

University of Chicago Law School

## Chicago Unbound

---

Journal Articles

Faculty Scholarship

---

2015

### The Rights of Secured Creditors after *ResCap*

Douglas G. Baird

Follow this and additional works at: [https://chicagounbound.uchicago.edu/journal\\_articles](https://chicagounbound.uchicago.edu/journal_articles)



Part of the [Law Commons](#)

---

#### Recommended Citation

Douglas G. Baird, "The Rights of Secured Creditors after *ResCap*," 2015 University of Illinois Law Review 849 (2015).

This Article is brought to you for free and open access by the Faculty Scholarship at Chicago Unbound. It has been accepted for inclusion in Journal Articles by an authorized administrator of Chicago Unbound. For more information, please contact [unbound@law.uchicago.edu](mailto:unbound@law.uchicago.edu).

# THE RIGHTS OF SECURED CREDITORS AFTER *RESCAP*

*Douglas G. Baird\**

*This Article explores the extent of secured creditor's rights in bankruptcy through an examination of In re Residential Capital. In particular, ResCap is used to ask whether secured creditors should have a right to value that comes into being solely by virtue of the bankruptcy process. Ultimately, this question is intertwined with the inquiry of whether bankruptcy reorganization needs to be treated as a day of reckoning at all.*

## TABLE OF CONTENTS

I.	INTRODUCTION.....	849
II.	NONBANKRUPTCY BASELINES AND ADEQUATE PROTECTION.....	851
III.	VALUE CREATED IN BANKRUPTCY.....	854
IV.	OPTION VALUE AND BANKRUPTCY.....	860

## I. INTRODUCTION

By the standard academic account, a secured creditor in bankruptcy is entitled to the value of its nonbankruptcy rights at the time the bankruptcy petition is filed, no more and no less.<sup>1</sup> The secured creditor should be protected from the risks and hazards of bankruptcy, but, by the same token, it should not enjoy its benefits. Whether this academic account of the rights of the secured creditor in bankruptcy is consistent with the law as we find it, however, is remarkably unsettled.

---

\* Harry A. Bigelow Distinguished Service Professor of Law, University of Chicago. I thank James Drain and Harvey Miller for their help. Much of this Article reflects ideas developed out of ongoing work with Don Bernstein and Tony Casey. The John M. Olin Fund provided research support.

1. In recent times, academics critical of the control secured creditors exercise in modern Chapter 11 make this argument, but, as they acknowledge, it is one long put forward by academics across the ideological spectrum. See, e.g., 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 (1984); Edward Janger, *The Logic and Limits of Liens*, 2015 U. ILL. L. REV. 589.

The dynamics of large corporate reorganizations keep many questions beneath the surface. A senior creditor often holds a blanket security interest in all of the business' assets, including the business' cash. To reorganize effectively, at the outset of the case the debtor ordinarily must reach some kind of deal to obtain postpetition financing or use cash collateral. The deal she reaches, once approved by the court, sets a baseline. There are disputes about things such as the amount of the carve-out the secured creditor must give to pay for the bankruptcy, but rarely is the court forced to put a precise value on the secured creditor's rights. By the end of the case, there is usually a consensual plan. Even when there is not, the secured creditor's claim is folded together with whatever it received in the way of adequate protection. How much it would have received the moment the petition filed in its absence is not an issue.

*In re Residential Capital* ("ResCap") is the unusual case that brings the rights of the secured creditor in bankruptcy into focus.<sup>2</sup> In that case, a group of junior secured noteholders held an odd collateral package. Oversimplifying somewhat, this group held two types of collateral. First, was a junior secured position on ResCap's principal assets.<sup>3</sup> These included ResCap's right to recover from mortgagors the payments it advanced to those whose mortgages it serviced, as well as revenues from servicing mortgages going forward.<sup>4</sup> Second, the group had a blanket senior security interest in other assets of ResCap, including the business's goodwill.<sup>5</sup>

