's case. But even in commercial cases one could expect politics to intrude. In a large commercial bankruptcy many of the unsecured creditors would regard the left as their patron. For example union members whose interests appear as present unsecured creditors and as potential future employees of a business in reorganization, might look to the Democrats in Congress to protect their rights in a reorganization against the competing secured claims of banks and other financial institutions.

Because of the composition of the Congressional right and of the academic right, the influence of the right was even weaker in 1978 and in the preceding five years of the Commission's work than might otherwise appear. Newt Gingrich was first elected to Congress in 1978 and was no part of the action that led to the Code's passage in that year; Richard Posner first came to fame by publishing "Economic Analysis of Law" in 1978. Few free market law and economic scholars were around to make the cruel argument that society would prosper if the free market were allowed to kill off weak and inefficient companies.¹ That the dismissed workers of a dead company might be better off in the long run as a result of that death (or that a competitor's workers would be) was hardly considered. The incantation, "reorganization, yes, liquidation, no" echoed through the Commissions

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** In preparing this article I interviewed more than a dozen lawyers who routinely represent parties in chapter 11 cases of public companies.

¹ In recent years, many have written on this topic, as will be discussed below. See [Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043, 1088-89 \(1992\)](#) (suggesting chapter 11 leads to no economic benefits and great social cost, and calling for its repeal or drastic overhaul); Martin J. Whitman et al., *A Rejoinder to "The Untenable Case for Chapter 11,"* 2 J. BANKR. L. PRAC. 839, 841-42 (1993) (noting effectiveness of capital markets in determining which firms are best reorganized and which should go out of business); A. Pressman, *Can Chapter 11 Be Put Back Together?* INVESTMENT DEALER'S DIG., Apr. 27, 1992, at 16.

meetings and in the halls of Congress.² Firms should be given every chance to save their goodwill; no one seems to have thought much of the firms with badwill that could be liquidated for a greater sum than they would command as going concerns, nor did anyone seem to believe that a large percentage of firms that would use chapter 11 might possess badwill, not good. So even in 1978 and certainly in the years during the Commission's work, the right was a pale and moderate version of its later self, and many of the arguments one might hear from the law and economic crowd today were but whispers then.

And the pros from the bankruptcy bar that were most deeply involved in the drafting and lobbying process also probably held the view that reorganization was to be favored and liquidation avoided. Most influential was a group of bankruptcy lawyers, academics, and judges that made up the National Bankruptcy Conference (NBC)³ who, as Professor David A. Skeel, Jr. succinctly put it, "sought to transform bankruptcy from a mildly unsavory, often archaic practice to a more useful, attractive, and reputable response to financial distress. 'Perfecting' the bankruptcy laws had been the National Bankruptcy Conference's main mission since the 1930s, and the 1970s reforms were very much in this spirit."⁴

As I have suggested elsewhere⁵ the bankruptcy lawyer members of the NBC would be natural beneficiaries of a flourishing reorganization practice. Their private interests did not lie in measures that might allow a determined secured creditor to abort a reorganization when it appeared that a firm should be liquidated. Reorganization was their game, and, for some, I suspect that reorganizations under the Code could not be too long or too complex.

It is likely, as Professor Markell has suggested in his criticism of a draft of this paper, that part of the secured creditors' difficulties arose from the fact that secured creditors asked for the wrong things in the negotiation of the Code. For example, secured creditors apparently argued hard for 1111(b)(2), a provision that they would gladly throw overboard now. Perhaps the secured creditors' negotiators can be forgiven for not anticipating the developments in public chapter 11 cases that I describe in Parts II through VI [infra](#).

For these political reasons it is no surprise to see consumer debtors make great gains in the Code, to see non-consumer creditors such as union employees gain ground against more affluent institutional creditors,⁶ and to see the petit bourgeoisie—the trade creditors—do better than the institutional secured and

² See [H.R. Doc. No. 93-137](#), pt. I, at 23 (1973) (referring to problems impeding successful reorganizations of troubled businesses); *id.* at 27–29 (suggesting specific reforms in order to create more favorable environment for reorganization).

³ See generally DAVID A. SKEEL, JR., *DEBT'S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA* 74 (Princeton Univ. Press 2001) (discussing history and formation of National Bankruptcy Conference).

⁴ *Id.* at 149–50.

⁵ See [James J. White, Comment, Harvey's Silence](#), 69 *AM. BANKR. L.J.* 467, 467–68 (1995) (suggesting provision for quick liquidation would eliminate work for National Bankruptcy Commission members).

⁶ Here, I focus on secured credit but many of the arguments I make, could be made about institutional unsecured creditors (e.g. unsecured bond and bank debt). I suspect that many who appear at filing as secured institutional creditors started out as unsecured creditors and took security only when the clouds thickened.

unsecured creditors. One would also expect to see the power of the commercial debtor strengthened—so to insure that reorganization, not liquidation, results in any close case.

Many writing at the time of the Code's enactment and during its early years emphasized the dangers that bankruptcy—as represented by the Code—presented to secured creditors. In a 1984 article Professors Baird and Jackson explain that junior parties who do not bear the true cost of their decisions will try to keep the firm together and that judges who have concluded (or assumed) that reorganization is the only goal of chapter 11 will assist these parties, all to the injury of the seniors.⁷ Professor Eisenberg makes a similar point by noting that the quest for "going concern value" should, but often will not, take account of the price of that quest which will be charged to the secured creditors' bill.⁸ Others expressed similar concerns about the stay, adequate protection and the debtor's enhanced rights to use and dispose of collateral.⁹ Some of these authors explicitly address the enlargement of the dangers from the Code; others do so only implicitly.

⁷ 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, 126–27 (1984):

A Chapter 11 proceeding typically buys time for the managers, the shareholders, and other junior owners at the expense of the more senior ones

Bankruptcy judges sometimes seem inclined to do little to remedy this state of affairs. A few seem to show either an inability or unwillingness to comprehend the possibility that secured credit may be something more than a perverse and unfair creature of state law that should be thwarted at every possible turn. Even more remarkable is their wonderful capacity for hope, their unshakeable faith that given time, the firm's ship will come in. Often, bankruptcy judges seem to think that markets systematically undervalue firms that have filed petitions in bankruptcy. A bankruptcy judge may insist that he, not the market, is the best one positioned to set a value on a firm in distress, even though year after year in case after case his valuations prove wildly inflated.

Id.

⁸ Theodore Eisenberg, *The Undersecured Creditor in Reorganizations and the Nature of Security*, 38 VAND. L. REV. 931, 958–60 (1985):

The creditors' bargain model assumes that creditors, secured, and unsecured, will find it advantageous to agree upon a collective proceeding in which to deal with financially troubled debtors. It is not clear, however, that secured creditors would or should agree in advance to the treatment of secured credit in the current bankruptcy system. Although secured creditors might find the idea of a collective proceeding attractive, on closer examination they would find that the current collective proceeding imposes distinctly unattractive burdens on them. Bankruptcy provisions such as the automatic stay and the trustee's power to use or sell collateral impose costs and risks on secured creditors without giving them any payoff other than allowing them to recover what they would have recovered under state law in the absence of bankruptcy proceedings. Indeed, the benefits of the bankruptcy provisions affecting secured creditors rights usually rest with unsecured creditors. For secured creditors, bankruptcy imposes risks without corresponding rewards.

Id. (footnotes omitted).

⁹ See Sheridan Downey III et al., *The Proposed Bankruptcy Reorganization Provisions: A Comparison of the Current Law with Chapter 11 of H.R. 8200 and S. 2266*, 18 SANTA CLARA L. REV. 567, 583–85 (1978):

Even a mildly neurotic secured creditor could see many threats in the new law. In the new chapter 11 the power of the courts, of the debtor and of any trustee against a secured creditor were larger than the powers of those persons under the dominant form of reorganization before 1978. Under chapter XI of the Act of 1898 (the Act) neither the debtor, nor a trustee nor, generally, the court could affect the rights of a secured creditor.¹⁰ While a court could issue a stay and so prevent repossession, it lacked the power to deal with a secured creditor's rights in a plan of reorganization. If the collateral was an important asset, in theory at least, the secured creditor could refuse to give up its interest and so forestall a reorganization.

Chapter X is the most flexible of the reorganization proceedings . . . permitting the alteration of the rights of both secured and unsecured creditors as well as those of stockholders . . .

In sharp contrast to the provisions of Chapter X, 'it is uniformly recognized that the rights of secured creditors cannot be affected or modified' by a Chapter XI plan of arrangement . . .

. . . [T]he ability to affect secured debt in the single reorganization chapter of the proposed act provides a flexibility that currently is available only in the otherwise restrictive Chapter X.

Id. (footnotes omitted). The article discusses in particular the ability of the debtor to impair or leave unimpaired debts, the automatic stay, and the ability of the debtor to use, sell, or lease property of the estate. See *id.*; Robert A. James & J. David Kirkland, Jr., *Adequate Protection Through Augmented Interests in Reorganization Plans*, 58 AM. BANKR. L.J. 69, 74-75 (1984):

The general insensitivity of courts to damages for prejudgment delay, and the pursuit of other bankruptcy goals, most notably that of avoiding piecemeal liquidations, may explain why secured parties are given less compensation than the absolute equality of value demanded by the [creditors] bargain model . . . Adequate protection in American bankruptcy law is *designed* to perform this compensatory role, even if it does not compensate fully; it gives value to secured creditors suffering one category of economic loss resulting from their inability to reclaim collateral.

Id. (footnotes omitted, emphasis added); John Lindon Smaha, *Automatic Stay Under the 1978 Bankruptcy Code: An Equitable Roadblock to Secured Creditor Relief*, 17 SAN DIEGO L. REV. 1113, 1134-35 (1980):

The new Code, even with adequate protection, can result in inequitable treatment of secured creditors. While the Code and the concept of bankruptcy seek to foster many important social goals, it would be improvident to require that secured creditors carry the burden of every debtor's rehabilitation effort. If the spirit of equity is truly the habit of fairness and justness and rendering to every man his due, the concepts of bankruptcy and automatic stay have a long way to evolve.

Id.; cf. Daniel T. Tyukody, Jr., *Good Faith Inquiries Under the Bankruptcy Code*; *Treating the Symptom, Not the Cause*, 52 U. CHI. L. REV. 795, 815 (1985):

Secured creditors object to bankruptcy petitions because bankruptcy courts do not grant the adequate protection required by the Code and predicted by the creditor's bargain model. Bankruptcy courts have consistently refused to grant secured creditors the time value of their investment. Moreover, the courts tend to overestimate the value of the secured creditor's collateral. Through such overvaluation, the courts are led to assert that the collateral fully protects the secured creditor's claim when, in fact, it does not. These valuation problems result from the actions of courts, not of debtors; to decide the question created by these valuation problems in terms of the debtor's good faith is to miss the point.

Id. (footnotes omitted).

¹⁰ Bankruptcy Act 356, 11 U.S.C. § 756 (repealed 1978) (permitted modification only of rights of unsecured creditors).

While a clever court and debtor might conspire to make it worthwhile for a secured creditor to agree to a reorganization, they could not force it.

In every case under the new chapter 11, the courts and the debtor in possession had all of the rights and more than a court and trustee would have had under chapter X of the Act. Under the Act, large companies were supposed to go into chapter X and smaller ones into chapter XI. For reasons too complicated to deal with here, few went into chapter X and many that should have been in chapter X used chapter XI. So the Code's largest threat was that the bankruptcy judges and the DIP would have the right to mess with the collateral in every reorganization where, formerly, that right was available only infrequently and at the cost of suffering the inefficiencies and aggravations of chapter X.

It must also have been threatening for the Code to spell out the rights of the DIP in such detail. Even if these rights had existed in old chapter X, many were buried in cases, rules or practices.¹¹ In the Code they were put out front, in the black letter so that even the slowest DIP lawyer could find and assert them. Consider some of these rights.

First is the automatic stay of section 362.¹² On filing of the petition, a creditor is automatically stayed from doing anything that might look, feel or smell like the collection of a debt. The secured creditor could not repossess. Even if he had repossessed, he could not sell. That a secured creditor could get "adequate protection" was cold comfort, for what was "adequate" was at the discretion of the judge, and the judge might find that a mortgage on a rusting plant was adequate protection for the impairment of a security interest in some A+ accounts receivable. Moreover the court might not find a need to protect the creditor's entire position or might conclude that the collateral was not decreasing in value (as the creditor claimed) and thus no protection would be needed.

It was not always so clear that the stay, which was frequently imposed under chapter XI, could stop a foreclosure proceeding that had begun before the

¹¹ See [Sexton v. Dreyfus](#), 219 U.S. 339, 343-44 (1911) (indicating no post-petition interest for secured creditor for amount above security interest); [In re J.S. Gissel & Co.](#), 238 F. Supp. 130, 134 (S.D. Tex. 1965) (foreclosing ship mortgage commenced prior to chapter X proceedings enjoined).

¹² Stay was automatic under chapter X, but was up to the discretion of the judge under chapter XI; [11 U.S.C. § 548 \(1967\)](#) (repealed 1978) (stating "Until otherwise ordered by the judge, an order approving a petition shall operate as a stay of a prior pending bankruptcy, mortgage foreclosure, or equity receivership proceeding, and of any act or other proceeding to enforce a lien against the debtor's property."); [11 U.S.C. § 714 \(1967\)](#) (repealed 1978):

The court may, in addition to the relief provided by section 11 of this Act and elsewhere under this chapter, enjoin or stay until final decree the commencement or continuation of suits other than suits to enforce liens upon the property of a debtor, and may, upon notice and for cause shown, enjoin or stay until final decree any act or the commencement or continuation of any proceeding to enforce any lien upon the property of a debtor.

Id.

bankruptcy was filed.¹³ Section 362 clearly stopped foreclosures in their tracks, and after *Whiting Pools*¹⁴ did so even with respect to personal property that had been repossessed before the filing.

Second was the expansive right in section 363 for the DIP to use and even sell collateral. Kmart can sell and United Airlines can fly the creditors' collateral. Here too the court could limit such use, but courts that saw a mandate to foster reorganizations and to avoid liquidations would not favor the secured creditors' arguments. Under 363, use and sale in the ordinary course do not require a court's or the creditor's approval, but such approval surely would have been necessary under chapter XI and likely so under chapter X.¹⁵

Third was section 506(b) that appeared to cut off interest liability of the debtor except to the extent that the value of the collateral exceeded the amount of the debt. That meant that if the debtor airline owed \$500 million secured by aircraft worth \$499 million, there was no obligation during the reorganization proceeding to pay or accrue interest on the debt. If a reorganization proceeding could be expected to last three or four years when interest rates were at 10 percent, it meant that the creditor stood to lose the right and opportunity to earn \$50 million of interest each year. In making its interest calculation, every secured creditor had to consider the risk that it might have to extend an interest free loan for a undetermined period.

The right of the DIP to control the reorganization was apparently insured by section 1121's grant of a 120 day exclusivity period. Of course, creditors feared that judges would extend the exclusivity period as they had the power to do so. During that period the DIP could make its own plan, negotiate with various creditors and conceivably get a plan approved that disfavored one or more creditors while that creditor was barred from even proposing an alternative plan.

Finally the Code explicitly granted the power to "cramdown" a plan over the objection of a secured creditor provided the plan met the requirements of section 1129, particularly that it promised the secured creditor a stream of payments with a present value equal to the value of the collateral.¹⁶ A secured creditor did not have

¹³ See *In re Lane Foods, Inc.*, 213 F. Supp. 133, 136 (S.D.N.Y. 1963) (holding bankruptcy referee had jurisdiction for stay even though warrant for execution had already been obtained where creditor landlord obtained warrant for eviction prior to filing chapter XI, but failed to execute it).

¹⁴ *United States v. Whiting Pools, Inc.*, 462 U.S. 198, 200-01 (1983) (stating section 362(a) is inapplicable to IRS).

¹⁵ See H.R. DOC. NO. 93-137, pt. I, at 17:

The procedures required by the Act in the sale of property of a bankrupt estate have been much criticized for the inordinate administrative detail and expense. The trustee must ordinarily obtain court approval in the form of an order permitting the sale; creditors must ordinarily be notified of any proposed sale; the property must ordinarily be appraised; the sale must ordinarily be a public sale; and the trustee's sale is subject to approval or disapproval by the court.

Id.

¹⁶ A similar provision existed under X; 11 U.S.C. § 616(7) (1967) (repealed 1978). Providing plan: shall provide for any class of creditors which is affected by and does not accept the plan by the two-thirds majority in amount required under this chapter, adequate protection for the realization by them of the value of their claims against the property dealt with

to be paranoid to fear that a judge might find that its collateral was worth less than the creditor thought or apply too high a discount rate—so limiting the secured creditor to a stream of payments with a smaller value than the creditor believed its collateral had.

The Code inflicted many other small cuts on the secured creditor. It expanded the bankruptcy court's jurisdiction to allow the debtor to bring a recalcitrant secured creditor into that court, a forum thought more favorable to the debtor than some remote state or federal court might be. Preference law was strengthened by adding a reach of one year for insiders, by the omission of the reasonable cause to believe requirement, and by the addition of a presumption of insolvency during the 90 days before the petition was filed. And section 364(d)'s authority for post-petition priming credit must have frightened secured creditors who did not wish to be DIP lenders.¹⁷

Some of the secured creditors' fears about the Code were soon borne out. First the cases affirmed that the bankruptcy court's new jurisdiction reached well beyond the boundaries that had existed. A court's jurisdiction over particular property under the Act of 1898 depended in many cases on the debtor's possession of that property.¹⁸ Shortly after the Code became effective, a series of lower court cases held that goods that had been repossessed prior to the filing were nevertheless part of the estate, subject to the stay, and liable to be turned over to the debtor.¹⁹ This line of cases was capped by a 1983 Supreme Court decision, *Whiting Pools*, where the Court held that even the supreme creditor, the Internal Revenue Service, had to turn back assets that it had taken from the debtor before it filed. By reaching back to acts done before the filing these cases diminished a secured creditor's incentive to hasten toward a repossession, for the expense and effort of such a repossession or

by the plan and affected by such claims, either as provided in the plan or in the order confirming the plan, (a) by the transfer or sale, or by the retention by the debtor, of such property subject to such claims; or (b) by a sale of such property free of such claims, at not less than a fair upset price, and the transfer of such claims to the proceeds of such sale; or (c) by appraisal and payment in cash of the value of such claims; or (d) by such method as will, under and consistent with the circumstances of the particular case, equitably and fairly provide such protection.

Id.

¹⁷ Ironically, as will be shown below, this came to protect secured creditors rather than injure them, through the ability of the DIP lender to control the terms of the DIP lending agreement.

¹⁸ See BENJAMIN WEINTRAUB & ALAN N. RESNICK, [BANKRUPTCY LAW MANUAL section 6.01](#), at 6–3 (15th ed. 1986) (finding court to only have jurisdiction over property either actually or constructively possessed by debtor on date of bankruptcy). In addition, the court had personal jurisdiction over debtor and other persons who consented to court's jurisdiction. *Id.* By basing jurisdiction on possession or consent, however, many disputes that arose in bankruptcy cases fell outside scope of the bankruptcy court's jurisdiction and therefore had to be adjudicated in non-bankruptcy state or federal courts. *Id.*

¹⁹ See *In re Day Res. & Dev. Co., Inc.*, 21 B.R. 176, 177–78 (Bankr. D. Idaho 1982) (ordering bank to turn over property subject to adequate protection plan); *In re King*, 14 B.R. 316, 317–18 (Bankr. M.D. Tenn. 1981) (ordering financial corporation to turn over truck repossessed prior to debtor's bankruptcy filing); *In re Gunder*, 8 B.R. 390, 392–93 (Bankr. S.D. Ohio 1980) (ordering bank to turn over automobile repossessed prior to debtor's bankruptcy filing); *In re Shockley Forest Indus., Inc.*, 5 B.R. 160, 162–63 (Bankr. N.D. Ga. 1980) (finding bank holding mortgage on real property subject to court's turnover order).

partial foreclosure would be for naught if the debtor filed shortly after the assets were taken from the debtor's possession.

Second the cases shortly found that "adequate protection" did not quite maintain the status quo ante. Assume an uncommonly vigilant secured creditor who not only insisted that his debtor hold collateral equal to 120% of the debt but, *mirabile dictu*, also enforced that requirement by diligent monitoring and by refusing to extend additional credit unless the ratio was maintained. In 1978 that creditor might have believed that section 361(3)'s promise to preserve the "indubitable equivalent" of his interest "in such property" would mean that his ratio of collateral to debt would be maintained during the bankruptcy. Those hopes were ended by Judge Maybe's decision in *In re Alyucan*.²⁰

Alyucan and cases following it²¹ concluded that only that part of the collateral equal to the amount of the debt was entitled to adequate protection. To add insult to injury the Court found that the "equity cushion," here the 20%, could itself be regarded as adequate protection for the 100%. Our vigilant creditor was punished for his vigilance by being forced to devour his own collateral. On the other hand his brother—a prodigal son who had allowed his collateral to shrink to the amount of the debt—was entitled to new security as adequate protection.

A third disappointment for secured creditors arose from bankruptcy courts' early practice in routinely extending the "exclusivity" period during which only the debtor could propose a plan of reorganization.²² Under section 1121 only the debtor can file a plan for the first 120 days of a chapter 11 case. For that period a debtor need not fear a competing plan from secured or unsecured creditors and has an accordingly reduced incentive either to hasten its plan to a vote or to bargain with its creditors over a plan. In *Manville* the court extended exclusivity 5 times and in *Ames Group* 9 times. These decisions seemed to portend that chapter 11 would take the wretched course of railroad reorganizations where railroads lingered in bankruptcy for decades.²³ Long delays are hurtful to secured creditors not only because they increase the risk that collateral will decline in value or be dissipated, but also because they constitute an interest free unilateral extension of an existing loan.

That most secured and all unsecured loans would be interest free during the bankruptcy was confirmed by the Supreme Court in the 1988 case *Timbers of*

²⁰ [*In re Alyucan Interstate Corp.*, 12 B.R. 803, 809–10 \(Bankr. D. Utah 1981\)](#) (rejecting equity cushion analysis).

²¹ See, e.g., [*In re Lee*, 11 B.R. 84, 85 \(Bankr. E.D. Pa. 1981\)](#) (recognizing equity cushions to satisfy adequate protection); [*In re Orlando Coals, Inc.*, 6 B.R. 721, 723–24 \(Bankr. S.D. W. Va. 1980\)](#) (same); [*In re 5-Leaf Clover Corp.*, 6 B.R. 463, 466–67 \(Bankr. S.D. W. Va. 1980\)](#) (noting that dissipated equity cushions no longer provide adequate protection for secured creditors).

²² See Richard M. Cieri et al., *Applying an Ax When a Scalpel Will Do: The Role of Exclusivity in Chapter 11 Reform*, 2 J. BANKR. L. & PRAC. 397, 410 n.53 (1993) (listing cases where exclusivity was extended several times).

²³ See Florence de Haas Dembitz, *Progress and Delay in Railroad Reorganizations Since 1933*, 7 LAW & CONTEMP. PROBS. 393, 407 (1940) (positing reasons for delay and expense in railroad reorganizations).

Inwood.²⁴ A secured creditor could make a powerful argument that the "indubitable equivalent" of its interest in its collateral included the opportunity to liquidate the collateral and invest the proceeds elsewhere—or alternatively that it receive interest during the bankruptcy. This right to liquidate, so the argument goes, was an opportunity that was part of the secured creditor's bargain and so should be recognized as part of the secured creditor's "interest." Against this argument was the statement in section 506 that explicitly granted interest to secured creditors to the extent that the value of their collateral exceeded the amount of the debt. Did that rule also contain an implication that one whose collateral did *not* exceed the amount of the debt was *not* entitled to interest? In *Timbers* the Court found that implication in section 506 and rejected the counter argument from section 361.

That secured creditors could expect no interest during the pendency of a chapter 11 proceeding magnified their concern over courts' willingness repeatedly to extend the exclusivity period. Note too that the debtor's escape from interest liability on its secured debt enabled a debtor to devote its cash flow to other needs and diminished its incentive to get out of chapter 11. Why should one venture into a world where one's competitors were paying 8 or 10 percent for their money when interest free money could be enjoyed behind the bankruptcy court's shield?

A fifth threat that the early cases confirmed arose from the bankruptcy court's discretion to shape adequate protection to its fancy. While section 362 and 363 promised adequate protection to the secured creditor and section 361 assured a version of Judge Hand's elegant "indubitable equivalence," in reality every bankruptcy judge had wide discretion in determining the length and breadth of adequate protection. The forms specified in section 361 are only examples and other forms of adequate protection could be as long or as short as the judge's imagination. For example a secured creditor who held a security interest in high quality accounts receivable at the start of the case might fear that the DIP would use the proceeds of his receivables and substitute a mortgage on a rusty factory of "equal value." While security in the former might be much more valuable than security in the latter, convincing a hostile judge of that (or overturning a contrary finding on appeal) would be hard. To prove that a stream payment or some other asset has a greater or smaller value than some other apparently comparable asset might require expert testimony and, in a big case, days of hearings with no certainty of success in front of a judge who might be hell bent on seeing a confirmed reorganization.

²⁴ [United Sav. Assoc. of Texas v. Timbers of Inwood Forest Assocs., Ltd.](#), 484 U.S. 365, 371–72 (1988). Of course, section 506(b) allows interest to the extent that the value of the collateral exceeds the amount of the secured debt. See [11 U.S.C. § 506\(b\) \(2002\)](#) (allowing postpetition interest to be paid from security cushion, if any).

Finally courts' unwillingness to permit sales,²⁵ early in the chapter 11 proceeding, of all or most of the assets of chapter 11 debtors seemed to close a door that offered an escape from a long chapter 11 proceeding. Shortly after it filed in May of 1982, Braniff Airlines had agreed to discontinue operations and to sell most of its assets to PSA, a west coast airline.²⁶ The employees and unsecured creditors objected to a sale that would have foreclosed the possibility of a reorganization.²⁷ Those objecting argued that such a sale deprived them of the protections built into section 1129 and into the rules on voting and negotiation that apply to plan approval.²⁸ The Court refused to allow an early sale under 363 in the hope of a successful reorganization.²⁹ In the end Braniff failed to reorganize and the secured creditors doubtless suffered losses from depreciation of their collateral as well as the loss of the time value of their money from the delay.³⁰

The thesis of this paper is that the predictions from the Code and the early interpretations of the Code have proved wrong. I believe that chapter 11s of public companies now form a market that facilitates dealings among secured and unsecured creditors, debtors, employees and others. In that market, the secured creditor has achieved a power and status (as this is written in 2004) that at least equals his status prior to the Code and, perhaps, exceeds it. In this paper I consider only secured creditors in chapter 11 cases of public companies.³¹

Secured creditors have achieved this resurrection by clever use of the provisions of the Code and, more importantly, by using their economic power to get agreements from debtors and debtors in possession that mitigate the sting of injurious provisions of the Code. Part of the sting of these provisions has been removed by changes in bankruptcy judges' attitudes and by creditors' guiding debtors to courts where judges might be sympathetic to the secured creditors' arguments and to the enforcement of agreements between debtors or DIP's and their secured creditors.

I divide the discussion into five major subjects:

²⁵ See *Pension Benefit Guar. Corp., Cont'l Air Lines, Inc. v. Braniff Airways, Inc. (In re Braniff Airways, Inc.)*, 700 F.2d 935, 940 (5th Cir. 1983) (requiring district courts to "scale the hurdles" erected in chapter 11 before approving sale of asset transactions); see also *Inst. Creditors of Cont'l Air Lines, Inc. v. Cont'l Air Lines, Inc. (In re Cont'l Air Lines, Inc.)*, 780 F.2d 1223, 1227-28 (5th Cir. 1986) (remanding to determine whether debtor used section 363(b) to sidestep protections creditors would have otherwise received); *Comm. of Equity Sec. Holders v. Lionel Corp. (In re Lionel Corp.)*, 722 F.2d 1063, 1071 (2d Cir. 1983) (finding sale of 82 % stock interest improper because it ignored creditors' equity interests).

²⁶ *In re Braniff Airways, Inc.*, 700 F.2d at 938-39.

²⁷ *Id.* at 940.

²⁸ *Id.*

²⁹ *Id.*

³⁰ See *In re Braniff, Inc.*, 110 B.R. 980, 981-82 (Bankr. M.D. Fla. 1990) (stating company created pursuant to Braniff's reorganization plan subsequently filed for bankruptcy as well); see also *Gregory G. Hesse, On the Edge: Defense to Chapter 22*, 17 AM. BANKR. INST. J. 22, 22 (1998) (noting Braniff has failed to reorganize); Grant Newton & Paul Wertheim, *Examining the Impact from the Repeal of the Stock-for-Debt Exception*, 3 AM. BANKR. INST. L. REV. 355, 366-67 (1995) (listing Braniff Airlines as failed reorganization).

³¹ It is possible that secured creditors have fared worse in small chapter 11s and in consumer bankruptcies, but I doubt it.

- I. Change in judicial attitude concerning the time that a debtor should be allowed to linger in bankruptcy.
- II. Securitization and other security substitutes that remove assets from bankruptcy's reach.
- III. Early liquidation under section 363.
- IV. Secured creditors' use of creditor protecting provisions in section such as 507(b), 547(c) and 1129.
- V. Elevation and protection of secured creditors' claims by agreement with the debtor.

I. CHANGE IN ATTITUDES CONCERNING TIME

The time a debtor lingers in bankruptcy matters. Lawyers charge by the hour, investment bankers charge by the month and assorted other professionals also charge by time, not by event. So, longer bankruptcies mean larger bills.³² But that is not the principal cost of lingering. The principal cost for the secured creditor—and for every other person that will receive a payment at the conclusion of the case—is the lost opportunity to put that payment to use. Outside of bankruptcy a secured creditor can foreclose, turn the collateral into cash and invest that cash. Inside bankruptcy and, absent a bargain of the kind described in Part VI, interest payments for pre-petition debt are suspended in almost all cases; consequently the creditor's bargained benefit is lost.

For some, prolonging bankruptcy is good. Of course, lawyers and others who charge by unit of time have an interest in prolonging the case; the same is true of employees of the debtor. Where liquidation will leave nothing for the shareholders, or, in more desperate cases, even for the unsecured creditors, they too lose nothing and may gain by prolonging. The shareholders—and less likely the unsecureds—share Mr. Micawber's hope that "something will turn up," the hope that the market for the debtor's product will turn, that the recession will end, or that the debtor's competitors will stumble. In most cases these hopes are as vain as Mr. Micawber's were. By hypothesis in these cases the debtor's trajectory is downward; those who have put the firm into this precarious position are usually still in the cockpit and the bankruptcy itself is increasing the dive angle. Still this hope of future payment, however unrealistic, is preferable to the present certainty of no recovery that liquidation brings.

³² See Joseph Mitzel, *When is an Order Final?: A Result-Oriented Approach to the [Finality Requirement for Bankruptcy Appeals to Federal Circuit Courts](#)*, 74 MINN. L. REV. 1337, 1367 ("[T]he accumulation of legal fees during a corporate reorganization can make long delays extremely expensive for both the debtor and the unsecured creditors."); Edward A. Adams, *Studies: Billing Rates Higher, Proceedings Take Longer Here*, N.Y.L.J., June 24, 1993, at 1 ("The more time a company spends in bankruptcy, the higher the fees will be."). It is estimated that Enron's legal fees will top \$1 billion. This would make it the most expensive bankruptcy ever; however, it is likely that it will be topped by WorldCom. See Eric Berger, *Legal Fees for Enron 'Shocking' in Stature*, HOUS. CHRON., Nov. 14, 2003, available at <http://www.chron.com/cs/CDA/printstory.htm?front/2221135>.

This is the conflict that the Code and the courts must resolve. The shareholders, employees and perhaps the unsecureds want the bankruptcy prolonged in the hope that they can capture some latent upside and the secureds want liquidation so they can cash out and move on. In life the arguments will not be as honest and crude as I have suggested. Those out of the money will not ask for extensions by expressing hope that something will turn up, rather they will argue that the value of the company is large enough to leave something for them. They will argue about the going concern value of the debtor and will scold the secureds for their selfish wish to destroy that value. The employees, fully aligned with shareholders for this purpose, need only stand in the wings with tears in their eyes to make their interest known. The lawyers and others with an interest in prolonging may covertly delay court proceedings but they dare not voice their private interests.

These conflicts between the secureds on the one hand and shareholders, et al. on the other, can be joined in several ways. The most obvious is over the debtor's request for an extension of the exclusivity period, the period within which only the debtor can propose a plan of reorganization. The period is 120 days³³ and the court has the power to extend it repeatedly.³⁴ The conflict might also be fought out over a secured's request for the stay to be lifted or for adequate protection.

In the large cases that followed on the heels of the Code, judges often spoke and acted as though the purpose of chapter 11 were to produce reorganizations and avoid liquidations at all costs. This attitude led to multiple extensions of the exclusivity period in early cases.

But then two things challenged conventional judicial attitudes. First there was a burst of academic writing. Professor Michelle White and others demonstrated the evils of prolonging the life of a dying firm. This writing demonstrated that prolonging bankruptcy could hurt not only secured creditors but also unsecured creditors and competing firms. And this cost was not offset by significant rewards for employees. For example Eastern Airlines flew for two years in bankruptcy. When it liquidated, its secured creditors were not paid in full, its unsecureds went hungry, and its employees lost their jobs. To the extent that its continued operation was subsidized by the bankruptcy process (no interest payments for 22 months),³⁵ it injured its competitors who had to pay their interest bills.³⁶

³³ See [11 U.S.C. § 1121\(b\) \(2002\)](#) (providing "only the debtor may file a plan until after 120 days after the date of the order for relief under this chapter.").

³⁴ See [11 U.S.C. § 1121\(d\) \(2002\)](#) (allowing for extension, or reduction, of 120 day period on request of party in interest).

³⁵ See Lawrence A. Weiss & Karen H. Wruck, *Information Problems, Conflicts of Interest, and Asset Stripping: Chapter 11's Failure in the Case of Eastern Airlines*, 48 J. FIN. ECON. 55, 56 (1998) (stating bankruptcy court allowed Eastern to use proceeds of asset sales to fund continued operations for 22 months).

³⁶ Economic arguments were made that the bankruptcy process allowed inefficient firms to continue operating, while more efficient firms would file for bankruptcy to redistribute debt loads. See Michelle J. White, *The Corporate Bankruptcy Decision*, 3 J. ECON. PERSP. 129, 129–30 (1989).

Professor White lists a number of "subsidies" that are given to reorganizing firms in bankruptcy,³⁷ such as an interest-free bankruptcy reorganization period, and the right selectively to cancel unprofitable projects.³⁸ White followed these writings a few years later by showing that both efficient and inefficient firms were likely to file for bankruptcy, and suggested that the process needed to be reformed to improve efficiency in chapter 11.³⁹

Also the courts began to take hits in the popular press. A 1993 Wall Street Journal article criticized courts for turning bankruptcies into "marathons." The article suggested that preserving dying companies did little to benefit the industry but forced competitors to suffer by having to compete with debt-reduced, reorganized dogs—often in crowded markets.⁴⁰ Some bankruptcy practitioners even joined in these complaints.⁴¹

A third event may have played a role here too. By the late '80's professional DIP lenders had evolved and those lenders and their lawyers had figured out that some courts were more favorable to their interests than others. As I explain more fully below, these DIP lenders directed their debtor clients to courts that would be more receptive to a creditor's request to lift the stay or to present a competing plan. Also, as I show below, the DIP lenders learned to take a stronger grip on the debtor than they had done previously. This may have had a direct impact on the length of cases even if the judges had not changed.

³⁷ See *id.* at 144–46 (listing subsidies reorganizing firms benefit from including: accrued tax loss carryforwards, right to terminate underfunded pension plans, non-recognition of debt forgiveness for tax purposes, etc.).

³⁸ See *id.* at 143–45 (noting interest-free reorganization period granted to debtors and ability of debtor to get out of unprofitable contracts during reorganization).

³⁹ See generally Michelle J. White, *Does Chapter 11 Save Economically Inefficient Firms?*, 72 WASH. U. L.Q. 1319 (1994).

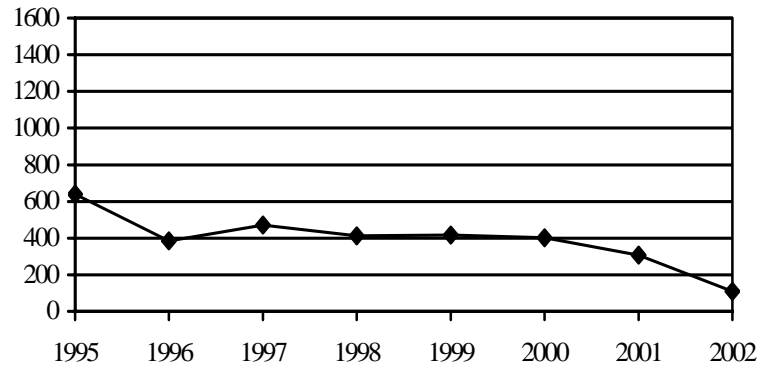
⁴⁰ See Kenneth H. Bacon, *Creditor Backlash: Losses in Bankruptcies Spur Lenders to Strive to Protect Themselves—Impetus to Stiffen Law Grows as More People use it Simply as Business Tactic—The 'Survival of the Unfittest'*, WALL ST. J., June 17, 1993, at A1 (using Bethlehem Steel as example of company suffering due to competition with reorganized competitors that reduced their debt and evaded obligations).

⁴¹ See Cieri, *supra* note 22, at 419–20 (asserting chapter 11 cases are taking too long, and overuse of exclusivity provisions is partly to blame).

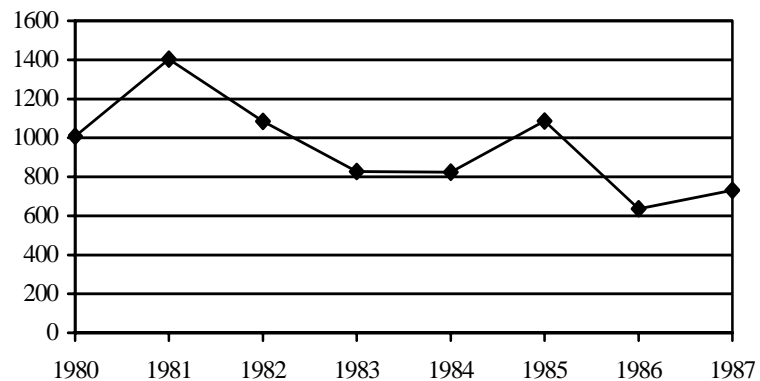
The upshot of this is shown by the charts in the footnotes.⁴² Note that the

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Mean Chapter 11 Duration, 1995 - 2002



Mean Chapter 11 Duration, 1980 - 1987



Year	All Bankruptcies		Controlling for "Pre-packaged" and "Pre-negotiated"	
	Mean	Frequency	Mean	Frequency
1980	1007	3	1007	3
1981	1403	5	1403	5
1982	1084	13	1084	13
1983	827	6	827	6
1984	823	6	823	6
1985	1087	6	1087	6
1986	970	10	1067	9
1987	636	8	636	8
1988	730	12	730	12
1989	990	15	1040	14
1990	747	27	792	25

average length of large bankruptcies of 1007 days in 1980 has shrunk to 402 days by 2000. Even when one controls for pre-packaged and pre-negotiated bankruptcies, the average length in days has fallen from 1007 in 1980 to 469 in 2000. The length of time has also dropped even if one excludes the cases that were filed away from the debtor's home (i.e., in a forum presumably favorable to the debtor); the average length of cases filed in the place of the debtor's headquarters has fallen from 926 in 1980 to 423 in 2000.

II. SECURITY SUBSTITUTES—SECURITIZATION AND LEASES

A. *Securitization*

A principal limitation on the bankruptcy court's jurisdiction is the definition of "Property of the Estate" in section 541. In general if something is property of the estate, the court and the DIP have power to mess with it; if not, they don't. If a lender can somehow transfer its collateral to a third party, such as a trust or a "special purpose vehicle," the property will be beyond the reach of the DIP and of the court in any bankruptcy of the debtor. This means that the creditor will not be subject to the stay with respect to the collateral, the DIP will not be able to use or sell it under section 363 as it could if the collateral were inventory or equipment subject to a security interest, and it means that interest (or the economic substitute

1991	670	38	738	34
1992	356	31	513	20
1993	315	25	512	14
1994	431	11	720	6
1995	639	18	798	14
1996	385	14	705	6
1997	472	14	673	9
1998	412	29	543	20
1999	417	35	549	21
2000	402	57	469	43
2001	306	57	348	40
2002	110	36	112	13

The charts above show the general trend of duration in days for large chapter 11 cases, using data compiled by Professor Lynn LoPucki. They show a general downward trend, though the number of cases in the first two years are statistically insignificant, at 3 and 5 respectively. Pre-packaged and pre-negotiated bankruptcies may have played a role, but the data suggests that it is a limited role. Controlling for "pre-packaged" and "pre-negotiated" bankruptcies, the mean duration in the first statistically significant year, 1982, was at 1084 days; that number had fallen to 348 days in 2001, and had shown a similar downward trend. "Pre-packaged" means that the debtor drafted the plan and successfully solicited votes on it before filing the case. Pre-packaged cases nearly always are filed solely to modify the company's liability on an issue of junk bonds. Once filed, these cases move very quickly. "Pre-negotiated" means that the debtor negotiated the terms of the plan with some, but not all creditor groups before filing, even if no pre-filing vote was taken on the plan. An example would be a plan to sell the debtor's business, which has been drafted and negotiated with a large secured creditor before filing, but not with trade creditors. *See* WebBRD: Lynn M. Lopucki's Bankruptcy Research Database, at <http://lopucki.law.ucla.edu/index.htm>.

for interest) continues to be paid. Finally of course this property and any claims to it are unaffected by any plan of reorganization.