Two issues in particular in *ResCap* forced the court to address the nature of the secured creditor's rights in bankruptcy. First, the group argued that it was overcollateralized, and, for this reason, it needed to be given postpetition interest in order to be adequately protected.<sup>6</sup> To succeed, however, the group needed to show that the value of its collateral in the debtor's hands, not its value in a foreclosure sale, provided the relevant baseline.<sup>7</sup>

Second, the group of junior secured noteholders argued that a substantial portion of ResCap's value was attributable to its goodwill, as opposed to its other assets.<sup>8</sup> The group held a senior security interest in the goodwill, but either only a junior interest or none at all in other assets.<sup>9</sup> The group argued that on this account it was again entitled to receive more than the plan offered it.<sup>10</sup> The goodwill, however, had increased substantially in value during the course of the case.<sup>11</sup> Even if the goodwill

---

2. Official Comm. of Unsecured Creditors *ex rel.* the Estates of the Debtors v. UMB Bank, N.A. (*In re Residential Capital, LLC*), 501 B.R. 549 (Bankr. S.D.N.Y. 2013).

3. *Id.* at 555.

4. *Id.* at 558.

5. *Id.* at 574.

6. *Id.* at 556–57.

7. *Id.* at 594.

8. *Id.* at 608–10.

9. *Id.* at 578.

10. *Id.* at 578–79.

11. *Id.* at 578.

were worth as much as the group claimed at the time of confirmation, the group still had to show why it was entitled to the increase in value that came during the course of the reorganization.<sup>12</sup>

These two questions—how to assess the value of a secured creditor's collateral for purposes of adequate protection and whether a secured creditor is entitled to value that is created during the reorganization—require identifying the nature of the secured creditor's rights in the first instance. In this Article, I set out the basic contours of the existing debate, both to assess the outcome of *ResCap* and to identify the issues that should be at the center of serious discussions of bankruptcy reform.

Part II uses *ResCap* to explore the conventional wisdom about the rights of the secured creditor in bankruptcy. By this account, the filing of the bankruptcy petition is a day of reckoning that collapses future possibilities. The secured creditor's nonbankruptcy right at this moment sets the value that must be adequately protected. *ResCap* suggests that this account is inconsistent with current law, or, at least, that current law is more complicated than academics commonly think.

Part III uses *ResCap* to explore rights to postpetition goodwill, and the larger question of whether secured creditors should have a right to value that comes into being solely by virtue of the bankruptcy process. This examination of *ResCap* suggests that current practice is more consistent with the idea that the day of reckoning comes not at the time of the filing of the petition, but rather at the time of plan confirmation. Part IV asks whether the existing debate with respect to both questions neglects an antecedent question, which is whether the reorganization needs to be treated as a day of reckoning at all.

## II. NONBANKRUPTCY BASELINES AND ADEQUATE PROTECTION

Bank has a \$150 loan secured by all the assets of Firm. Lender is a general creditor owed \$200. If Firm's assets are sold outside of bankruptcy, they will bring \$200. In bankruptcy, Firm will be worth \$100, \$200, or \$300, all with equal probability in a year's time. If Bank insists upon adequate protection, how much must the debtor give it?

By the conventional account, the moment the petition is filed is the critical event. We take a snapshot at this moment and ask how much the secured creditor's rights were worth. This is the approach Justice Holmes took in *Sexton v. Dreyfus*:

[T]he rule was laid down not because of the words of the statute, but as a fundamental principle. . . . It simply fixes the moment when the affairs of the bankrupt are supposed to be wound up. If . . . the whole matter could be settled in a day by a pie-powder court, the secured creditor would be called upon to sell or have his security

---

12. *Id.* at 611.

valued on the spot, would receive a dividend upon that footing, would suffer no injustice, and could not complain.<sup>13</sup>

Bankruptcy brings about a day of reckoning that collapses all future possibilities to present value. During the era of the law merchant, court proceedings lasted but a single day. Even if modern court proceedings cannot take place so quickly, the substantive rights of the parties should be valued as if they could.