An ancient practice called "factoring" fits this model. A "factor" is one who buys a seller's accounts receivable for a discount and without recourse. The factor thus buys the entire upside (if the accounts pay more than his discounted price, he gains) and bears the risk of default by the account debtors (if many default, he bears that loss). Factoring is the economic equivalent of a secured, non-recourse loan under which the creditor has agreed to look to the accounts as its sole recovery.

Beginning in 1948,⁴³ factoring graduated to the big leagues where it was given a new name, "securitization." Securitization first developed in the home mortgage market. In that market Fannie Mae struck upon the idea of bundling packages of mortgage loans, putting them in a trust or other entity and then selling interests in the pool of mortgages. This transaction gave Fannie Mae cash for its mortgages so enabling it to make new mortgage loans. Separating the loans from Fannie Mae meant that the pool of mortgages carried a credit rating unrelated to Fannie Mae's business and freed the investors from any need to monitor Fannie Mae or to determine its creditworthiness. It seems unlikely that fear of bankruptcy of the lenders, Fannie Mae, et al., stimulated those early securitizations (for the Freddie's, Fannies', and Ginnies' liabilities are thought to carry the implicit guarantee of the federal government) but moving them off the balance sheet of Fannie Mae, et al. simplified the credit evaluation.

Soon securitization spread to other markets where bankruptcy of the original lender was conceivable. Beginning in 1985,⁴⁴ consumer lenders, weak and strong,

⁴³ See TAMAR FRANKEL, *SECURITIZATION: STRUCTURED FINANCING, FINANCIAL ASSETS POOLS, AND ASSET-BACKED SECURITIES* § 6.2, at 180 (Little, Brown & Co. 1991) ("In 1948, Congress chartered the Federal National Mortgage Administration ("FNMA" or "Fannie Mae"), which had been established as a subsidiary of the Reconstruction Finance Corporation in 1938, to develop a secondary market in mortgage loans.") (citations omitted); see also [Claire A. Hill, *Securitization: A Low-Cost Sweetener for Lemons*, 74 WASH. U. L.Q. 1061, 1119-21 \(1996\)](#):

The modern era of securitization began in 1970 when the United States government created the Federal Home Loan Mortgage Corporation ("Freddie Mac"). Freddie Mac joined its siblings, Government National Mortgage Association ("Ginnie Mae") and Federal National Mortgage Administration ("Fannie Mae"; all three collectively, "GSEs" or "government sponsored entities") in making a secondary market in mortgages—that is, buying and selling mortgages. Fannie Mae and Ginnie Mae had bought and sold mortgages and mortgage backed securities guaranteed by the Veterans Administration ("VA") and the Federal Housing Administration ("FHA"). By contrast Freddie Mac's secondary market activities involved 'conventional' mortgages . . .

Id. (citations omitted).

⁴⁴ See FRANKEL, *supra* note 43, at 183 ("By 1980 the success of the secondary mortgage market was established, and private sector lenders, mortgage bankers, and the securities industry sought to enter this market."); see also [Lois R. Lupica, *Revised Article 9, Securitization Transactions and the Bankruptcy Dynamic*, 9 AM. BANKR. INST. L. REV. 287, 291-92 n.29 \(2001\)](#) [hereinafter *Revised Article 9*] ("Sperry Corporation originated the first non-real estate-related public securitization in 1985. This issuance was followed by General Motors Acceptance Corporation securitization in 1986." (noted in Lowell L. Bryan, *Structured Securitized Credit: A Superior Technology for Lending*, J. APPLIED CORP. FIN., Fall 1988, at 10-11)).

and many others started securitizing. In some of these cases bankruptcy of the original lender, no longer Ginnie or Freddie protected by the government's wing, was a possibility. When so, investors would be willing to pay to be free of that risk. Therefore in those cases, the seller of the accounts would enjoy a lower effective interest rate (a smaller discount) than they would have to pay on a conventional direct secured loan against the same accounts. Professor Lupica describes this growth of securitization as follows:

[C]lever investment bankers realized in the mid-1980s that the same financial innovation could be applied to non-real estate related receivables. Once discovered, the securitization market grew quickly, and currently, it is the fastest growing segment of the capital markets. More than 2.5 trillion of asset-backed securities are outstanding, and over the past fifteen years, the market has grown at a rate of thirty percent per year. Industry experts have observed that virtually any asset income stream can be securitized, and recent years have seen a volume of \$150 billion in issuances. An estimated \$700 million in public asset-backed securities are now issued in an average business day.⁴⁵

It is indisputable that for many debtors securitization is a cheaper way of acquiring capital than secured borrowing is. What part of that savings is attributable to avoidance of the trustee's reach in bankruptcy is not clear, but surely some part of the savings comes from bankruptcy "remoteness." Whether the process is efficient, whether, as Prof Schwarcz argues, it is truly an alchemy, is also subject to dispute.⁴⁶ Despite all the arguments that one sees about freedom from the debtors' "exposure to external events, business downturns, interest rate fluctuations, [and] management decisions,"⁴⁷ it seems plausible to me that avoidance of the debtor's trustee is the only virtue in many cases. Apart from the bankruptcy risk, I

⁴⁵ [Lois R. Lupica, *Circumvention of the Bankruptcy Process: The Statutory Institutionalization of Securitization*, 33 CONN. L. REV. 199, 208-09 \(2000\)](#) [hereinafter *Circumvention of Bankruptcy Process*].

⁴⁶ See generally [Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J.L. BUS. & FIN. 133, 146-51 \(1994\)](#) [hereinafter *Alchemy of Asset Securitization*]. But see [Lois R. Lupica, *Asset Securitization: The Unsecured Creditor's Perspective*, 76 TEX. L. REV. 595, 659 \(1998\)](#):

The most modest conclusion that may be drawn is that structured finance's efficiency is unproven. A bolder assertion, and one this Article predicts will be supported by empirical evidence, is that securitization is inefficient. When value is diverted from nonadjusting creditors to parties with greater knowledge, resources, and opportunity to bargain *ex ante* for greater leverage to encourage voluntary repayment (and in the event of bankruptcy, to guarantee priority repayment), then this value represents a distributional inefficiency. Moreover, unsecured creditors of securitizing originators do not receive the benefits of protection from the phenomenon of debtor misbehavior that they receive when their debtor uses its assets as security for credit. In the absence of such protections, unsecured creditors are most vulnerable to the risk of nonpayment as well as the risk of debtor's bankruptcy.

Id. (citations omitted); [Alan Schwartz, *The Continuing Puzzle of Secured Debt*, 37 VAND. L. REV. 1051, 1054 \(1984\)](#) (defending, from recent scholarly attack, his thesis declaring secured lending inefficient). Schwartz believes secured credit is inefficient because it is costly to issue, and the benefit of the lower interest rate from the secured lender, for their decreased risk, will be completely offset by the increased interest rates unsecured lenders will charge for their increased risk of being unable to levy against assets. *Id.*

⁴⁷ *Circumvention of Bankruptcy Process*, *supra* note 45, at 211.

see no reason why a fully secured creditor should charge a higher interest rate than a securitization investor would demand.⁴⁸ Absent bankruptcy, full security protects from bad business decisions, external events, claims of other creditors of the debtor's business, etc.

Let me explain the "bankruptcy risk." Compare a secured creditor who lends \$10 million and takes a security interest in debtor's \$12 million of receivables with a group of investors who buys notes from a trust that holds the debtor's \$12 million worth of receivables. Experience tells us that the investors will demand a lower effective interest rate than the bank will charge.

It is indisputable that the debtor's interest in the receivables in which it has given a security interest is part of the bankruptcy estate under section 541.⁴⁹ Even though the debtor has given a perfected security interest, the debtor retains title. In the second case most commentators and virtually every practitioner of securitization believe that the "sale" of the receivables to the trust has removed them from the bankruptcy estate as that estate is defined in section 541.⁵⁰

⁴⁸ Of course a secured lender's cost of funds might be higher than the cost of funds of mutual funds and others who buy securitized assets as investors. If so, one would expect securitized loans to be cheaper than secured loans, irrespective of bankruptcy. See Claire A. Hill, *Is Secured Debt Efficient?*, 80 TEX. L. REV. 1117, 1130 (2002) (discussing differences between lenders and markets concerning secured debt).

⁴⁹ 11 U.S.C. § 541(a)(1) (2002) (including "all legal or equitable interest of the debtor in property as of commencement of the case.").

⁵⁰ See STEVEN L. SCHWARCZ, STRUCTURED FINANCE, A GUIDE TO THE PRINCIPLES OF ASSET SECURITIZATION 16–24 (Practicing Law Inst., 2d ed. 1992) (discussing important aspect of transactions and extensive efforts of originators when SPVs are structured so courts will characterize transactions as true sales, and not loans, so SPV will not become part of bankruptcy estate of originator, should originator fail); *Alchemy of Asset Securitization*, *supra* note 46, at 151 ("Securitization, thus, creates genuine cost reductions. By eliminating the risk of bankruptcy to investors, many different types of companies can better utilize their most valuable assets, their receivables, by accessing low cost capital market funding."); see also U.C.C. § 9-318 (2002) (covering the rights and title of sellers of accounts or chattle paper with respect to creditors and purchasers); PEB COMMENTARY NO. 14, § 9–102(1)(b) (June 10, 1994) (proposing addition to comment 2 to 9-102, which denied any intention to leave any interest with seller of accounts despite using terms "debtor" and "secured party"). The Commentary declares, "a close reading of the text of Article 9 and its comments . . . compels the conclusion that Article 9 does not prevent the transfer of ownership." *Id.* This comment was issued in response to *Octagon Gas v. Rimmer*, 995 F.2d 948 (10th Cir. 1993), where the court held that a perfected sale of a 5% interest in the proceeds of a gas distribution system were part of the bankrupt's estate, because Article 9 treats the buyer of an account as a secured creditor, the seller as debtor and the accounts sold as collateral. *Id.*; 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, 1398 n.178 (1999) ("Revised section 9-318 rejects Octagon Gas insofar as the opinion interpreted Article 9."). But see *In re LTV Steel Co.*, 274 B.R. 278, 279 (Bankr. N.D. Ohio 2001) (involving LTV, "one of the largest manufacturers of wholly-integrated steel products in the United States," entered into unconventional securitizations of its receivables and inventory). Having filed for bankruptcy, the debtor sought an interim order to permit the use of cash collateral arguing that the pre-petition financing arrangements were not "true sales." *Id.* at 281. The court granted the motion until the determination of whether the transactions were "true sales" could be made, over the objections of the owners of the assets who claimed the court had no basis to determine whether the assets were part of the debtor's estate. *Id.* at 282. Judge Bodoh responded to these objections:

[T]here seems to be an element of sophistry to suggest that Debtor does retain at least an *equitable* interest in the property that is subject to the interim order. Debtor's business requires it to purchase, melt, mold and cast various metal products. To suggest

When the debtor enters bankruptcy, the trustee or DIP has rights over the receivables in the former but not the latter case. The most threatening of those rights is the right to use property of the estate under section 363. For example the DIP might propose to take one month's payments from the receivables to pay for operating expenses and offer to give the bank a mortgage on its unmortgaged plant as adequate protection. As I suggest above, the bank might find this collateral not adequate because it is illiquid or because it believes that the value of the plant is much less than the value of the receivables. Because the securitized receivables are sold, and not within the estate, the DIP has no such power over them.

At this writing it is not absolutely clear that the law will continue to treat these two transactions differently. Some argue that the sale to the trust or special purpose vehicle is no more than the grant of a security interest and therefore that the sold account is still within the estate.⁵¹

In section 541 the drafters of the Code were generally content to follow the state law on ownership in defining property of the bankruptcy estate.⁵² With few

that Debtor lacks some ownership interest in products that it creates with its own labor, as well as the proceeds to be derived from that labor, is difficult to accept. Accordingly, the Court concludes that Debtor has at least some equitable interest in the inventory and receivables, and that this interest is property of the Debtor's estate.

Id. at 285. The issue as to whether the transactions were true sales or not was never fully litigated, the court approved DIP financing which was conditioned on debtors concession that the transactions were "true sales." *Id.* at 284. See generally Jonathan C. Lipson, *Enron, Asset Securitization and Bankruptcy Reform: Dead or Dormant?*, 11 J. BANKR. L. & PRAC. 101, 109 (2002) (discussing section 912 of Bankruptcy Reform Act of 2001, which would have protected securitization by prohibiting courts from treating securitizations as secured transactions). Support for section 912 was undercut by the collapse of Enron, but Professor Lipson predicts that similar provisions will be introduced in the future due to the "powerful, wealthy, and articulate lobby" for the reform. *Id.*; Revised Article 9, *supra* note 44, at 292-93:

The long-term attractiveness of the ABS vehicle to investors, however, turns upon the extent of the isolation of these assets from the credit risk of the originator. The extent of the secured assets' isolation from the originator in turn, depends upon the efficacy of the transaction's structure. The strength of any transaction's structure is a product of a targeted and well developed legal system Seeing that the legal regime governing securitization has been outpaced by the growth of the securitization market, legal protection against the credit risk of the originator, used as a selling point to the ABS investors, may in fact, be 'oversold'.

Id. (citations omitted). Lupica then describes the increased protection securitizations received in the 1999 amendments of article 9, but notes, "Section 9-318, however, does not address the equitable determination of whether a particular asset transfer is properly characterized as a sale of assets or a transfer of collateral in connection with a loan (the sale versus loan dilemma)." *Id.* at 301. (citations omitted). Greg Zipes, *Securitization: Challenges in the Age of LTV Steel Company, Inc.*, 2002 ANN. SURV. BANKR. L. 105, 111-13 (2002) (noting securitizations are susceptible to grasp of trustee in bankruptcy through true sale analysis, as in LTV, or through substantive consolidation law). Substantive consolidation is when a court determines that equity requires the debtor and subsidiary be dealt with as one, usually because the affairs of the two were heavily intertwined. *Id.* at 115.

⁵¹ See *In re LTV Steel Co.*, 274 B.R. at 285 (highlighting Abbey National's arguments on whether receivables are property of debtor's estate).

⁵² See H.R. DOC. NO. 93-137, at 192-93:

The commission recommends that all property owned by the debtor as of the date of the filing of the petition be considered property of the estate subject to administration In addition to property owned by the debtor at the date of the petition, the property of

exceptions that was "all legal or equitable interests of the debtor in property" as defined by the applicable state law. There is no indication that the Commission or the legislative drafters foresaw the rise of securitization; in any case there was no attempt to deal with it in section 541.

Had the drafters of the Code looked for state law on the nature of a securitizer's rights in property they would have found it in Article 9 of the Uniform Commercial Code (UCC). Earlier the drafters of Article 9 in turn could have taken either of two positions on the rights of a factor/securitizer. First they might have treated a factor/securitizer as a secured creditor for all purposes. They might have disregarded the form and simply ruled as a matter of state law that title to a "sold" account was not sold but remained the property of the seller and that the factor/securitizer held only a security interest that could be perfected by filing.

Alternatively the drafters could have recognized the "sale" as valid but ruled that the "buyer" had to file a financing statement or be subordinated to the rights of the seller's creditors.

By specifically referring to "sale of accounts" in section 9-102(1)(b) and by treating the buyer's interest as a security interest in 1-201(37) and subordinating unperfected security interests to the rights of lien creditors in 9-301, the drafters apparently chose the latter alternative. That alternative was less radical than a complete statutory reconfiguration of the transaction. So the law as adopted did not say that a "sale of an account" was merely the "grant of a security interest" for all purposes, rather by applying Article 9 to certain "sales," it appeared to recognize those transactions as sales for certain undisclosed purposes but to require that the buyer perfect if he wishes to enjoy priority over certain creditors of the seller.

If the drafters of the Code had foreseen this issue and had examined the probable rights of a trustee in bankruptcy to the use of proceeds of sold accounts under Article 9 (which in 1973 was already widely adopted) they might not have been content to rely solely on state law. Despite periodic eruptions of dissent, it seems likely that most courts will now follow the lead of the PEB⁵³ and the revisers of Article 9⁵⁴ to conclude that securitized accounts are outside of the seller's

the estate would include (a) recoveries under the avoidance sections of the proposed act; (b) property subject to a power of appointment to the extent exercisable by the debtor for his own benefit; and (c) property acquired within six months of the petition by bequest, devise, or inheritance or as a result of a property settlement or interlocutory or final divorce decree. In the case of a partnership debtor, property of the estate would include the recovery from any partner of the deficiency in partnership assets to meet partnership obligations.

Id. (footnotes omitted).

⁵³ See PEB COMMENTARY, *supra* note 50 (concluding "Article 9's application to sales of receivables does not prevent the transfer of ownership" and amending U.C.C. section 9-102, comment 2 accordingly).

⁵⁴ See U.C.C. § 9-318 (2002). No interest retained in right to payment that is sold; rights and title of seller of account or chattel paper with respect to creditors and purchasers:

- (a) A debtor that has sold an account, chattel paper, payment intangible, or promissory note does not retain a legal or equitable interest in the collateral sold.
- (b) For purposes of determining the rights of creditors of, and purchasers for value of an account or chattel paper from, a debtor that has sold an account or chattel

bankruptcy estate and so removed from the DIP's reach. The uncertainty as to whether securitized assets were to be out of the reach of a trustee in bankruptcy was to be resolved once and for all in section 912 of the 2001 Bankruptcy Reform Act, but the collapse of Enron undercut the proposal's support.⁵⁵

The magnitude of securitization—new public and private issue volume in the ABS market set a record in 2002 of \$420 billion⁵⁶—makes this process the most significant anti-bankruptcy device for secured creditors. The dollar amount of receivables that are securitized must swamp the dollar amount in which secured creditors take conventional security interests. It seems unlikely that securitization can be stretched to be a substitute for security in inventory but the creditors tried to do so in *LTV Steel*⁵⁷ and it is conceivable that others will succeed. Judge Bodoh was particularly offended that the creditors in *LTV* thought that they could convey the inventory of raw steel to a third party (who was to hold it ready for production), make finished products of the steel on the day before LTV filed and yet claim that the steel was not part of LTV's estate.⁵⁸ Were effective securitizations of inventory possible, Article 9 would become obsolete for large firms.

B. Leases

Leases and deals that are documented as leases but are in fact secured loans are well known. Here I ignore the kinds of leases—often with inexpensive purchase options—that are treated as security agreements under section 1-201(37) of the UCC. I consider only deals that would be regarded as true leases, not subject to Article 9 but rather to Article 2A.

Even though this latter group is classified as leases and not as security agreements, they can be a secured lending substitute. For example a trucking company might lease a new truck for ten years. If these leases had no option to buy, they would not be treated as a security agreement under section 1-201(37) but would enable the trucking company to have assured long-term use of the asset in

paper, while the buyer's security interest is unperfected, the debtor is deemed to have rights and title to the account or chattel paper identical to those the debtor sold.

Id.

⁵⁵ See, e.g., Lipson, *supra* note 50, at 102, 102, 115–16 (claiming while "the connection between Enron and Section 912 . . . is only circumstantial" the legal uncertainty makes it "easy to see why Congress appears to have jettisoned Section 912.").

⁵⁶ *U.S. Market Outlook*, RESEARCH (The Bond Mkt. Research Ass'n, Wash. D.C.), Jan. 2003, at 2, available at http://www.bondmarkets.com/research/US_Market_Outlook_for_2003.pdf (last visited Mar. 24, 2004).

⁵⁷ *In re LTV Steel Co.*, 274 B.R. 278, 285 (Bankr. N.D. Ohio 2001) (rejecting creditor's argument that "receivables which constitute its collateral are not property of Debtor's estate" as circular and containing "element of sophistry").

⁵⁸ I am informed that one law firm gave an opinion that the sale of receivables by LTV was ok but that it did not give the opinion on the inventory. The latter opinion came from another firm. My informant suggested that the firm that gave the receivable letter declined to give a similar opinion on the inventory.

return for installment payments. Economically, if not legally, such a lease is a substitute for a loan secured by the asset.⁵⁹

The rights of lessors, covered in exquisite detail in section 365, differ widely from the rights of a secured creditor in bankruptcy. First the debtor must either assume the lease or reject it within a reasonable period after the filing. To assume a lease, the DIP must bring the lease payments up to date or give adequate assurance (not to be confused with the weaker adequate protection) that he will promptly do so. After he affirms, the DIP must pay according to the lease terms. Failure to pay on a lease that the lessee has assumed would be a basis for lessor's cancellation,⁶⁰ and amounts not paid after an assumption earn administrative expense priority.⁶¹ Most important, the debtor has no right to tender mere adequate protection nor does he have the right in reorganization to keep the asset on payment of an amount equal to its value. In short the cramdown under section 1129 that may be forced on every secured creditor (making it settle its secured claim for the value of the collateral) cannot be imposed on a lessor.

Leases are not perfect or pervasive substitutes for security. They are not suitable for inventory and they carry a debtor's option to cancel. Under section 365 a debtor who chooses not to assume may reject a lease, return the asset to the lessor and suffer only an unsecured claim equal to the damage caused to the lessor by the rejection.⁶²

⁵⁹ Lessors have always had the right to repossess aircraft under section 1110. See [11 U.S.C. § 1110\(a\)\(1\) \(Supp. 2003\)](#) (detailing ability of both secured creditors and lessors to repossess aircraft with few limitations); see also Gregory P. Ripple, *Special Protection in the Air[line industry]: The Historical Development of Section 1110 of the Bankruptcy Code*, 78 NOTRE DAME L. REV. 281, 283, 294 (2002) (noting section 1110 "provides an exception to the automatic stay, and allows the financiers of aircraft[s] . . . to repossess their collateral if the airline is unable to cure any defaults within thirty days" and that "[a]ny lease or security interest in aircraft now falls under the umbrella of section 1110.").

⁶⁰ Cf. 7 COLLIER ON BANKRUPTCY ¶ 1110.05, at 2[b] (Lawrence P. King et al. eds., 15th ed. rev. 2001):

[I]f the trustee formally assumes the relevant lease or executory contract, either pursuant to a plan or in accordance with the provisions of section 365, then the obligation becomes a binding obligation of the estate. After assumption, breach of the relevant obligation will give rise to a damage claim allowable as an administrative expense (if the breach occurs before confirmation of a plan) or recoverable against the reorganized debtor (if the breach occurs after confirmation).

Id.

⁶¹ See, e.g., Laura B. Bartell, *The Lease of Money in Bankruptcy: Time for Consistency?*, 16 BANKR. DEV. J. 267, 275 n.34 (2000) ("If the rejected lease had been previously assumed, the breach is deemed to occur at the time of rejection . . . meaning that the damages occasioned by the breach will be entitled to administrative expense priority.") (footnotes omitted).

⁶² See Bartell, *supra* note 61, at 274-75:

When neither assumption nor assumption and assignment are beneficial to the estate, the trustee may opt to reject the unexpired lease Some consequences of rejection are clear: section 365(g)(1) provides that such rejection of an unexpired lease which has not previously been assumed constitutes a 'breach' of the lease immediately before the date of the filing of the petition. The claim arising from such a breach is treated as is any other claim arising prior to the filing of the bankruptcy petition; that is, it is considered a pre-petition claim subject to discharge.

Id. (footnotes omitted).

This means that leases are preferable to security agreements for certain only where the leased goods will retain value to the debtor/lessee that is greater than the present cost of the lease payments. Consider a hypothetical airline that leases both 777's and 727's. The former are new large two engine aircraft with low operating costs per seat/mile; the latter are smaller, older three engine gas pigs. When the airline declares bankruptcy, it will want to keep the 777's and get rid of the 727's, and the market will share the debtor's opinion—777's resale market will be high and the 727's, low. In a proposed renegotiation of the 777 leases, the lessor will have the upper hand; in a renegotiation of the 727 leases, vice versa.⁶³

So in some cases leases side-step many of the barriers that chapter 11 places in front of secured creditors. If the asset is suitable for lease, and if there is a reasonable likelihood that the asset will retain sufficient value to make a reorganizing lessee assume the lease, the lease is likely to preserve the lessor's analog to interest, likely to avoid issues of unsatisfactory adequate protection and, under the terms of section 365, be impervious to any other tricks of the DIP.

III. SECTION 363 SALES

Chapter 11 was designed for reorganization. I suspect that many of the drafters had visions of railroad reorganizations before them as they sat down to work every day. In drafting sections 1129, 1121 and like sections, they must have visualized extended negotiation among creditors of various ranks, shareholders and employees as the parties untangled a complicated capital structure.

Did they anticipate that section 363, used commonly for ordinary course sales (and even for an occasional sale of an asset out of the ordinary course), could also be used to sell off the principal business, the going concern guts of the firm that

⁶³ See Edward Wong, *The Silver Lining in United's Clouds: Good Lease Deals*, N.Y. TIMES, Dec. 24, 2002, at C1:

United, the world's second-largest airline, after American, leases nearly 40 percent of its 633 planes, according to Back Aviation Solutions, an airline consulting company. So renegotiating better lease rates – as well as rejecting leases outright on the least useful aircraft – would mean tremendous cost savings

.... Russell Young, a spokesman for Boeing Capital, which has \$1.3 billion of exposure to United through aircraft loans, leases and bonds, said that the street value of planes had fallen 15 to 40 percent since the Sept. 11 attacks, and that United would be using the new values as benchmarks in its talks.

United can bargain hard to get better rates on its older or out-of-production aircraft, experts say. The airline could tell its lessors it will terminate leases on, say, all its Boeing 757's and sign new leasing agreements on only the first dozen handed it on generous conditions. But that tactic might not work well with United's younger Airbus fleet. The airline's 153 Airbus A320's are only four years old on average, and it is unlikely United would want to lose those planes. Furthermore it would be tougher to bargain for a basement rate on the A320's since they are thought to be a hot commodity, especially because of their popularity among growing low-cost carriers. Those planes could be more easily redeployed by lessors if they were to take them back from United.

Id.

entered chapter 11? Of course, such a sale of the principal operating unit short circuits extended palaver over the various parties' rights in a plan; there is no vote on a plan or opportunity to litigate over rights under section 1129. If the assets sold are subject to a perfected security interest, the sale cuts off the possibility that the unsecureds or shareholders will profit from a later increase in the value of those assets or from a finding by the bankruptcy court that the assets have greater value than the price to be received on their sale. The sale also ends the jobs of employees who are not carried away with the sold operations. So one might expect that shareholders and employees who are to lose jobs always and unsecured creditors, sometimes, would oppose such sales and would argue that they are a perversion of chapter 11's purpose.

In *Pension Benefit Guar. Corp. v. Braniff Airways, Inc. (In re Braniff Airways, Inc.)*,⁶⁴ the Court of Appeals for the Fifth Circuit struck down the proposed transfer to PSA of Braniff's cash, terminal leases, landing slots, airplanes, and equipment for travel scrip, unsecured notes, and profit participation in PSA's proposed operation.⁶⁵ The objection was that section 363(b) is not applicable to sales of all, or substantially all of the assets of a debtor, and that these transactions must be made pursuant to the "voting, disclosure and confirmation requirements" of the Code. The court viewed the transaction as a whole, as the lower courts had, and concluded that since certain portions of the transaction were outside the scope of section 363, the transaction could not be approved.⁶⁶ The court held, "In any future attempts to specify the terms whereby a reorganization plan is to be adopted, the parties and the district court must scale the hurdle erected by Chapter 11."⁶⁷

But Braniff's reign was short. In another 1983 opinion, *In re The Lionel Corp.*,⁶⁸ the Second Circuit disapproved of a section 363 sale of the principal asset of the company prior to confirmation. The Court held, "there must be some articulated business justification, other than appeasement of major creditors, for using, selling, or leasing property outside the normal course of business before the

⁶⁴ [700 F.2d 935 \(5th Cir. 1983\)](#).

⁶⁵ *Id.*

⁶⁶ *See id.* at 939–40 (discussing aspects of proposed sale outside scope of section 363):

Three examples will illustrate our rationale. The PSA Agreement provided that Braniff would pay \$2.5 million to PSA in exchange for \$7.5 million of scrip entitling the holder to travel on PSA. It further required that the scrip be used only in a future Braniff reorganization and that it be issued only to former Braniff employees or shareholders or, in a limited amount, to unsecured creditors. This provision not only changed the composition of Braniff's assets . . . it also had the practical effect of dictating some of the terms of any future reorganization plan . . .

Second, under the agreement between Braniff and its creditors, the secured creditors were required to vote a portion of their deficiency claim in favor of any future reorganization plan approved by a majority of the unsecured creditors committee. . . .

Third, the PSA transaction also provided for the release of claims by all parties against Braniff, its secured creditors and its officers and directors.

Id.

⁶⁷ *Id.* at 940.

⁶⁸ [In re Lionel Corp., 722 F.2d 1063 \(2d Cir.1983\)](#).

bankruptcy judge may order such disposition under 363(b)." Even though the quoted statement was dictum, it directed later courts toward "business reasons" to justify a sale and away from the case law that required an "emergency" for a sale outside the ordinary course of business.⁶⁹ Later cases took up the cause and soon even "appeasement of major creditors," marching under the banner of business justification, was enough.⁷⁰

In a modest bit of hyperbole Professors Baird and Rasmussen were able to claim in 2002 that 363 sales of businesses had nearly pushed conventional reorganizations off the stage:

Corporate reorganizations have all but disappeared. Giant corporations make headlines when they file for chapter 11, but they are no longer using it to rescue a firm from imminent failure. Many use chapter 11 merely to sell their assets and divide up the proceeds. TWA filed only to consummate the sale of its planes and landing gates to American Airlines. Enron's principal assets, including its trading operation and its most valuable pipelines, were sold within a few months of its bankruptcy petition. Within weeks of filing for chapter 11, Budget sold most of its assets to the parent company of Avis. Similarly, Polaroid entered chapter 11 and sold most of its assets to the private equity group at Bank One. Even when a large firm uses chapter 11 as something other than a convenient auction block, its principal lenders are usually already in control and chapter 11 merely puts in place a preexisting deal. Rarely is chapter 11 a forum where the various stakeholders in a publicly held firm negotiate among each other over the firm's destiny.⁷¹

⁶⁹ See *id.* at 1070–71:

The history surrounding the enactment in 1978 of current Chapter 11 and the logic underlying it buttress our conclusion that there must be some articulate business justification . . . for using, selling, or leasing property out of the ordinary course of business

The case law under section 363's statutory predecessors used terms like "perishables," "deteriorating," and "emergency" as guides in deciding whether a debtor's property could be sold outside the ordinary course of business. The use of such words persisted long after their omission from newer statutes and rules. The administrative power to sell or lease property in a reorganization continued to be the exception, not the rule. In enacting the 1978 Code Congress was aware of existing case law and clearly indicated as one of its purposes that equity interests have a greater voice in reorganization plans -- hence, the safeguards of disclosure, voting, acceptance and confirmation in present Chapter 11.

Resolving the apparent conflict between Chapter 11 and section 363(b) does not require an all or nothing approach. Every sale under section 363(b) does not automatically short-circuit or side-step Chapter 11 . . . some play for the operation of both section 363 (b) and Chapter 11 must be allowed for.

Id. (citations omitted). But cf. *id.* at 1071 ("The administrative power to sell or lease property in a reorganization continued to be the exception, not the rule.").

⁷⁰ Craig A. Sloane, *The Sub Rosa Plan of Reorganization: Side-Stepping Creditor Protections in Chapter 11*, 16 *BANKR. DEV. J.* 37, 48 (1999) ("The Lionel 'business justification' test has become the preeminent standard for applications to sell assets outside the ordinary course of business pursuant to section 363(b) of the Bankruptcy Code.").

⁷¹ Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 *STAN. L. REV.* 751, 751–52 (2002).

Although he is more critical of the new attitude than Professors Baird and Rasmussen, Professor Kuney's work confirms their claims about the prevalence of business sales and shows that the practice and bankruptcy court rules have now accommodated 363 business sales.⁷² His survey shows the extensive use of section 363 to liquidate assets in chapter 11.⁷³

Professor Kuney advocates a uniform non-plan sale process because it would standardize what courts are already doing. He describes the benefits of non-plan sales as follows:

By selling the assets of a business as a unit, rather than in a piecemeal liquidation, going concern value can be captured for the benefit of the estate. Further, by reducing the assets of the estate to cash, a note secured by the assets sold, the stock purchaser, or some other similar form of fungible valuable consideration, the tasks and costs of post-sale management and administration of a debtor and its estate can be dramatically reduced. This, in turn, allows for a reduction in the amount of a debtor's value that is redistributed from pre-petition creditors to post-petition administrative claimants as a case drags on. It takes little in the way of a management team to preside over an estate comprised solely of liquid assets. Further, once reduced to liquid assets, proposal and confirmation of a strict or absolute priority plan or conversion of the case to one under chapter 7 should lead to speedy distributions to creditors and a minimum of haggling and litigation over proper priorities.⁷⁴

So what does this offer to the secured creditors? Well, it gives them the same benefit that everyone else enjoys, a lower priced reorganization. Part of that comes from reduced administrative fees, but more of it comes from the shortening of the term of their non interest-bearing loan. Presumably the ultimate payout in these cases comes sooner than in other chapter 11s and that payout can be put to use. But as I indicate above, it also minimizes the possibility that the unsecureds or the employees successfully bargain for a larger share of the assets as a payoff for ending their delay and it minimizes the possibility that the court will give the unsecureds too large a share because it overvalues the debtor's assets.

IV. USE OF STATUTORY PROTECTIONS

Notwithstanding any preference that the Commission or the Congress might have had for facilitating reorganization and for protecting the rights of certain

⁷² See George W. Kuney, *Let's Make it Official: Adding an Explicit Preplan Sale Process as an Alternative Exit From Bankruptcy*, 40 HOUS. L. REV. 1265 (2004) [hereinafter *Alternative Exit From Bankruptcy*]; see also George W. Kuney, *Misinterpreting Bankruptcy Code Section 363(f) and Undermining the Chapter 11 Process*, 76 AM. BANKR. L. J. 235, 272 (2002) [hereinafter *Misinterpreting Bankruptcy*] (indicating chapter 11 use to achieve pre-negotiated sale of business or assets flows from inclusion of claims under section 363(f)).

⁷³ See *Alternative Exit From Bankruptcy*, *supra* note 72, at 1266–67 (providing number of proposed amendments to Bankruptcy Code to provide for uniform, non-plan sale process nationwide).

⁷⁴ *Id.*

unsecureds and debtors, both recognized the interests of secured creditors. The Code includes many provisions to protect those interests, and a few provisions that strengthen those interests have been added since 1978. Well-heeled and well represented, secured creditors have made the most of these provisions in the 25 years since the Code's adoption. Among these are 1129(b)(2)(A), 364(d), 547(c), 507(b), 1110 and the post Code enactments on swaps, repo agreements and the like, section 555 et seq.

A. 1129(b)(2)(A)

The most prominent (but seldom tested) of the secured creditor protection provisions is section 1129(b)(2)(A). That subsection protects against "cramdowns," the imposition of a plan over the objection of a secured creditor. It requires that an unconsenting secured creditor get a stream of cash with a present value equal to the value of its collateral or the indubitable equivalent of that stream.⁷⁵ Cramdowns on secured creditors may be often threatened, but they are seldom done. Why?

First few DIP lenders need cramdown protection. Any DIP lender with its wits about it will be in the driver's seat for all of the reasons described in Part VI below.⁷⁶ Having made itself indispensable by making the DIP loan, the DIP lender will be intimately involved in the formulation of a plan, and any such plan of reorganization will accommodate the lender's wishes.

Second the cost and difficulty of a fight with a major secured creditor may be more than a reorganizing debtor can bear, even if a cramdown were likely at the end of the fight. Some commentators believe that the uncertainties involved in the bankruptcy process, specifically collateral valuation, the determination of the discount rate, and the cost of delay, are the reasons few cramdowns are attempted.⁷⁷

⁷⁵ Each secured claim is usually in its own class because the claim is different from all other secured claims in either: priority, nature of the collateral, or particular subordination agreements the lender may have. See 7 COLLIER ON BANKRUPTCY ¶ 1122.01 (Lawrence P. King et al. eds., 15th rev. ed. 2001) ("Section 1122 of the Bankruptcy Code, which governs the classification of claims or interests in a chapter 11 plan, provides a plan proponent with an important tool in aid of reorganization—namely, the ability to classify substantially similar claims in the same class for purposes of voting and treatment.") (footnotes omitted); see also 7 COLLIER ON BANKRUPTCY ¶ 1122.03[4][c] (Lawrence P. King et al. eds., 15th ed. 1996) ("As a general rule, each holder of an allowed claim secured by a security interest in specific property of the debtor should be placed in a separate class Conceptually, classification of secured claims must be determined on the basis of (i) priority, (ii) nature of the collateral, and (iii) agreements among creditors with respect to subordination.") (footnotes omitted).

⁷⁶ See *infra* Part VI.

⁷⁷ See Charles D. Booth, *The Cramdown on Secured Creditors: An Impetus Toward Settlement*, 60 AM. BANKR. L.J. 69, 104-05 (1986) (highlighting risks of cramdown process: confusion, delay, valuation, discount rates, and increased likelihood of liquidation due to adversarial posturing of parties). Booth then concludes "All of these risks and uncertainties may be avoided if the parties avert a cramdown [I]n most chapter 11 cases, it will be in the best interest of all the parties to reach a settlement and to consent to a plan under section 1129(a), rather than to resort to a cramdown under section 1129(b)." See also Richard F. Broute, *Cramdown and Chapter 11 of the Bankruptcy Code: The Settlement Imperative*, 39 BUS. LAW. 441, 454 (1984):

Valuation of the company is something that sophisticated participants in any significant Chapter 11 avidly desire to avoid. The imposition of the fair and equitable standard and a modified version of the absolute priority rule in [C]hapter 11 is thus designed to bring the parties to the bargaining table in an attempt to avoid the various risks described throughout this article. By compromise and settlement, secured creditors can avoid the risks inherent in collateral valuation and a court-imposed interest discount rate

Id. But see Jack Friedman, *What Courts Do To Secured Creditors in Chapter 11 Cramdown*, 14 CARDOZO L. REV. 1496, 1499 (1993) (examining entire cramdown case law from passage of Code to January 1993). "The final and most general purpose of this Article is to demonstrate that the traditional mystique concerning cram down which instills fear among secured creditors is exaggerated. Cram down is applied in a remarkably

Furthermore, in disputes over these issues, debtors and creditors are forced into adversarial proceedings where funds are redirected from the organization toward expert witnesses and bankruptcy professionals, decreasing the probability of a successful reorganization.⁷⁸

Jack Friedman undertook a comprehensive analysis of the cramdown case law from the enactment of the [Code in 1978](#) until January of 1993.⁷⁹ Friedman's investigation revealed that there were only 175 published cases where plans had been crammed down on secured creditors during the Code's first 15 years of operation.⁸⁰ Friedman also noted, "The overwhelming majority of cases involved real estate as collateral (80% or more). In a significant minority of these cases, the debtor's only asset was a single real estate property."⁸¹ My interviews confirm Mr. Friedman's conclusion—cramdowns occur with respect to major secured creditors only in single asset bankruptcies where they are frequent.⁸² Some noted that cramdowns are often threatened and in effect negotiated against minor secured creditors in conventional reorganizations. These creditors might have security in certain office machines or other tangential assets, but would not be the principal secured lender. Infrequent cramdowns, largely on smaller secured creditors, is still the trend as confirmed by a survey of the reported cases from 2001 through 2003.⁸³

Providing a stream of payments with a value equal to the value of the collateral to a non-consenting secured creditor is essentially allowing the plan's proponent to write a new loan. The real fight is over the discount rate; should \$1million to be paid 10 years from now be valued presently at \$385,543.29 (a 10% discount rate) or at \$613,913.25 (a 5% discount rate)? Friedman determined, "there are almost fifty Chapter 11 cases on this issue under clause (i), surprisingly, all but three cases cited below held that the market rate for commercial loans is the correct legal standard

homogenous and predictable manner regarding secured claims." *Id.* Friedman concedes there are still uncertainties regarding delay, valuation, and cost of the process. *See id.*

⁷⁸ *See* Booth, *supra* note 77, at 104–05 (noting threat of cramdown is factor regarding settlement due to problems associated with cramdowns).

⁷⁹ *See* Friedman, *supra* note 77, at 1498 (stating author examined every cram down decision found under current Code).

⁸⁰ *See id.* (asserting 175 cases represented entire body of precedent).

⁸¹ *Id.* at 1507–08.

⁸² *See id.* at 1508.

⁸³ A search for terms "1129(b)(2)(A)" on Lexis, over the period of 1/1/2001 to 7/14/2003 yielded five cases where chapter 11 cramdown plans had been attempted. Only two of the plans were confirmed pursuant to 1129(b)(2)(A). *See GE Capital Corp. v. Mach., Inc. (In re Mach., Inc.)*, 275 B.R. 303 (B.A.P. 8th Cir. 2002). Creditor had a \$2,582,680.14 claim. Debtor proposed to cramdown a plan valuing creditors collateral at \$1,700,000. Creditor valued the collateral at \$2,600,000 and made a motion for the court to determine the value of the collateral. The court determined the value of the collateral was \$1,668,000.00. Creditor appealed but the appeal was dismissed. *Id.* at 305–07. There was no subsequent history. *See In re Seatco, Inc.*, 257 B.R. 469 (Bankr. N.D. Tex. 2001). Debtor manufactured custom van and truck seats and other accessories. *Id.* at 472. Debtor was able to have a plan confirmed over objecting creditor, holding a \$190,000 claim, because creditor would retain its liens and receive payments for the current value of the collateral. *Id.* at 484. WorldCom's bankruptcy case was also recently confirmed using 1129(b)(2)(A). *See* Barnaby Feder, *Court Approves WorldCom Plan*, N.Y. TIMES, Nov. 1, 2003, at C3.

for a secured creditor cramdown."⁸⁴ The three outliers held that the original contract rate was the correct standard.⁸⁵ Determining which market rate to apply is where courts have diverged. Some courts determine the rates according to local lending rates,⁸⁶ including what the lender itself is charging for a similar loan.⁸⁷ Other courts have used a formula rate where risk premiums are added to base rates, such as that of a treasury bill⁸⁸ or a prime rate.⁸⁹ None of these is perfect, and each offers purchase for any critic.