By this metric, Bank should receive as adequate protection a bundle of rights worth \$150. Bank has the right to \$150 and could realize this amount in the absence of the automatic stay. It could seize Firm's assets and sell them for \$200, keep \$150, and turn the balance over to the debtor. Bankruptcy needs to provide Bank with a package of rights to ensure Bank receives, in expectation, this amount, but no more. The bankruptcy is being run for the benefit of the general creditors.<sup>14</sup> They are entitled to the upside as long as they can protect Bank from the downside.

The general creditors cannot force Bank to accept a claim against the estate as adequate protection,<sup>15</sup> but Bank can consent to a portion of the upside as adequate protection to compensate it for the risk that, when the bankruptcy is over, it receives only \$100. The court can grant Bank a portion of the upside, even if some object, as long as it is not overcompensatory. In this case, promising Bank an extra \$33 when Firm turns out to be worth \$200 or \$300, compensates it for the one-third chance that it will end up losing \$50 when Firm is worth only \$100.

This example posited that Firm could be sold for as much outside of bankruptcy as in. This may not be the case and, under *Butner v. United States*,<sup>16</sup> nonbankruptcy law provides the relevant benchmark. Assume that if there had been no bankruptcy and no automatic stay to keep Bank from exercising its rights, it would have repossessed its collateral and sold it for only \$100. In such a case, it would seem that the debtor need do no more than keep Bank's lien in place to give it adequate protection. Even when the reorganization goes badly and Firm proves to be worth only \$100, Bank will receive as much as it would have if it exercised its nonbankruptcy rights.

Indeed, one can take the argument further. To the extent that Bank's priority is benchmarked by the value of its nonbankruptcy rights, its secured claim at the end of the bankruptcy should be capped at \$100 *even if Firm proves to be worth \$200 or \$300*. The value of Bank's nonbankruptcy right at the time of the petition should fix the amount of Bank's secured claim for all purposes. The balance of what it is owed (\$50 in this case) is unsecured. Bank and Lender should split whatever is realized in bankruptcy between them pro rata, with Lender taking the

---

13. *Sexton v. Dreyfus*, 219 U.S. 339, 344–45 (1911).

14. *See id.* at 345–46.

15. 11 U.S.C. § 361(3) (2012).

16. 440 U.S. 48, 55 (1979).

lion's share and with Bank not being paid in full even if the firm proves to be worth \$300.

However correct as a matter of first principle, this approach is hard to implement in practice. It requires, at the time of confirmation, a retrospective measure of the value on Firm. In addition to setting the current value of the firm, the court would have to put a value on Firm at a hypothetical disposition in a different forum at some time in the past. Moreover, if the secured creditor is given some of the upside as part of its adequate protection package, the court would have to calculate how much extra the secured creditor should receive on that account. One doubts that litigation over what might have happened in such counterfactual worlds makes much sense.

In any event, the distinction between values realized in bankruptcy and out is overdrawn. Even if the proper benchmark is the value of the senior lender's nonbankruptcy right, it is a mistake to think that the value of this right is the modest amount realized in a foreclosure. Nonbankruptcy remedies also include the ability to have a receiver appointed or to initiate an assignment for the benefit of creditors.<sup>17</sup> Going-concern liquidation sales outside of bankruptcy are possible.<sup>18</sup> Assignments for the benefit of creditors are commonplace.<sup>19</sup> Especially when only institutional debt is to be restructured, creditors outside of bankruptcy can effect going-concern sales of entire firms quite easily.<sup>20</sup>

If, for example, the debtor has an operating subsidiary and the debt is at the holding company level, the senior creditor's nonbankruptcy remedy is the sale of the equity of the operating subsidiary. Such an Article 9 sale need not look much different from an ordinary going-concern sale. If the Chapter 11 itself takes the form of a going-concern sale, it may not in fact yield an amount that is appreciably different from what could be captured under nonbankruptcy law.