The other option for cramming down a plan on a secured creditor is to grant the "indubitable equivalent" of its claim.⁹⁰ Three types of cramdown proposals have

⁸⁴ Friedman, *supra* note 77, at 1512.

⁸⁵ See [Confederation Life Ins. Co. v. Beau Rivage Ltd.](#), 126 B.R. 632, 638 (N.D. Ga. 1991) ("[A] market rate approach is not the exclusive means of insuring that Confederation Life receive the value of the amount owed on the date the plan was confirmed."); [In re Naugle's Nursery, Inc.](#), 37 B.R. 574, 576 (Bankr. S.D. Fla. 1984) ("The Court should confirm a Plan pursuant to 11 U.S.C. § 1129(b) notwithstanding the lack of acceptance by a creditor secured by mortgages on real property where these standards are met."); [In re Patel](#), 21 B.R. 101, 105 (Bankr. M.D. Fla. 1982) ("This Court believes that where a seller negotiates a fixed rate with a buyer for a purchase money mortgage on a particular piece of property, that rate is far more persuasive than the money market or other sources of financial data.").

⁸⁶ See, e.g., [In re Stratford Assocs. Ltd. P'ship](#), 145 B.R. 689, 702 (Bankr. D. Kan. 1992) (stating rates for similar loans in local region should be used); [In re Hulen Park Place Ltd.](#), 130 B.R. 39, 42 (N.D. Tex. 1991) (stating rate is determined by looking to what regional lenders would charge in similar circumstances); [In re Memphis Partners, L.P.](#), 99 B.R. 385, 386 (Bankr. M.D. Tenn. 1989) (asserting appropriate interest rate is current market rates of interest used for similar loans in the region); [In re Edgewater Motel, Inc.](#), 85 B.R. 989, 996 (Bankr. E.D. Tenn. 1988) (commenting appropriate interest rate is current market rates of interest used for similar loans in the region); [In re McCombs Properties VIII, Ltd.](#), 91 B.R. 907, 912 (Bankr. C.D. Cal. 1988) (adding risk factors); [In re Arnold](#), 80 B.R. 806, 810-13 (Bankr. M.D. La. 1987) (noting appropriate interest rate is current market rates of interest used for similar loans in the region); [In re Landmark at Plaza Park, Ltd.](#), 7 B.R. 653, 657 (Bankr. D. N.J. 1980) (asserting appropriate interest rate is current market rates of interest used for similar loans in the region).

⁸⁷ See, e.g., [In re Gene Dunavant & Son Dairy](#), 75 B.R. 328, 336 (Bankr. M.D. Tenn. 1987) (court factored in rate lender charged); [In re Timber Tracts, Inc.](#), 70 B.R. 773, 776 (Bankr. D. Mont. 1987) (same); [In re Foster](#), 79 B.R. 906, 911 (Bankr. D. Mont. 1987) (same).

⁸⁸ See, e.g., [In re James Wilson Assocs.](#), 965 F.2d 160, 165 (7th Cir. 1992) (adding 2.5% to Treasury note rate); [In re IPC Atlanta Ltd. P'ship](#), 142 B.R. 547, 557-58 (Bankr. N.D. Ga. 1992) (adding 3% to Treasury bond rate); [In re Oak Partners, Ltd.](#), 135 B.R. 440, 447 (Bankr. N.D. Ga. 1991) (adding 3% to Treasury bond rate); [In re E.I. Parks No. 1 Ltd. P'ship](#), 122 B.R. 549, 556 n.4 (Bankr. W.D. Ark. 1990) (adding 2.34% to Treasury bond rate); [In re Aztec Co.](#), 107 B.R. 585, 588 (Bankr. M.D. Tenn. 1989) (adding 2% to Treasury security rate); [In re Noe](#), 76 B.R. 675, 678-79 (Bankr. N.D. Iowa 1987) (adding 2% to Treasury bond rate); [In re Smithfield Estates, Inc.](#), 52 B.R. 220, 225 n.5 (Bankr. D.R.I. 1985) (adding 2% to Treasury bond rate).

⁸⁹ See [In re Ofra Corp.](#), 129 B.R. 404, 421 (Bankr. E.D. Pa. 1991) (adding 2% over prime rate); [In re Wood](#), No. 90-0042-C, 1991 WL 332637, at *8 (W.D. Va. Nov. 11, 1991) (adding 2% to prime rate); [In re Guilford Telecasters, Inc.](#), 128 B.R. 622, 626 (Bankr. M.D. N.C. 1991) (adding 1.5% to prime rate); [In re Manion](#), 127 B.R. 887, 889 (Bankr. N.D. Fla. 1991) (stating interest rates would normally be 1.5% to 2% over prime); [In re Computer Optics, Inc.](#), 126 B.R. 664, 670-72 (Bankr. D. N.H. 1991) (adding 2.5% to prime rate and at 4% to Treasury bond rate); [In re S.E.T. Income Props., III](#), 83 B.R. 791, 794 (Bankr. N.D. Okla. 1988) (adding 1.5% to prime rate); [In re Crane Auto., Inc.](#), 88 B.R. 81, 85 (Bankr. W.D. Pa. 1988) (adding 2% to prime rate); [In re 360 Inns, Ltd.](#), 76 B.R. 573, 594 (Bankr. N.D. Tex. 1987) (suggesting debtor amend its plan to add 2.5% over prime rate); [In re Lewis Indus.](#), 75 B.R. 862, 870 (Bankr. D. Mont. 1987) (adding 2% to prime rate); [In re Fursman Ranch](#), 38 B.R. 907, 913 (Bankr. W.D. Mo. 1984) (using rate slightly over prime).

⁹⁰ See 11 U.S.C. § 361 (2002) (authorizing adequate protection equal to indubitable equivalent of entities interest in property); see also [Koopmans v. Farm Credit Servs. of Mid-America](#), 102 F.3d 874, 874 (7th Cir.

emerged from the case law involving 1129(b)(2)(A)(iii). The first type has been characterized as a collateral substitution arrangement, where a lien from real property is transferred to shares of stock.⁹¹ Successful proposals that substitute new collateral do not increase creditors risk.⁹² Plans that propose complete payment in the future, with no cash payments in the interim are called full accrual arrangements.⁹³ Here courts require a large equity cushion and a relatively short-term.⁹⁴ More common are collateral payment plans, where the debtor surrenders the value of the collateral to the secured lender for the value of the collateral at the time of confirmation.⁹⁵ The Fifth Circuit in *Sandy Ridge Development Corp. v. Louisiana National Bank*⁹⁶ determined that "property is the indubitable equivalent of itself,"⁹⁷ but other courts have not followed suit.⁹⁸

[1996](#)) (indicating "indubitable equivalence" of secured creditor's property interest meant payments including interest that add up to present value of creditor's property interest); [In re Arnold & Baker Farms, 85 F.3d 1415, 1423 \(9th Cir. 1996\)](#) (holding debtor's plan to satisfy creditor's claim by transferring to creditor 566.5 of 1,320 acres of land securing debt did not provide creditor with indubitable equivalent of its secured claim).

⁹¹ As of 1993, six of these plans had been proposed, and two approved. See Friedman, *supra* note 77, at 1533-35.

⁹² See [In re Sun Country Dev., Inc., 764 F.2d 406, 409 \(5th Cir. 1985\)](#) (finding twenty-one first liens debtor held on lots it had sold were indubitable equivalent to first lien creditor held on two hundred adjacent acres and that twenty-one first lien notes provided 86% equity cushion in hard assets over debt); [In re San Felipe @ Voss, Ltd., 115 B.R. 526, 528-529, 531-32 \(S.D. Tex. 1990\)](#) (giving creditor package of stocks, mostly in British company, for its first mortgage on office building). The court noted that the stocks had a history of stability and liquidity, and gave the secured creditor an equity cushion of 21%. See *id.* at 531. For collateral substitution plans not approved by the court, see [In re Wester, 84 B.R. 771, 772 \(Bankr. N.D. Fla. 1988\)](#) (holding plan proposing to require objecting mortgagee to release land from lien in five acre tracts, trade tracts for similar tracts owned by debtor's mother, and sell mother's tracts would not give mortgagee "indubitable equivalent" of its claim); [In re Future Energy Corp., 83 B.R. 470, 496 \(Bankr. S.D. Ohio 1988\)](#) (holding proposed stock transfer to objecting creditors to satisfy their secured claims did not meet requirement that objecting creditors receive "indubitable equivalent" of their claim); [In re Hoff, 54 B.R. 746, 753-54 \(Bankr. N.D. 1985\)](#) (indicating lien on future crops is not the "indubitable equivalent" of lien on existing commodities); [In re Elijah, 41 B.R. 348, 352 \(Bankr. W.D. Mo. 1984\)](#) (stating if sale of surrendered collateral does not pay claims in full then deficiency must be treated as secured claim).

⁹³ As of 1993, three full accrual arrangements have been proposed and two have been approved. See Friedman, *supra* note 77, at 1535-37.

⁹⁴ See [In re Pikes Peak Water Co., 779 F.2d 1456, 1459 \(10th Cir. 1985\)](#) (approving plan provided interest would accrue at 13% for thirty six months at which time debt had to be paid off or brought current.). The court approved the plan because there was an estimated 20% equity cushion. *Id.* at 1461. See also [Woods v. Pine Mountain Ltd. \(In re Pine Mountain, Ltd.\), 80 B.R. 171, 174-75 \(B.A.P. 9th Cir. 1987\)](#) (approving full interest accrual on \$275,000 promissory note for thirty-nine months while land was developed and sold, there was \$900,000 equity cushion.).

⁹⁵ As of 1993, twenty-two of these plans had been proposed, and nineteen approved. See Friedman, *supra* note 77, at 1537-40.

⁹⁶ See, e.g., [In re Sandy Ridge Dev. Corp., 77 B.R. 69, 80 \(Bankr. M.D. La. 1987\)](#) *overruled sub nom. Sandy Ridge Dev. Corp. v. Louisiana Nat'l Bank (In re Sandy Ridge Dev. Corp.), 881 F.2d 1346, 1350 (5th Cir. 1989)* (debtor proposed to transfer partially developed property as full payment of their debt).

⁹⁷ *Id.* at 80.

⁹⁸ [In re Martindale, 125 B.R. 32, 38 \(Bankr. D. Idaho 1991\)](#) ("[I]n an uncertain market it is doubtful that such a plan offers the creditor the indubitable equivalent of its claim unless the appraised value of the property, demonstrated by competent proof, far exceeds the amount of the debt to be paid.").

Most of the cases cited in the footnotes are penny ante cases; the general trend is that few cramdowns involve big creditors in big cases.⁹⁹ A big creditor in a big case may have a strong incentive to oppose a cramdown if it is a repeat bankruptcy player, and determined opposition in such a case may be insurmountable. Too, living with a hostile secured creditor who is looking for every opportunity to call a default may be daunting.

B. 364(d)

Section 364(d) allows a DIP to grant security to a DIP lender that takes priority over the interest of an existing secured creditor.¹⁰⁰ But to do this the DIP must show that it cannot get credit otherwise and that it has provided adequate protection for the existing secured creditor.¹⁰¹ In practice these tests are seldom met. In fact the ability to pass one of the tests may show an inability to pass the other: If there is true adequate protection for the existing secured creditor, why can't the DIP find someone else to lend? Put another way, does the refusal of a third party to lend without a senior lien show that there can be no adequate protection?

An electronic search for 364(d) cases turns up only one chapter 11 case where financing pursuant to 364(d) was proposed, and the court rejected the debtor's proposal.¹⁰² This suggests that priming existing secured creditors is a desperate

⁹⁹ Cf. Friedman, *supra* note 77, at 1498–1508:

This Article analyzes every decision found in which a plan of reorganization was crammed down on a secured creditor under the current Bankruptcy Code. The approximately 175 cases discussed do not involve mere *dicta*, but represent the entire body of actual precedent

....

. . . The overwhelming majority of cases involved real estate as the collateral (80% or more).

Id. (citations omitted). A Lexis search of "1129(b)(2)(A)" from January 17, 1993 until July 11, 2003 resulted in 236 cases. These cases have not been examined. Included in this number are plans that were not approved, as well as courts referencing 1129(b)(2)(A) jurisprudence in other chapter cases, thus the actual number of 1129(b)(2)(A) plans that have been crammed down over the last ten years, is fewer than 236.

¹⁰⁰ [11 U.S.C. § 364\(d\)\(1\) \(2002\)](#):

The court, after notice and a hearing, may authorize the obtaining of credit or the incurring of debt secured by a senior or equal lien on property of the estate that is subject to a lien only if –

- (A) the trustee is unable to obtain such credit otherwise; and
- (B) there is adequate protection of the interest of the holder of the lien on the property of the estate on which such senior or equal lien is proposed to be granted.

Id.

¹⁰¹ See Joseph U. Schorer & David S. Curry, *Chapter 11 Lending: An Overview of the Process*, THE SECURED LENDER, Mar.-Apr. 1991, at 19–21 (asserting motion for financing must state terms are best available and financing is necessary).

¹⁰² A search for terms "364(d)" was performed on Lexis for the time period of 8/30/2002 to 8/30/2003. The search yielded eleven documents. Of the eleven documents, only one related to a chapter 11 proceeding in which a debtor was moving to obtain secured credit by using a senior priming lien for a post-petition lender. The debtor's motion was rejected because the existing lienholders would not be adequately protected. See [In re Windsor Hotel, L.L.C.](#), 295 B.R. 307, 316–17 (Bankr. C.D. Ill. 2003).

measure, undertaken only by debtors who have no other possibilities. Of the few cases that have allowed priming secured credit, the courts have found that there is sufficient equity to protect the existing lienholder, as well as provide security for the new lender.¹⁰³

The rules in 364(d) might be beside the point if the DIP needs cash at once. If, as is common, the debtor was suffering illiquidity when it filed, it may need money immediately to stay open. A victory under 364(d) against an existing recalcitrant secured lender that might open the door to a new lender will be too late if it comes only after a hearing that takes days or even weeks to schedule and try. So I surmise that most going concerns—like airlines or a retail firm—cannot afford to litigate with an existing secured creditor, for even a short shut down of such a business is likely to destroy their going concern value. My interviews show that there is a way around this problem in some cases.

Sometimes the court will allow the DIP loan to go forward with the understanding that the existing secured creditor who might object may make its objections later. The subject of that later hearing is the right of the DIP lender to prime the existing lender under 364(d). Of course the DIP lender is likely to appear in the white hat at that hearing. After all it is the DIP lender who is keeping the debtor afloat and it is the pre petition secured creditor who is being difficult. Depending on the terms of the original order, the DIP lender may get some cover from 364(e). My interviews show that the likely outcome of this argument is not a court decision; it is a negotiated deal under which the DIP lender gets priority but the pre pre-petition secured creditor gets some new collateral, current payments or assurance of payments. So it appears that 364(d) does come into play but only at a level that seldom rises to view in reported opinions.

C. *Special Collateral*

In its original form the Code had special rules for lenders who held security interests in aircraft and vessels. Those have since been expanded with the additions

¹⁰³ See [*In re Snowshoe*, 789 F.2d 1085, 1090 \(4th Cir. 1986\)](#) (approving district courts permission to allow trustee in bankruptcy to obtain additional credit by granting senior lien on property of estate pursuant to 364(d) over objection of Snowshoe's major creditor Shenandoah). Shenandoah claimed that their interest in the estate was not adequately protected, and that Snowshoe had not made sufficient efforts to secure additional credit. *Id.* at 1087–88. The appellate court approved the district courts authorization to incur up to \$2 million in debt, based on the findings that: Snowshoe owed Shenandoah between \$13 and \$14 million dollars, the estate was worth over \$19 million dollars, and the trustee made a good faith effort to secure credit without granting the super-priority. *Id.* at 1089. See also [*Anchor Sav. Bank FSB v. Sky Valley, Inc.*, 99 B.R. 117, 119 \(N.D. Ga. 1989\)](#) (district court approving bankruptcy court's authorization for super-priority financing of approximately \$425,000). The objecting creditor had a first priority security interest on collateral worth \$8 million to secure a loan of \$3 million. The creditor's objection was that, "the debtor has no equity in its property, considering all encumbrances against all assets, and because the debtor has sustained negative cash flow and is not likely to reorganize." *Id.* at 118. The district court affirmed the bankruptcy court's finding that the creditor was adequately protected by the equity cushion and approved the financing. *Id.* at 119.

of 1110(c)¹⁰⁴ and (d),¹⁰⁵ and have been joined by section 555 (liquidation of securities contracts), 556 (commodities contracts), 557 (grain assets), 559 (repos), and 560 (swaps). Some of these have the characteristics of secured credit and, in general, the special sections give the persons in the position of the secured creditor rights to act free of the stay and outside of the bankruptcy process.¹⁰⁶

All of these sections have been justified on the ground that the collateral covered or the transactions involved are unique. But can a clever lawyer structure a more conventional loan so that it fits one of these sections?

D. 547(c)(2)

Under the current law ordinary course payments are not preferences even if they meet the test of 547(b).¹⁰⁷ Before 1978 this exception was known as the *de minimis* rule; not to worry about small payments. In the original Code the section covered ordinary course payments but only if the payment was made "not later than

¹⁰⁴ See 7 COLLIER ON BANKRUPTCY ¶ 1110.LH[2][c] (Lawrence P. King et al. eds., 15th rev. ed. 2001):

Congress amended section 1110 through section 744 of the Wendell H. Ford Aviation and Reform Act. In doing so, Congress further clarified and strengthened the rights of secured parties, lessors, and conditional sales vendors with respect to qualifying aircraft and watercraft equipment. In addition to reconfiguring the section, Congress added new section 1110(c), directing the trustee's surrender of equipment to the extent that a secured party, lessor, or conditional sales vendor is entitled to possession under section 1110(a)(1) and has made a written demand therefore. Congress also provided for the surrender of certain records and documents in section 1110(b)(3)(B).

Id. (internal citations omitted).

¹⁰⁵ See *id.* ¶ 1110.03[1][A]:

Furthermore, new section 1110(d)(1) (applicable only in cases commenced after October 22, 1994), retroactively limits the ability of a court to recast a lease as a security agreement with respect to equipment first placed in service on or before October 22, 1994. Specifically, section 1110(d)(1) provides that a 'lease' within the meaning of section 1110 includes 'any written agreement with respect to which the lessor and the debtor, as lessee, have expressed in the agreement or in a substantially contemporaneous writing that the agreement is to be treated as a lease for Federal income tax purposes.' This provision was specifically intended to create a 'safe harbor' to shield aircraft 'leases' from recharacterization as security agreements, thus making it more difficult for a trustee in a case commenced after October 22, 1994 to recast a lease of equipment first placed in service before October 22, 1994 as a general security agreement in order to disqualify the lessor from obtaining the benefits of section 1110.

Id. (internal citations omitted).

¹⁰⁶ See, e.g., [11 U.S.C. § 555 \(2002\)](#) (stating in some circumstances liquidations of securities contract shall not be stayed); [11 U.S.C. § 557](#) (stating with respect to debtor who operates grain storage facilities, procedure may be expedited upon request for relief from stay); [11 U.S.C. § 559](#) (stating exercise of contractual right of repo participant to cause liquidation of repurchase agreement shall not be stayed); [11 U.S.C. § 560](#) (stating exercise of contractual right of swap participant in some instances shall not be stayed).

¹⁰⁷ See [11 U.S.C. § 547\(c\)\(2\) \(2002\)](#) (stating trustee may not avoid transfer made in ordinary course of business); see also [11 U.S.C. § 547\(b\) \(2002\)](#) (explicitly providing for exception contained in subsection (c) whereby trustee may not avoid transfer of interest of debtor in property).

45 days after such debt was incurred."¹⁰⁸ In its original incarnation, apparently this provision was intended to facilitate payment of small recurring bills, like utility bills. After the 45 day limit was removed in 1984,¹⁰⁹ creditors, including partially secured creditors, began to claim its protection for sums that could be far beyond *de minimis*.¹¹⁰ In *Union Bank v. Wolas*,¹¹¹ the Supreme Court confirmed that the section applied even to payments on long-term debt to an institutional creditor.¹¹²

In *Wolas*, the debtor borrowed \$7 million from a bank, and filed for chapter 7 seven months later.¹¹³ Within 90 days of filing for chapter 7, the debtor had paid approximately \$100,000 on interest, and \$2,500 on loan fees to the bank.¹¹⁴ The trustee in *Wolas* tried to recover these payments as preferences, but the bankruptcy court found that the loans and the payments on the loans had been made in the ordinary course of business.¹¹⁵ The district court upheld the bankruptcy court's decision, but the Ninth Circuit reversed, holding that the ordinary course of business exception to avoidance of preferential transfers was not available to long-term creditors.¹¹⁶ The Supreme Court overturned the Ninth Circuit, and held that payments on long-term debt, as well as those on short-term debt, may qualify for the ordinary course of business exception to the trustee's power to avoid preferential transfers.¹¹⁷

Since no payment to a fully secured creditor can be a preference under 547(b), strictly this change does not help secured creditors, but many creditors are only partially secured, or depending on the valuation of their collateral, may or may not be fully secured, so the section gives them some cover in cases on the margin.

¹⁰⁸ 5 COLLIER ON BANKRUPTCY ¶ 547.04[2] (Lawrence P. King et al. eds., 15th rev. ed. 2001) ("As originally enacted, section 547(c)(2) required transfer to have been made within 45 days after the debt was incurred in order to qualify for ordinary course of business exception.").

¹⁰⁹ See *id.* (stating "in 1984, Congress eliminated the 45-day requirement.").

¹¹⁰ See *id.* ¶ 547.04[2][a][i]:

As early as 1989, however, courts began interpreting subparagraph (C) as requiring an independent inquiry into whether the payment practice at issue comports with industry standards. At least 10 [sic] of the courts of appeals have now adopted this view. This shift in interpretation coincided with the repeal of the 45-day limit, the onslaught of cases in which the defendant sought to use the ordinary course of business defense and the decision of the United States Supreme Court in *Union Bank v. Wolas*. The march of the circuits to the holding that subparagraph (C) requires an independent analysis of the standard of the industry was based partially upon the principle of statutory construction that "[a]n interpretation of § 547(c)(2)(C) which focuses exclusively on the relationship between the creditor and the debtor, would deprive subsection (c)(2)(C) of any independent meaning because (C)(3)(B) already requires that the payment be evaluated in the context of the ongoing relationship between the debtor and the creditor.

Id. (internal citations omitted).

¹¹¹ [502 U.S. 151 \(1991\)](#).

¹¹² *Id.* at 162–63.

¹¹³ *Id.* at 152–53.

¹¹⁴ *Id.* at 153.

¹¹⁵ *Id.*

¹¹⁶ *Id.*

¹¹⁷ *Id.* at 163.

E. 507(b) Inadequate Adequate Protection

I indicate above that one of the recurring worries of secured creditors is that courts will give them protection under section 361 that the court finds to be adequate but that is not.¹¹⁸ A protection against that risk is buried in section 507(b).¹¹⁹ Where the adequate protection proves not adequate, the recipient of the protection has a right to treat the resulting loss as an administrative expense under 507(a)(1) and, better, an expense that goes to the head of the 507(a)(1) line, ahead of the lawyers, accountants and other post petition creditors.

To enjoy this benefit the debtor must have "provided" adequate protection to the creditor. That is why even secured creditors who do not expect to get much may ask for adequate protection under 363(e) even if they do not ask to have the stay lifted under 362(d). And this perfunctory motion may not be seriously challenged by the debtor. The debtor has little to lose by agreeing to some grants of adequate protection. If the reorganization fails, the payment under 507 will come from unsecureds and others lower down the chain, not from the debtor who will be dead. The motion and order for adequate protection merely fulfills the condition precedent for recovery under 507(b).¹²⁰

Establishing the right to a superpriority does not necessarily preclude payments being made to administrative claimants having a lower priority. Payment will depend on the court's determination of whether there are likely to be sufficient assets for payment of all administrative expenses.¹²¹ Adequate protection cannot be assumed from the circumstances,¹²² but a superpriority claim may be asserted on the

¹¹⁸ See *infra* pp. 146–47.

¹¹⁹ See [11 U.S.C. § 507\(b\) \(2002\)](#) (granting priority to secured creditor's claim over any other claims allowable under same subsection assuming trustee has provided adequate protection).

¹²⁰ See 4 COLLIER ON BANKRUPTCY ¶ 507.12, at n.4 (Lawrence P. King et al. eds., 15th ed. rev. 2001):

It should be noted that section 361(3) prohibits using the grant of an administrative expense as the sole method of providing adequate protection to a secured creditor. That section does not, however, prohibit an agreement or order providing that the creditor shall have an administrative expense for its losses if the other adequate protection fails to protect the creditor's interest.

Id.; see also [In re Carpet Center Leasing Co.](#), 4 F.3d 940, 941 (11th Cir. 1993) ("Despite . . . ex ante prohibition on the use of an administrative expense claim, it is specifically allowed as a *remedy* for the later failure of the adequate protection granted."); [In re Cason](#), 190 B.R. 917, 922 (Bankr. N.D. Ala. 1995) ("[W]hen adequate protection is given which later turns out to be inadequate, the creditor is entitled to request superpriority administrative expense status.").

¹²¹ See [In re Moulton Excavating](#), 143 B.R. 955, 956 (Bankr. D. Utah 1992) (stating when superpriority is granted and estate appears insolvent, no payments should be made other than to holder of superpriority claim); [In re Wise Transp., Inc.](#), 148 B.R. 52, 54 (Bankr. N.D. Okla. 1992) (same); [In re Callister](#), 15 B.R. 521, 534 (Bankr. D. Utah 1981) (asserting existence of superpriority claim does not prohibit payment of interim compensation under section 331). But see [In re Wilson-Seafresh, Inc.](#), 263 B.R. 624, 631 (Bankr. N.D. Fla. 2001) (requiring interim fee awards to be disgorged due to unpaid superpriority claim).

¹²² [In re Five Star Partners, L.P.](#), 193 B.R. 603, 609 (Bankr. N.D. Ga. 1996) (providing adequate protection must be affirmatively provided and cannot be implied from mere denial of motion for relief from stay); [In re James B. Downing & Co.](#), 94 B.R. 515, 520 (Bankr. N.D. Ill. 1988) (same).

basis of adequate protection provided without prior court approval.¹²³ Determining the amount of a superpriority claim under 507(b) depends on how the claim arose.

The amount of a claim awarded a 507(b) priority may not be greater than the damage caused by the stay. In the case of *In re J.F.K. Acquisitions Corp.*,¹²⁴ the possessor of a first mortgage on the J.F.K. Hilton filed a motion seeking relief from the 362 stay alleging the debtor had no equity in the property.¹²⁵ According to the creditor, the collateral was worth only \$16.7 million while the debtor owed \$20.2 million.¹²⁶ The court found the value of the property to be \$21 million, based on the debtor's valuation of the property at over \$30 million, and denied relief from the automatic stay.¹²⁷ The debtor was ordered to give a stream of payments as adequate protection.¹²⁸ When the motion was made to fix the value of the payments, 10 months later, the debtor valued the hotel at \$10 million.¹²⁹ The court valued the hotel at \$16.5 million, and granted a superpriority claim for the creditor for \$4.5 million, the difference between the amount of the creditor's claim and its probable recovery from the remaining collateral.¹³⁰ This is the damage caused by the stay if the collateral once had a greater value than the amount of the claim.

When a 507(b) claim arises from the trustee's use of property pursuant to section 363, the amount of the claim is the decrease in value attributable to the trustee's use of the property. In *Bonapel v. Nalley Motor Trucks*,¹³¹ the debtor, who operated a fleet of tractors and trailers, was allowed to continue using twenty-six tractors in exchange for monthly adequate protection payments.¹³² The value of the tractors at the time of the automatic stay was \$575,000.¹³³ The debtor failed to make timely adequate protection payments, and the automatic stay was lifted.¹³⁴ The tractors at this point were valued only as salvage and sold for \$60,000.¹³⁵ The debtor had made adequate protection payments of \$108,500.¹³⁶ The court awarded the creditor a 507(b) claim for \$370,000, the inadequacy of the adequate protection limited to the amount paid by Nalley pursuant to a recourse obligation.¹³⁷

For DIP lenders there is a more direct route to 507(b). Some DIP lending agreements explicitly provide for treatment of any deficiency under 507(b) if the

¹²³ [In re Blehm Land & Cattle Co.](#), 859 F.2d 137, 140 (10th Cir. 1988) ("[N]either the Code nor its legislative history supports the interpretation that court approval of an ex parte adequate protection agreement is a prerequisite to a 507(b) expense.").

¹²⁴ [166 B.R. 207 \(Bankr. E.D.N.Y. 1994\)](#).

¹²⁵ *Id.* at 208.

¹²⁶ *Id.* at 209.

¹²⁷ *Id.* at 210.

¹²⁸ *Id.* at 209.

¹²⁹ *Id.*

¹³⁰ *Id.* at 212.

¹³¹ [991 F.2d 682 \(11th Cir. 1993\)](#).

¹³² *Id.* at 684.

¹³³ *Id.*

¹³⁴ *Id.*

¹³⁵ *Id.*

¹³⁶ *Id.*

¹³⁷ *Id.* at 684–85.

collateral proves inadequate to pay off the DIP loan. While it is not obvious that a debtor and a DIP lender can so invoke 507(b) by agreement without action of the court and without meeting the terms of the section, a judge that blesses the DIP loan with an order is probably disposed to recognize the 507 right if the DIP lender needs to invoke it later in the same case where the judge has already approved the DIP lender's documents.

V. PROTECTION ARISING FROM AGREEMENT WITH THE DEBTOR¹³⁸

By hypothesis most public firms that file in chapter 11 need money. They have used up their available capital in operating losses, unexpected tort or contract liability, or have made improvident investments. Because of their financial plight they are excluded from the public borrowing markets. To survive they must usually turn to a "DIP lender;" the DIP lender might be the firm's existing secured creditor or it might be a new lender who may partner with the existing lender.¹³⁹ Section 364 is a roadmap for secured and unsecured lending to a DIP.¹⁴⁰ It authorizes not only unsecured credit that will be treated as an administrative expense (and so paid ahead of the unsecured creditors) but also secured credit.¹⁴¹ In every case post petition lending of this kind will bear interest at the rate agreed and both principal and interest will have administrative priority—superior to the priority of the debtor's pre petition unsecured creditors.

Beginning in the early 90's¹⁴² secured creditors realized that by agreeing to become the DIP lender they might make money on any new loans and, more to the point for us, might avoid many of the traps that the Code and the cases put before pre-petition secured creditors. Now facing bankruptcy, the debtor had become a pigeon. The debtor, who earlier might have played one potential creditor against another to get the best terms, had lost its bargaining position. The imminence of bankruptcy will have scared off other lenders and the debtor might face liquidation if it had to go into chapter 11 without new money. Such a debtor would be amenable to terms in a loan agreement that would limit its rights. And such a debtor would cheerfully accept terms that strengthen the DIP lender's hand against

¹³⁸ For several tricks and tactics used by DIP Lenders, see Schorer & Curry, *supra* note 101, at 12–13 (suggesting premium returns enjoyed by DIP financiers would soon disappear).

¹³⁹ To enjoy all of the benefits described in this section the existing lender must become a DIP lender. If the existing secured lender chooses not to join the DIP financing, it is unlikely to be subordinated under section 364(d) against its wishes, but it may be forced to subordinate as the cost of attracting another to be the DIP lender. If that happens, the existing secured creditor will usually get some form of adequate protection payments but little else. By joining the DIP lending the existing secured creditor can get the benefit of the many important promises that will be in the DIP lending agreement and may also enjoy current payments of interest and, perhaps, even a rollup.

¹⁴⁰ See [11 U.S.C. § 364 \(2002\)](#) (detailing how trustee may obtain unsecured credit and incur debt secured by liens).

¹⁴¹ See *id.*

¹⁴² Sometime between 1990 and 1995 several lenders came to understand that DIP financing was relatively safe and quite profitable. As the market developed and become more mature, the rates that had been 400 to 600 basis points or more over prime, dropped. However banks are hesitant to pick up letter of credit liability.

trade and other unsecured creditors, for there the debtor truly would be spending another's money.¹⁴³

But not every court will let the DIP lender have his way with the debtor.¹⁴⁴ Some courts might be hesitant to let the debtor trade away the rights of absent unsecureds even to a powerful DIP lender whose loan might be critical to the debtors' life. Understand that granting priority to a large new loan carries the possibility that pre-petition unsecured creditors, who might receive a payment in a prompt liquidation, might get nothing in a later liquidation or reorganization where the DIP lender had to be paid first. Too, some courts might find that the debtor's grant of rights to the DIP lender (or its disavowal of rights such as the stay's protection) invaded the court's prerogatives.¹⁴⁵

The solution to these problems was to find a court that appreciated the importance of the DIP lender and respected the debtor's agreements with that lender even when those agreements might step on other toes. But how to find such a court?

Here the debtor, encouraged by his potential DIP lender, turned to the generous venue rules applicable to chapter 11 cases.¹⁴⁶ Under section 1408 a debtor may file in any court where it is "domiciled", where its "principal place of business" is, or where its "principal assets" are located.¹⁴⁷ Even better, it can file anywhere there is a pending case concerning any "affiliate."¹⁴⁸ Every subsidiary is an affiliate under

¹⁴³ As this was written in 2003 several institutions have developed a reputation and expertise as DIP lenders. Among them are JP Morgan Chase, Citibank, Wachovia and several non-bank lenders including General Electric Credit, CIT, Foothill and Cerberus. Usually, however, if a large bank has extended secured credit to the debtor, it will wind up as the DIP lender as well. There are exceptions to this rule, however, as Chase will often go hunting for the opportunity to become the DIP lender.

¹⁴⁴ See William Barnett, *Test Your Expertise – DIP Financing*, 20 NO. BANKR. STRATEGIST 3, 3 (2003) ("Bankruptcy courts understand the role of the DIP lender and, within limits, are willing to approve DIP financing agreements that disproportionately favor the DIP lender over the debt As with other categories default provisions may or may not be granted depending upon the policy of the particular bankruptcy judge.").

¹⁴⁵ See *In re Pease*, 195 B.R. 431, 435 (Bankr. D. Neb. 1996) (refusing to enforce pre-petition agreement between debtor and creditor that would limit use of automatic stay provision); *In re Madison*, 184 B.R. 686, 690 (Bankr. E.D. Pa. 1995) (holding debtor's agreement to temporarily forego bankruptcy protection violates public policy and is unenforceable).

¹⁴⁶ See 28 U.S.C. § 1408 (2002).

[A] case under title 11 may be commenced in the district court for the district –

- (1) in which the domicile, residence, principal place of business in the United States, or principal assets in the United States, of the person or entity that is the subject of such case have been located for the one hundred and eighty days immediately preceding such commencement, or for a longer portion of such one hundred and eighty day period than the domicile, residence, or principal place of business, in the United States, or principal assets in the United States, or such person were located in any other district; or
- (2) in which there is pending a case under title 11 concerning such person's affiliate, general partner, or partnership.

Id.

¹⁴⁷ *Id.*

¹⁴⁸ *Id.*

section 101(2).¹⁴⁹ These rules explain why one looking for the bankruptcy of Eastern Airlines, headquartered in Miami, finds it under the name of "Ionosphere Clubs" in New York,¹⁵⁰ why Enron, with its headquarters in Houston, was able to file in New York,¹⁵¹ and why dozens of companies incorporated in Delaware but having no other connection with the state have been able to file there.¹⁵²

It is now common¹⁵³ for the debtor and its existing principal secured creditor, if there is one, or the debtor and any other creditor who is willing to do DIP lending to negotiate before the filing.¹⁵⁴ One issue to be discussed with the potential DIP lender is the place of filing.¹⁵⁵ If some or many of the judges in the District where the debtor proposes to file are hostile to terms that the DIP lender wants in its loan agreement, the lender can refuse to lend. Particularly when the secured's major issues have to do mostly with the secured rights vis`a vis unsecureds, the debtor may be indifferent about the place of filing. We now observe a large number of filings in Delaware and, more recently, some filings in the Southern District of New York and in Chicago.¹⁵⁶ I believe that this pattern of filing is directly responsive to the DIP and DIP lender's interests. Both the lender and the debtor probably want certainty; for the DIP lender that certainty means assurance that its favorite clauses in the cash collateral order and in the DIP lending agreement will be acceptable to the court. If the District has a couple of hare-brained judges, if its rules and practices are not well spelled out, or if it has rules¹⁵⁷ or decisions on important

¹⁴⁹ See [11 U.S.C. § 101\(2\) \(2002\)](#) (defining "affiliate").

¹⁵⁰ See, e.g., [In re Ionosphere Clubs](#), 111 B.R. 436 (Bankr. S.D.N.Y. 1990); see also [Lynn M. LoPucki & William C. Whitford, Venue Choice and Forum Shopping in the Bankruptcy Reorganization of Large, Publicly Held Companies](#), 1991 WIS. L. REV. 11, 22 (1991) (stating Eastern was headquartered in Miami, yet filed for bankruptcy in New York through small subsidiary).

¹⁵¹ See, e.g., [In re Enron Corp.](#), 281 B.R. 836 (Bankr. S.D.N.Y. 2002); see also [Catherine E. Vance & Paige Barr, The Facts & Fiction of Bankruptcy Reform](#), 1 DEPAUL BUS. & COM. L.J. 361, 384 n.93 (2003) (discussing why Enron was able to file in New York).

¹⁵² I am told that United Airlines, that filed at home in Chicago, believed it could have found proper venue in more than one dozen jurisdictions.

¹⁵³ See, e.g., David Bond, *United's DIP Loans Require Profit in 2003*, AVIATION WEEK & SPACE TECH., Dec. 16, 2002, at 26 ("United began debtor-in-possession (DIP) financing talks late in September, even as it pursued Air Transportation Stabilization Board (ATSB) approval of a \$1.8-billion loan guarantee . . ."); Edward Wong, *United Works to Pull Together a Financing Plan*, N.Y. TIMES, Dec. 8, 2002, at 44 (reporting United was waiting until DIP financing negotiations were complete to file chapter 11).

¹⁵⁴ One of my interviewees said that it is desirable and common to have almost all of the terms of the DIP loan agreement negotiated before the filing. Others tell of cases where the baby came too soon and the parties arrive in court with only a term sheet for the court's approval.

¹⁵⁵ My interviewees knew of no case where a DIP lender insisted on a particular place, but they all confirmed that the place of filing was discussed by the DIP and DIP lender and that place of filing would be an important question for the DIP lender.

¹⁵⁶ Chicago may be a problematic venue for any debtor who needs an expansive critical vendor ruling. See [In re Kmart Corp.](#), No. 03-1956, 2004 WL 343520 (7th Cir. Feb. 24, 2004).

¹⁵⁷ For example, some DIP lenders are concerned that the courts allow "rollups," described below. For example, Massachusetts' rules allow rollups, provided that they are disclosed. MASS. L. BANKR. R. 4001-2(c) and 4001-2(d):

- (c) Subject to section (d), the following provisions contained in an agreement between the debtor and the holder of a secured claim as to use of cash collateral, obtaining credit, or adequate protection, or any interim or final order approving or

issues that are anathema to any of the important players (debtor, secured creditor, critical vendor), no bankruptcy of a large public company will darken its door.¹⁵⁸

Perhaps because the SEC or an SEC nominated trustee had the whip hand in chapter X cases under the Act,¹⁵⁹ in 1978 no one seems to have foreseen this alliance between the debtor and its principal secured creditor to manipulate the venue rules for their common interest. In fact the removal of the SEC¹⁶⁰ has fostered the current bargain between the debtor and its principal secured creditor. Under chapter X, the SEC had the right to intervene as a party in interest in large bankruptcies,¹⁶¹ give an advisory report on the confirmation of the plan,¹⁶² and

authorizing the use of cash collateral, obtaining credit, or adequate protection, shall be unenforceable:

- (1) any acknowledgement of the validity, amount, perfection, priority, extent, or enforceability of the secured claim, if the agreement or order purports to bind any party other than the debtor, unless the agreement or order affords an objection period of not less than ninety (90) days after (i) for any party in interest, the entry of the order approving the agreement; (ii) for the creditor's committee, the entry of an order approving the employment of counsel to the creditor's committee; and (iii) for a Chapter 11 or Chapter 7 trustee, the entry of an order approving the employment of counsel to said Chapter 11 or Chapter 7 trustee;
 - (2) any waiver of defenses by the debtor or estate representative;
 - (3) any post-petition lien which purports to secure any claim of a secured creditor other than (i) a claim arising from postpetition advances which constitute an additional non-replacement extension of credit; or (ii) a claim representing the diminution in value of the secured claim after the commencement of the case;
 - (4) any grant of a security interest in avoidance power recoveries available to the trustee;
 - (5) any provision granting a creditor relief from the automatic stay without further order or hearing upon the breach of the cash collateral, adequate protection or postpetition financing order or agreement; or
 - (6) any waiver by the debtor or the estate representative of rights provided by [11 U.S.C. § 506\(c\)](#), in whole or part.
- (d) Notwithstanding section (c), the Court may order enforcement of any terms and conditions on the use of cash collateral or obtaining credit, provided that (i) the proposed order or agreement specifically states that the proposed terms and conditions vary from the requirements of section (c), and (ii) any such proposed terms and conditions are conspicuously and specifically set forth in the proposed agreement or order.

Id.

¹⁵⁸ See *supra* notes 155–57 and accompanying text.

¹⁵⁹ See SKEEL, *supra* note 3, at 160–66 (stating chapter X provided SEC with pervasive oversight role).

¹⁶⁰ See [11 U.S.C. § 1109\(a\) \(2002\)](#) (implying SEC is not party in interest).

¹⁶¹ See [11 U.S.C. § 608 \(repealed 1978\)](#):

The Securities and Exchange Commission shall, if requested by the judge, and may, upon its own motion if approved by the judge, file a notice of its appearance in a proceeding under this chapter. Upon the filing of such a notice, the Commission shall be deemed to be a party in interest, with the right to be heard on all matters arising in such proceeding, and shall be deemed to have intervened in respect of all matters in such proceeding with the same force and effect as if a petition for that purpose had been

forestall confirmation of the plan by refusing to release the report.¹⁶³ In addition the SEC had effective control over trustees by its ability to appoint and fix the compensation of all officers, attorneys and examiners.¹⁶⁴ If neither the existing management nor its lawyers were going to be around after the petition was filed in chapter X, they had no incentive and little power to negotiate with any existing creditor. The removal of the SEC from the process and the replacement of the trustee with the DIP have created both the incentive and the possibility for the negotiations that we now observe.

Note too why any opposing cries from trade and most other unsecured creditors are muffled. Until the bankruptcy petition is filed, there is no creditor's committee and until then no unsecured creditor may have a large enough stake to make it worth his while to monitor the debtor's behavior or to bargain with him over place of filing. Some of the orders on cash collateral and perhaps on the DIP lending will be tentatively approved before any committee of unsecured creditors is appointed.¹⁶⁵ My purpose is not to enter the debate over the merits of the venue rules but only to explain how those rules and the bargains struck between the DIP lender and the debtor facilitate the lender getting what it needs by agreement with the debtor.

allowed by the judge; but the Commission may not appeal or file any petition for appeal in any such proceeding.

Id.
¹⁶² See [11 U.S.C. § 572 \(repealed 1978\)](#):

After the hearing, as provided in section 569 or section 570 of this title, and before the approval of any plan . . . the judge may, if the scheduled indebtedness of the debtor does not exceed \$3,000,000, and shall, if such indebtedness exceeds \$3,000,000, submit to the Securities and Exchange Commission for examination and report the plan or plans which the judge regards as worthy of consideration. Such report shall be advisory only.

Id.
¹⁶³ See [11 U.S.C. § 573 \(repealed 1978\)](#):

The judge shall not enter an order approving a plan submitted to the Securities and Exchange Commission until after the Securities and Exchange Commission has filed its report thereon or has notified the judge that it will not file a report, or until the expiration of such reasonable time for the filing of such report as the judge has fixed, whichever first occurs.

Id.
¹⁶⁴ See [11 U.S.C. § 665\(b\) \(repealed 1978\)](#):

The provisions of section 78d(b) of title 15 shall be applicable with respect to the power of the Securities and Exchange Commission to appoint and fix the compensation of such officers, attorneys, examiners, and other experts, and such other officers and employees, as may be necessary for carrying out its functions under this chapter.

Id.
¹⁶⁵ The order in United Airlines, for example, was approved tentatively allowing unsecured creditors a 30-day period to file any objections. See *In re UAL Corp.*, No. 02-B-48191 (Bankr. N.D. Ill. 2002) (Final order [\(I\) Authorizing Debtors to Obtain Post-Petition Financing Pursuant to 11 U.S.C. §§ 105](#), 361, 362, 364(c)(2) and 364(c)(3)).

A. Converting Pre-Petition Debts into Post-Petition "Rollups"

Section 364 authorizes a debtor in chapter 11 to "obtain credit."¹⁶⁶ Subsections (a) and (b) authorize unsecured lending and give those loans administrative expense status under section 503(b)(1).¹⁶⁷ Implicit in the grant of administrative expense

¹⁶⁶ [11 U.S.C. § 364 \(2002\)](#) provides:

- (a) If the trustee is authorized to operate the business of the debtor under section 721, 1108, 1203, 1204, or 1304 of this title, unless the court orders otherwise, the trustee may obtain unsecured credit and incur unsecured debt in the ordinary course of business allowable under section 503(b)(1) of this title as an administrative expense.
- (b) The court, after notice and a hearing, may authorize the trustee to obtain unsecured credit or to incur unsecured debt other than under subsection (a) of this section, allowable under section 503(b)(1) of this title as an administrative expense.
- (c) If the trustee is unable to obtain unsecured credit allowable under section 503(b)(1) of this title as an administrative expense, the court, after notice and a hearing, may authorize the obtaining of credit or the incurring of debt--
 - (1) with priority over any or all administrative expenses of the kind specified in section 503(b) or 507(b) of this title;
 - (2) secured by a lien on property of the estate that is not otherwise subject to a lien; or
 - (3) secured by a junior lien on property of the estate that is subject to a lien.
- (d)
 - (1) The court, after notice and a hearing, may authorize the obtaining of credit or the incurring of debt secured by a senior or equal lien on property of the estate that is subject to a lien only if--
 - (A) the trustee is unable to obtain such credit otherwise; and
 - (B) there is adequate protection of the interest of the holder of the lien on the property of the estate on which such senior or equal lien is proposed to be granted.
 - (2) In any hearing under this subsection, the trustee has the burden of proof on the issue of adequate protection.
- (e) The reversal or modification on appeal of an authorization under this section to obtain credit or incur debt, or of a grant under this section of a priority or a lien, does not affect the validity of any debt so incurred, or any priority or lien so granted, to an entity that extended such credit in good faith, whether or not such entity knew of the pendency of the appeal, unless such authorization and the incurring of such debt, or the granting of such priority or lien, were stayed pending appeal.
- (f) Except with respect to an entity that is an underwriter as defined in section 1145(b) of this title, section 5 of the [Securities Act of 1933 \[15 USCS § 77e\]](#), the [Trust Indenture Act of 1939 \[15 USCS §§ 77aaa et seq.\]](#), and any State or local law requiring registration for offer or sale of a security or registration or licensing of an issuer of, underwriter of, or broker or dealer in, a security does not apply to the offer or sale under this section of a security that is not an equity security.

¹⁶⁷ [11 U.S.C. § 503\(b\)\(1\) \(2002\)](#) provides:

- (b) After notice and a hearing, there shall be allowed, administrative expenses, other than claims allowed under section 502(f) of this title, including—
 - (1)
 - (A) the actual, necessary costs and expenses of preserving the estate, including wages, salaries, or commissions for services rendered after the commencement of the case;

status is the right to receive market rate interest in the ordinary course and current repayment of principal. Subsection (c) authorizes secured debt and subsection (d) allows secured debt that primes existing secured debt.¹⁶⁸ All of the debt authorized under section 364 primes pre petition unsecured debt.

If only pre-petition secured creditors could find a way to transform themselves into post-petition secured creditors with robust collateral, most of their concerns described above would be alleviated. Since they would be paid current interest at market rates, the opportunity to reinvest would be recaptured. Since they would have the pick of the collateral litter, concerns about insufficient collateral or about its decline in value leading up to the bankruptcy would be gone. Since they would be bargaining with a needy debtor, they could demand a large cushion of collateral and insist on protection of that position by the toughest of warranties and promises.

Nothing in the Code explicitly permits changing pre-petition debt into post-petition debt, and the logic of cases like *In re Alyucan Interstate Corp.*¹⁶⁹ and *United Savings Assoc. of Texas v. Timbers of Inwood Forest Assoc.*¹⁷⁰ conflicts with the idea that such a transformation of pre-petition debt into post-petition priority debt is permitted under the Code. If section 506 means that pre-petition debt earns no interest during the proceeding, what logic says that a new name on that old debt changes the legal rule? If there is no adequate protection for an equity cushion under *Alyucan*, what logic permits the securing of old debt with new assets of the bankrupt debtor?

A few early cases traveling under the name of "cross-collateralization" deal tangentially with these issues.¹⁷¹ In those cases the parties proposed to allow pre-petition secured debt to be secured by post-petition assets. Of course, such collateralization should be permitted to the extent that the new collateral replaced

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- (B) any tax—
 - (i) incurred by the estate, except a tax of a kind specified in section 507(a)(8) of this title; or
 - (ii) attributable to an excessive allowance of a tentative carryback adjustment that the estate received, whether the taxable year to which such adjustment relates ended before or after the commencement of the case; and
 - (C) any fine, penalty, or reduction in credit relating to a tax of a kind specified in subparagraph (B) of this paragraph.

Id.

¹⁶⁸ *See id.*

¹⁶⁹ 12 B.R. 803 (Bankr. D. Utah 1981).

¹⁷⁰ 484 U.S. 365 (1988).

¹⁷¹ *See In re Keystone Camera Prods. Corp.*, 126 B.R. 177, 182 (Bankr. D. N.J. 1991) (validating cross-collateralization if loan would otherwise be unobtainable); *In re Beker Indus. Corp.*, 58 B.R. 725, 742 (Bankr. S.D.N.Y. 1986) ("[F]orward cross-collateralization has thus been permitted where, *inter alia*, there was no objection by unsecured creditors because they agree that the lender's pre-petition loan was fully secured by a perfected security interest."); *In re Vanguard Diversified, Inc.*, 31 B.R. 364, 366 (Bankr. E.D.N.Y. 1983) (allowing cross-collateralization, but indicating practice is disfavored). *But see In re Saybrook Mfg. Co.*, 963 F.2d 1490, 1496 (11th Cir. 1992) (holding cross-collateralization is not within equitable authority of bankruptcy court).

collateral that was held when the petition was filed and consumed in the debtor's business. But what about new collateral that does not replace the old? Under the Act, cross-collateralization may have been permissible but only on proper notice and a hearing confirming that the post-petition debt could not be obtained in any other fashion.¹⁷²

Whatever its legal merits, the practice of rolling up old secured debt into new, post-petition secured debt has become frequent if not commonplace.¹⁷³ Sometimes the rollup occurs on soft little creditors' feet; this is where an existing revolving loan is authorized to continue and the after-acquired clause is permitted to survive the filing under 552.¹⁷⁴ Each payment on the loan reduces the pre-petition debt and each advance on the revolving loan increases the principal balance of the post-petition 364 loan. When the loan has gone through one complete cycle after the filing, it has all become post-petition secured debt entitled to current interest and to heightened priority.¹⁷⁵ If one did not look closely at the documents, this quiet transmogrification might be missed. And if it is done under an agreement that invokes 507(b) successfully, any part of the loan that is not liquidated on the sale of collateral will be entitled not just to administrative expense priority but to elevated administrative expense priority—it goes to the head of the administrative priority line.¹⁷⁶

Some rollups are noisy. In some cases the DIP lender pays off the existing loan in full.¹⁷⁷ That payment is treated as the first advance on the post-petition secured

¹⁷² *In re Texlon Corp.*, 596 F.2d 1092, 1099 (2d Cir. 1979) (Friendly, J.) (indicating cross-collateralization can only be allowed under Act if there is notice, hearing and showing of need by DIP that financing cannot otherwise be obtained).

¹⁷³ There were rollups in *Lamonts Apparel, Inc.* (Wash.) Case No. 00-00045, *Republic Technology* (Ohio) Case No. 01-51117, *Loews Cineplex* (S.D.N.Y.) Case No. 01-12974 and *Covanta Energy* (S.D.N.Y.) Case No. 02-40826.

¹⁷⁴ See generally 11 U.S.C. § 552(a) (2002) (stating "property acquired by the estate or by the debtor after the commencement of the case is not subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case.").

¹⁷⁵ See 11 U.S.C. § 1129(a)(9)(A) (stating "with respect to a claim of a kind specified in section 507(a)(1) or 507(a)(2) of this title, on the effective date of the plan, the holder of such claim will receive on account of such claim cash equal to the allowed amount of such claim."). Section 507(a)(1) gives 503(b) administrative expenses top priority. See 11 U.S.C. § 507(a)(1). Since section 503(b)(1)(A) administrative expenses include all "actual, necessary costs of preserving the estate", if payment were not made on the post-petition loan it would become an administrative expense, and receive the highest priority. See 11 U.S.C. 503(b). Thus it will be more difficult to cramdown a plan against the wishes of the DIP lender using a rollup, and the DIP lender has more effective control over the plan. See 11 U.S.C. § 503; 11 U.S.C. § 507.

¹⁷⁶ See 11 U.S.C. § 507(b):

If the trustee, under section 362, 363, or 364 of this title, provides adequate protection of the interest of a holder of a claim secured by a lien on property of the debtor and if, notwithstanding such protection, such creditor as a claim allowable under subsection (a)(1) of this section arising from the stay of action against such property under section 362 of this title, from the use, sale, or lease of such property under section 363 of this title, or from the granting of a lien under section 364(d) of this title, then such creditor's claim under such subsection shall have priority over every other claim allowable under such subsection.

Id.

¹⁷⁷ See cases cited *supra* note 173.

loan; it instantly transforms pre-petition debt to post-petition. No one could miss that event.

Under the guidelines,¹⁷⁸ in Delaware rollups are permitted only where they are identified in the motion to approve financing and are "justified,"¹⁷⁹ New York requires a hearing to approve rollup,¹⁸⁰ and Massachusetts forbids securing pre-petition collateral with post-petition debt without a clear reason.¹⁸¹ Whether and how any particular rollup is "justified" is a question for another time. The absence of published judicial defenses of the practice might make one skeptical about courts' ability to find proper justification.

B. Debtor's Appointment of Creditor's Representative

In some cases the DIP lender insists on the DIP's informal or formal agreement to appoint a person called a Chief Restructuring Officer (CRO).¹⁸² In the words of several bankruptcy lawyers familiar with the practice, the DIP may appoint anyone in the world—as long as that person is on the secured creditor's list of three approved candidates. Many of these appointments go to members of three firms: AlixPartners LLC, Alvarez and Marsala, and Kroll Zolfo Cooper.¹⁸³ While this

¹⁷⁸ The guidelines given in each state accurately reflect what lenders are doing and not what they are allowed to do. In this sense they are responsive to tricks that lenders try to slip by and force lenders to highlight when they are using these "tricks". Delaware's guidelines, for example, are given in a letter written by Chief Judge Walsh of the Delaware Bankruptcy Court, noting that they were set forth to help limit first-day orders, but that a set of blanket prohibitions would not be practicable. For an excellent discussion of these rules, see [Scott Cousins, Postpetition Financing of Dot-Coms, 27 DEL. J. CORP. L. 759, 781 \(2002\)](#).

¹⁷⁹ See DEL. L. BANKR. R. 4001-2(a)(i) (2002):

All Financing Motions must (1) recite whether the proposed form of order and/or underlying cash collateral stipulation or loan agreement contains any provision of the type indicated below, (2) identify the location of any such provision in the proposed form of order, cash collateral stipulation and/or loan agreement, and (3) the justification for the inclusion of such provision:

....

(E) Provisions that deem prepetition secured debt to be post-petition debt or that use post-petition loans from a prepetition secured creditor to pay part or all of that secured creditor's prepetition debt, other than as provided in [11 U.S.C. section 552\(b\)](#).

Id.

¹⁸⁰ See N.Y. L. BANKR. R. 4001-2 (stating "A motion pursuant to § 364(c) and (d) of the Bankruptcy Code seeking priority for obtaining credit or incurring debt shall state whether priority over any administrative expense specified in § 503(b) or § 507(a) of the Bankruptcy Code is sought.").

¹⁸¹ See MASS. L. BANKR. R., *supra* note 157.

¹⁸² See Douglas Baird & Martin Bienenstock, *Symposium: Mega-Bankruptcies: Representing Creditors and Debtors in Large Bankruptcies*, 1 DEPAUL BUS. & COMM. L.J. 589 (2003) ("For example, debtor may have to hire a chief restructuring as a condition of the DIP loan."); Douglas Baird & Robert K. Rasmussen, *Reply Chapter 11 at Twilight*, 56 STAN. L. REV. 673, 685 (2003) (noting Worldcom's DIP financing agreement required board to hire chief restructuring officer).

¹⁸³ For example, Stephen Cooper is currently the CEO of Enron, *available at* http://money.cnn.com/2002/01/29/news/enron_roundup/ (Jan. 29, 2002) and Gregory F. Rayburn of AlixPartners LLC was appointed by Worldcom as chief restructuring officer, *available at* <http://www.computerworld.com/managementtopics/outsourcing/isptelecom/story/0,10801,73088,00.html> (July 29, 2002). CRO's were also appointed in Pharmor (Alvarez), Nations Rent (Zolfo), Metromedia (A&M), and Warnaco (Alvarez).

person is not truly an agent of the secured creditor, usually his bread is buttered by the secured creditor not by the DIP. The CRO's are repeat players in the bankruptcy process, and they offend the secured creditor who nominated them only at the cost of losing future nominations.

For fear of making such a person truly an agent and so incurring liability for his acts or failure to act, the DIP lender would prefer to have the CRO's duties left to informal understandings or to general practices and expectations that do not rise to the level of formal agreements about the CRO's duty to his sponsor. For that reason one finds scarcely any reference to the CRO in the many pages of agreements signed by the DIP who has informally agreed to take on a CRO.

My interviews tell that there are considerable variations in the work and terms of employment of CRO's. In some cases the CRO has been hired by the debtor before the bankruptcy or at least before the DIP lender insisted on it. In those cases the CRO is beholden mostly to the debtor who brought him there, and not directly to the secured creditor. Also different CRO's have different skills. Some are accountants, there to straighten out the accounting; some are managers, there to manage in place of prior failed managers.¹⁸⁴

A CRO's experience as a professional manager of distressed companies may give him knowledge of solutions to problems that face companies in chapter 11 that far exceeds the knowledge of regular management. To that extent the CRO can be presented and regarded as a friendly advisor to the DIP. I suspect that a DIP lender sponsored CRO also fills a role not welcomed by the DIP; he can be a spy for the DIP lender to see that the DIP toes the line and to squeal on him when he does not.

Because of his status as the *eminence grise* little is written on the workings of the CRO and even less appears in the cases. Surely a good CRO brings experience and wise counsel to chapter 11 management that has never seen a chapter 11 proceeding before. One might expect that the CRO's suggestion to a patron DIP lender sometimes moves existing management out the door. His reports might call for a tightening of the DIP lending agreement, and presumably the CRO would have input to any decision of the lender to force liquidation. The CRO gives the DIP lender better intelligence and greater assurance that the DIP is conforming to his promises than the DIP lender would have otherwise.

C. DIP's Agreements to Forego Bankruptcy Rights

Agreements by a debtor to disavow rights that it would otherwise have in bankruptcy deserve special consideration. Most of these rights are enjoyed only through the order of the judge and, usually, at the judge's discretion. No judge,

¹⁸⁴ See, e.g., [In re Exide Techs.](#), 303 B.R. 48, 69 (Bankr. D. Del. 2003) (discussing CRO was former Chief Financial Officer); [Keeny v. Larkin](#), 306 F. Supp. 2d 522, 540 (D. Md. 2003) (CRO was hired to "assist in the development of the Company's recovery plan."); [In re Convenience USA, Inc.](#), 2003 WL 21459559, at *2 (M.D. N.C. June 17, 2003) (describing terms of restructuring agreement as requiring replacing old management with new management).

from the lowest to the highest, welcomes interference with what he regards as his rightful jurisdiction. None welcomes inhibitions on his discretion or power. So agreements that limit the debtor's rights in bankruptcy which in turn restrict or imply restrictions on judges' power are special and inherently more suspect than other more conventional promises that the DIP might make in its loan agreements.

An obvious solution to many secured creditor fears is to require the DIP to forego any irksome rights that may have been conferred on him or on the bankruptcy court by the Code. At the far extreme, one might agree never to file in chapter 11.¹⁸⁵ Despite the academic literature¹⁸⁶ that has proposed the authorization of corporations without the right to file, no such authorization exists and none is likely to soon.¹⁸⁷ Some agreements sniff at the edges of a promise not to file (e.g., agreement by members of the board of directors not to vote for filing), but it seems quite unlikely that any bankruptcy court would recognize any such promise.¹⁸⁸ In

¹⁸⁵ But my interviews reveal cases where a debtor agreed not to file in a certain jurisdiction.

¹⁸⁶ See [Robert K. Rasmussen, *An Essay on Optimal Bankruptcy Rules and Social Justice*, 1994 U. ILL. L. REV. 1, 1 \(1994\)](#) (suggesting economic approach to bankruptcy law should allow debtor and creditors to contractually dictate terms that would govern in event of insolvency).

¹⁸⁷ See [Hayhoe v. Cole \(In re Cole\)](#), 226 B.R. 647, 652 n.7 (B.A.P. 9th Cir. 1998) (listing cases denying in general ability to contract out of bankruptcy rights):

[Fallick v. Kehr](#), 369 F.2d 899, 904 (2d Cir. 1966) (stating, in dictum, advance agreements to waive benefits of bankruptcy are void); [In re Weitzen](#), 3 F. Supp. 698, 698 (S.D.N.Y. 1933) ("The agreement to waive the benefit of bankruptcy is unenforceable. To sustain a contractual obligation of this character would frustrate the object of the Bankruptcy Act . . ."); [In re Shady Grove Tech. Ctr. Assocs., L.P.](#), 216 B.R. 386, 390 (Bankr. D. Md. 1998) ("Prohibitions against the filing of a bankruptcy case are unenforceable, self-executing clauses in pre-petition agreements purporting to provide that no automatic stay arises in a bankruptcy case are contrary to law and hence unenforceable, and . . . self-executing clauses in pre-petition agreements . . . to vacate the automatic stay are likewise unenforceable."); [In re Southeast Fin. Assocs., Inc.](#), 212 B.R. 1003, 1005 (Bankr. M.D. Fla. 1997) (recognizing that a pre-petition waiver of bankruptcy benefits is not self-executing or binding on third parties); [In re Gulf Beach Dev. Corp.](#), 48 B.R. 40, 43 (Bankr. M.D. Fla. 1984) (stating, in dictum, "the Debtor cannot be precluded from exercising its right to file Bankruptcy and any contractual provision to the contrary is unenforceable as a matter of law"); [In re Tru Block Concrete Prods., Inc.](#), 27 B.R. 486, 492 (Bankr. S.D. Cal. 1983) ("It is a well settled principal that an advance agreement to waive the benefits conferred by the bankruptcy laws is wholly void as against public policy"); [In re Pease](#), 195 B.R. 431, 435 (Bankr. D. Neb. 1996) ("I conclude that any attempt by a creditor in a private pre-bankruptcy agreement to opt out of the collective consequences of a debtor's future bankruptcy filing is generally unenforceable. The Bankruptcy Code pre-empts the private right to contract around its essential provisions, such [as] those found in 11 U.S.C. § 362"); [In re Madison](#), 184 B.R. 686, 690 (Bankr. E.D. Pa. 1995) (holding pre-petition agreement to waive debtor's right to file further bankruptcies within 180 days from filing of debtor's last bankruptcy petition was unenforceable because it violated public policy).

Id.

¹⁸⁸ See Bruce H. White & William L. Medford, *Ipsa Facto Clauses and Reality: I Don't Care What the Documents Provide*, AM. BANKR. INST. J., Apr. 2002, at 28, 52 (suggesting alternate ways of directing firm to forego filing for bankruptcy would not be practical). The article mentions the "Remote Bankruptcy Entity", where a firm is created with a creditor on the board requiring unanimous consent for a chapter 11 filing. See *id.* at 52. It is suggested that in the event of insolvency creditor directors would be forced to resign in order to avoid a fiduciary duty quandary. See *id.*

consumer cases no court would find the right to file waivable; I suspect most courts would hold the same even for corporate promises. Bankruptcy courts' justification for holding such promises invalid is likely to be couched in public policy grounds, but one should remember that bankruptcy judges have one eye on their dockets. If bankruptcy filings could be promised out of existence, then what is a bankruptcy judge to do for a living?

There are many more limited promises that DIP's make; many of these will be enforced, but the case law is thin where the DIP promises not to use its bankruptcy rights. For example in *United Airlines* the DIP agreed that its rights under 362 were "vacated" and "modified."¹⁸⁹ The DIP agreed not to ask for an examiner with enlarged powers and not to make a variety of motions (e.g., for superpriority for certain competing claims).¹⁹⁰

D. Promises to the DIP Lender that Restrict Continuing Creditors such as Employees

Although the press was full of coverage about how the DIP loan agreement would force renegotiations of all of United's labor contracts, nothing in the DIP loan agreement mentions the unions or aircraft lessors or any other continuing creditor by name.¹⁹¹ Rather it is a condition of the continuation of the loan¹⁹² that the DIP have certain EBITDAR¹⁹³ each month and that it cut expenses by a certain

¹⁸⁹ United's DIP loan agreement is on file with author.

¹⁹⁰ *See id.*

¹⁹¹ *See id.*

¹⁹² *See* Bond, *supra* note 153, at 26 (describing failure of United to live up to covenants in its financing agreement would lead to default and foreclosure on United's collateral).

¹⁹³ Section 6.05 of United's DIP agreement makes the following requirement:

- (a) Permit cumulative consolidated EBITDAR for each fiscal period beginning on December 1, 2002 and ending in each case on the last day of each fiscal month ending on the dates listed below to be less than the amount specified opposite such date:

<u>Month</u>	<u>EBITDAR</u>
February 28, 2003	\$(964,000,000)
March 31, 2003	\$(881,000,000)
April 30, 2003	\$(849,000,000)
May 31, 2003	\$(738,000,000)
June 30, 2003	\$(585,000,000)
July 31, 2003	\$(448,000,000)
August 31, 2003	\$(219,000,000)
September 30, 2003	\$(98,000,000)
October 31, 2003	\$46,000,000
November 30, 2003	\$112,000,000

- (b) Permit cumulative consolidated EBITDAR for each rolling twelve (12) fiscal month period ending on the dates listed below to be less than the amount listed opposite such month:

amount.¹⁹⁴ On the heels of filing, United successfully¹⁹⁵ renegotiated all of its labor obligations and it commenced renegotiations of its aircraft leases with undisclosed results.

Promises of this sort are important for the DIP lender, for its repayment may depend on the DIP's successful reorganization and success there may—as surely was true in United—depend on reigning in wage or other expenses. But there is also a strategic side to these agreements. By agreeing to lose its DIP financing if it could not renegotiate its collective bargaining agreements to achieve the agreed savings and profitability, United strengthened its hand with the unions.¹⁹⁶ Like the truck driver who gains the upper hand in the game of chicken by throwing his steering wheel out the window, United's management gained a power with the unions that it had never had before. So the DIP at United secretly may have welcomed the requirements on savings and profitability. The agreement strengthened the hand of both the DIP lender and the DIP at the expense of United's employees and lessors. Of course United's bankruptcy has not yet been successfully concluded and the DIP could yet rue the day that it agreed to the clauses on profits and savings. The day could come when the DIP lender has had enough and wishes to force United into liquidation and the DIP wants to continue; then their interests will diverge.

CONCLUSION

Because a chapter 11 proceeding is instituted by the filing of a petition with a court and because that court and the parties in the proceeding are endowed with many statutory rights and burdened with many statutory obligations, it is inviting to think of a chapter 11 as primarily a judicial proceeding, like a civil suit that ends with a judicial determination of the parties' rights. One might visualize the conclusion of a chapter 11 as the court's confirmation of one plan of reorganization because it conforms more closely to the law than another. Alternatively one might liken a chapter 11 to a proceeding in front of an administrative agency such as

<u>Month</u>	<u>EBITDAR</u>
December 31, 2003	\$575,000,000
January 31, 2004	\$901,000,000
February 28, 2004	\$1,084,000,000
March 31, 2004	\$1,196,000,000
April 30, 2004	\$1,297,000,000
May 31, 2004	\$1,383,000,000

¹⁹⁴ See Bond, *supra* note 153, at 26 (describing over two dozen covenants limiting capital spending and requiring profitability).

¹⁹⁵ See Susan Carey, *United Air, Union for Ground Staff Reach Agreement*, WALL ST. J., Apr. 9, 2003, at B2 (reaching tentative agreement ground worker's union); Micheline Maynard, *United and Pilots' Union Reach Tentative Agreement*, N.Y. TIMES, Mar. 28, 2003, at C5 (reaching tentative agreement with pilots' union); Micheline Maynard, *United and 2 Unions Reach Tentative Agreements*, N.Y. TIMES, Apr. 5, 2003, at C3 (reaching tentative agreement with flight attendants, dispatchers).

¹⁹⁶ See sources cited *supra* note 195.

FERC or the FCC where the culmination is an administrative order. None of that thinking was ever right; today it is farther from the truth than it ever was before.

Ignoring the pesky details of the Bankruptcy Reform Act of 1978 that I discuss above, what I describe in this paper is the rise of a private market for the reorganization and sale of public companies. I believe that the major effect of the Code on public companies' bankruptcy is its facilitation of that market. The participants in this market are the Bankruptcy Courts, the DIP, the professional DIP lenders, traders in bankruptcy debt, lawyers and investment bankers that specialize in bankruptcy, and bankruptcy managers (CRO's and others). The firm's assets and its non-management employees, are like hogs at auction, what is bargained over.

Three parts of the Code have facilitated the growth of this market. First is the banishing of the Securities and Exchange Commission from chapter 11.¹⁹⁷ Second is the nearly insurmountable conditions for a court's appointment of a trustee that are found in section 1104.¹⁹⁸ Third is the venue rules discussed in Part VI above.¹⁹⁹

With its right to appoint a trustee in chapter X, and its right to advise on any proposed plan, the SEC could influence if not control a chapter X. Its right to appoint (and practice of appointing) a trustee foreclosed existing management and their lawyers from a significant role in that chapter. It left no one home to negotiate with a prospective DIP lender or with anyone else. The SEC's right to interfere in the plan of reorganization and perhaps even to insist on certain terms over the opposition of the parties burdened the parties' negotiation of a plan. By depriving the SEC of status of party in interest, section 1109 keeps it even from asking for a trustee's appointment, for section 1104 permits only a "party in interest" to make that request.²⁰⁰ So the Code castrated the SEC; no SEC bureaucrat may mess with this market.

The statement in section 1104(a)(1) that a trustee can be appointed only for cause, such as "fraud dishonesty . . . or gross mismanagement" and the statement that large size or large numbers of bond or stockholders are not enough to justify a trustee, has successfully warned the courts away from appointing trustees.²⁰¹ This means that no party answerable to an uninvolved actor such as the SEC or a court appointed trustee will be at the controls in chapter 11. These rules in 1104 and 1109 were consciously chosen to have that effect.²⁰²

¹⁹⁷ See *supra* notes 161–65 and accompanying text.

¹⁹⁸ See [11 U.S.C. § 1104 \(2002\)](#) (listing requirements for appointment of trustee).

¹⁹⁹ See *supra* Part VI.

²⁰⁰ See [11 U.S.C. § 1104\(c\) \(2002\)](#) (giving parties in interest power to request appointment of trustee); [11 U.S.C. § 1109\(b\)](#) (not including SEC among list of parties in interest).

²⁰¹ Cf. e.g., [In re Kingston Square Assocs.](#), 214 B.R. 713, 738 (Bankr. S.D.N.Y. 1997) (appointing trustee where debtor's board of directors had abdicated its fiduciary duty); [In re Rivermeadows Assocs.](#), 185 B.R. 615, 619 (Bankr. D. Wyo. 1995) (stating trustee may be appointed solely based on pre-petition activities of debtor's management); [In re Bellevue Place Assocs.](#), 171 B.R. 615, 624 (Bankr. N.D. Ill. 1994) (appointing trustee when prior agreement deprived management of ability to discharge of fiduciary duties).

²⁰² See 7 COLLIER ON BANKRUPTCY ¶ 1104.02[1] (Lawrence P. King et al. eds., 15th ed. rev. 2004) ("The concept of the debtor remaining in possession recognizes that the debtor's managers are most familiar with

The third set of rules, those on venue, has had at least as much influence, but this influence may have been unintended. As I show above, the generous venue rules allow a debtor and its potential DIP lender to choose among many courts.²⁰³ Bankruptcy judges everywhere are aware of these opportunities for forum shopping.²⁰⁴

Judges appreciate that the legal issues in large chapter 11s are more interesting than those in one horse chapter 11s or in the huge gob of chapter 7s that gum up every bankruptcy court, and they know that the work of the lawyers in big cases will be carefully done, that the legal issues will be ably and fully argued. So the big cases will be more interesting than the small; they bring more than intellectual stimulation, for prominence and prestige also accompany these cases. An important decision might merit discussion in the popular business press.²⁰⁵

Understand how the venue rules make this implicit bargain possible. The judges want big cases and the DIP's and DIP lenders want certainty, favorable law, and, most of all, laissez faire. Because the offerees' identity (potential DIP's and DIP lenders) is unknown and because an explicit, bilateral bargain would be at least unseemly and possibly illegal, this bargain can never be direct, open or, I suspect, legally binding.²⁰⁶ The judges are like the offeror of a unilateral contract. Like offerors of rewards, the judges necessarily make their offers for the ears of persons unknown. They make these offers by their decisions, by publishing friendly rules and, generally, by being laissez faire. They must depend on the offerees' agents—bankruptcy lawyers—to hear, interpret and report these offers. The acceptance of the offer is, of course, the act of filing a big chapter 11. The implicit deal between the judges on the one hand and the DIP and its lender on the other leaves the DIP and DIP lender free to make a bargain first between themselves and later with

the business and normally will be able to provide the most capable and efficient management during the chapter 11 process.").

²⁰³ See *supra* notes 146–52 and accompanying text.

²⁰⁴ My interviews disclose several jurisdictions where bankruptcy judges have done things to attract large chapter 11 cases. See also Robert K. Rasmussen & Randall S. Thomas, *Timing Matters: Promoting Forum Shopping by Insolvent Corporations*, 94 NW. U. L. REV. 1357, 1407 (2000) (arguing forum shopping allows for insolvent corporations to choose forum maximizing value received from financial investments in firm, so long as choice is made early). But see Lynn M. LoPucki & Sara D. Kalin, *The Failure of Public Company Bankruptcies in Delaware and New York: Empirical Evidence of a "Race to the Bottom"*, 54 VAND. L. REV. 231, 248 (2001) (presenting empirical data showing bankruptcy cases filed in Delaware and New York have higher rate of refiling than ordinary, and arguing some forum-shopped cases may be responsible for higher refiling rates).

²⁰⁵ For example, entering the terms "Enron bankruptcy", "United bankruptcy" and "Kmart bankruptcy" in a Google search nets 413, 1430, and 309 news stories, respectively.

²⁰⁶ Some of my interviewees and other bankruptcy lawyers say that judges in three districts have approached local bankruptcy lawyers to inquire how they might change the rules of judge selection for chapter 11 cases or otherwise modify their practice in order to attract more of the large cases. Two of those attempts came to naught; I do not know what happened in the third case. In a fourth jurisdiction one judge apparently met with potential DIPs before they filed to discuss the kind of first day orders they would seek. Whether there was more than implicit consideration of the possibility of filing elsewhere at that point is unclear.

others in the bankruptcy without fear of interference from the court (at least if they stay within reasonable limits).

While it is more overt than the deal with the judges, the bargain between the DIP and the DIP lender is not quite forthright. Some of the DIPs most important promises have little or no effect on the DIP but a large effect on unsecured creditors. If, for example, the DIP agrees to a rollup of the DIP lender's pre-petition debt and if no plan of reorganization results, on liquidation the cost of the rollup will be borne by the unsecured creditors who will receive a smaller payout than they would have received if the secured creditor's debt had not been rolled up into post-petition debt.²⁰⁷ On liquidation the debtor and its management will be gone. So to some degree, the DIP is truly spending from the unsecureds' purse when it strikes a deal with the DIP lender.

Of course the DIP cannot be a complete whore in its bargain with the DIP lender. The DIP management may hope to ride out the chapter 11 and continue to operate the reorganized company.²⁰⁸ Since the unsecureds will be a large block of the new stockholders and since even before that they can stop approval of a plan by a large enough vote, the managers must have an eye on the unsecureds' interest too. If the DIP agrees to a deal too favorable to the DIP lender, the unsecured committee may vote it down or challenge it in court and, if the deal deviates too far from the norm, even a *laissez faire* court will reject it.²⁰⁹

The unsecureds hold a weaker position in this market than the secureds for many reasons. First they enjoy none of the benefits of the secured creditors that I describe above.²¹⁰ Second since the DIP and the DIP lender choose the venue and so confer a benefit on the judge, they, not the unsecureds, presumably command the lion's share of the benefit from that bargain; put differently no judge need fear the poorly organized rabble of unsecured creditors for they do not choose the venue.²¹¹ Only after the case is filed are the unsecureds invited.

Despite the fact that the unsecureds as a class are at the bottom of the bankruptcy hierarchy, much of the action is with them. Except for the claim of the DIP lender who goes from beginning to end, both secured and unsecured claims are bought and sold continuously in a large chapter 11. This part of the market is of course made possible by the earlier deals among the judge, the DIP and the DIP lender. *Laissez faire* not only entices the DIP lender, it also facilitates trades of the

²⁰⁷ See *supra* notes 173–77 and accompanying text; see also Cousins, *supra* note 178, at 800 (discussing rollover financing).

²⁰⁸ See Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. PA. L. REV. 669, 799 (1993) (suggesting rule be adopted that management seek to maximize value of firm, even when it conflicts with general desire of management to ride out chapter 11 and thus keep their jobs).

²⁰⁹ See *In re Phase-I Molecular Toxicology, Inc.*, 285 B.R. 494, 496 (Bankr. N.M. 2002) (rejecting debtor's post-petition financing plan because court was not convinced it was in creditors' best interest).

²¹⁰ See *supra* Parts II–VI; see also Vance & Barr, *supra* note 151, at 383 (explaining, from unsecured creditor's point of view, bankruptcy may be meaningless).

²¹¹ See *Hunt v. Bankers Trust Co.*, 799 F.2d 1060, 1068 (5th Cir. 1986) (stating unsecured creditors have no right to decide venue).

secured and unsecured debt of the bankrupt. The certainty that comes from a judge who will not interfere without reason and who has consistent and predictable behavior makes it simpler for these buyers and sellers to evaluate the worth of particular claims. A buyer or seller must evaluate the legal rights attached to a particular claim (its share of the pie) and he must evaluate the worth of the firm on its exit from chapter 11 (size of the pie). The first is mostly legal, the second is mostly economic. The *laissez faire* attitude of the court helps to answer the first, for it minimizes the chance that an outlier will convince the court to deviate from shared expectations about the law.

It is often asserted that most claims at the end of a large chapter 11 are not held by the same persons that held them at the beginning of the case.²¹² A majority of the claims have been traded at least once in this market. Without knowing more and assuming that the participants in this market have no disabilities, economic learning would say that the presence of a flourishing market in claims is *ipso facto* beneficial. Each trader here must think that he benefits from the trade, the buyer to take part in the bankruptcy and the seller to take his money elsewhere.

The bargaining that we see is probably made easier by the fact that professionals control it. The DIP lender enters with full understanding of the game; the unsecureds are recent buyers of the debtor's paper who have paid less than par, sometimes far less than par. All will be represented by lawyers and investment bankers skilled at the game. These lawyers must perceive the courts' offer of an implicit contract and urge their clients to accept it. They must understand not only the applicable law and practice in the District where the case is filed but, more important, the informal rules of the market and every other persons' probable expectations. They appreciate the damage that they can do to others and, better, that others can do to them. Working with the lawyers' evaluation on the first issue (size of a claim's share), the investment bankers can evaluate the probable economic payoff.

I hypothesize that these professional players are less likely to cling to impossible dreams; in the words of negotiation literature, the original lender may be "anchored" at 100 cents—his original expectation.²¹³ The bankruptcy pros are more

²¹² The estimate of all of my informants was that more than half of the debt of most public companies was not in the same hands at the end of the bankruptcy as it was at the beginning. They noted that the trade debt was the least likely to be traded, but that corporate bonds were actively traded and that bank debt, even secured bank debt is often traded. One suggested that the vultures who feast mostly on unsecured debt now sometimes buy secured debt in order to vote in the secured classes and so inhibit the secured's chance of hurting their main position as unsecured debt holders.

²¹³ Of course somewhere and sometime the person anchored at 100 cents must have sold to someone else for far less than 100 cents. Why if he would not settle for far less than 100 cents in the bankruptcy will he sell for far less to a trader? My interviewees gave uncharacteristically simple-minded opinions on this. One answer is that the vultures offer money; there will be no payment from the bankrupt estate until the confirmation and then it may come in stock and not cash. But of course that argument ignores the point that the vultures' offer is already greatly discounted because of the waiting time and the possibility that the equity may be worth less than the debtor asserts. Another response is that the vultures are smarter than the commercial bankers, that the bankers are good at other things, not at valuing failing companies. That answer too is unsatisfying. Why can't banks hire vultures and so share in the intelligence? The best answer is that

likely to have a realistic estimate of the probable payoff than inexperienced players would have and are less likely to be anchored at an unreasonable figure. That of course means that a bargain is likely to be struck and that no one will be put to the cost and risk of making the court decide.

The Code's adoption, and its application by the courts may have been necessary for this market to arise but neither the Code's adoption nor its application by the courts is sufficient to cause the market to exist. I suspect that the market's rise depends equally on the growth of chapter 11s by public companies and on the rise of a class of nationwide specialists

In conclusion I believe it is sensible to think of chapter 11s of public companies as large and unruly markets where many interrelated deals lead incrementally to a corporate reorganization. To be sure neither the law nor the courts are irrelevant, for the private bargain often depends on the courts' power to bind dissenting members of a class²¹⁴ and the parties derive their bargaining power from rights granted by Article 9 and by many provisions of the Code. And of course, the judge must approve the plan and, perhaps, even resolve a conflict or two.

But make no mistake, these plans are not crammed down; they will have the agreement of every class. The parties will have chosen a venue where an outlier is unlikely to get his wish from the court and where the outcome negotiated in the private market and reflecting the economic power of the parties will control. The Code has made this market possible.

banks are sometimes forced by regulators to write down this debt to unrealistically low prices. Then even a bad sale improves their balance sheets.

²¹⁴ See [11 U.S.C. § 1126 \(2002\)](#) (stating ways class can accept plan); [11 U.S.C. § 1129\(a\)\(8\)](#) (stating court shall confirm plan if each class of claims or interests "has accepted the plan" or each class "is not impaired under the plan").