There is likely to be some difference between dispositions under bankruptcy and nonbankruptcy law. Buyers in bankruptcy may pay more because they are more confident they are acquiring the assets free and clear.<sup>21</sup> If the senior creditor controls the decision to file for Chapter 11, it presumably believes that Chapter 11 provides it with a net benefit. But, it is a mistake, especially given bankruptcy's higher costs, to think that these benefits are necessarily high. Moreover, if a rule were put in place to provide the senior creditor only with the value of what it could have reached outside of bankruptcy, it could either avoid bankruptcy or take steps (such as changing the capital structure or lending less in the first in-

---

17. *Id.* at 52–53.

18. See Edward R. Morrison, *Bargaining Around Bankruptcy: Small Business Workouts and State Law*, 38 J. LEGAL STUD. 255, 256 (2009).

19. See *id.*

20. See *id.*

21. Anthony J. Casey, *The Creditors' Bargain and Option-Preservation Priority in Chapter 11*, 78 U. CHI. L. REV. 759, 774 (2011).

stance) to ensure that its nonbankruptcy alternative was more promising or was sufficient to pay it in full.

All this, however, is likely beside the point. As the court in *ResCap* shows, focusing mechanically on liquidation valuations at the time of the petition (or, indeed, at any time) as the benchmark for the secured creditor's rights is likely not the law.<sup>22</sup> It is hard to reconcile with the Supreme Court's opinion in *Associates Commercial Corp. v. Rash*.<sup>23</sup>

*Rash* was a Chapter 13 case, but the decision turned on the Court's interpretation of section 506.<sup>24</sup> It held that "the 'proposed disposition or use' of the collateral is of paramount importance to the valuation question."<sup>25</sup> If Firm plans on remaining intact as a going concern, its value in a liquidation outside of bankruptcy is not relevant, at least for purposes of confirming a plan of reorganization. The court in *ResCap* held that a going-concern valuation was necessary for adequate protection purposes as well, at least when the debtor planned a going-concern sale from the start.<sup>26</sup> If the debtor proposes to keep the assets intact, it cannot use a different and lower value for purposes of adequate protection.<sup>27</sup>

Even if the value of the senior lender's right at the time of the petition provided the appropriate benchmark, one might still focus on the amount actually realized in Chapter 11 if a going-concern sale takes place there. Outside of bankruptcy, there might have also been a going-concern sale that takes place on the same time scale and in much the same fashion. The amount actually brought in bankruptcy is a decent proxy for the amount that would have been generated from a nonbankruptcy sale. Given the difficulties of using other benchmarks, the party who argues in favor of valuing the secured creditor's right by some hypothetical disposition that never happened should bear the burden of explaining to the court why taking everyone down such a rabbit hole makes sense.

### III. VALUE CREATED IN BANKRUPTCY

*Sexton v. Dreyfus* affirms a principle found in traditional bankruptcy law, but not in the equity receivership. This should come as no surprise. *Sexton* is a useful doctrine when the typical security interest extends only to a specific asset of the debtor, such as its equipment, accounts, or inventory, and the bankruptcy itself is run for the benefit of the general

---

22. See Official Comm. of Unsecured Creditors *ex rel.* the Estates of the Debtors v. UMB Bank, N.A. (*In re Residential Capital, LLC*), 501 B.R. 549, 593 (Bankr. S.D.N.Y. 2013).

23. 520 U.S. 953 (1997).

24. *Id.* at 955–56.

25. *Id.* at 962.

26. *In re Residential Capital*, 501 B.R. at 551.

27. As the court noted, some cases point in the other direction. See, e.g., *id.* at 594 n.33 (citing *In re Scotia Dev., LLC*, No. 07–20027, slip op. at 23–24 (Bankr. S.D. Tex. July 7, 2008) ("With noncash property, the interest that secured creditor has a right to is the right to foreclose. Therefore, the case law suggests that the appropriate value to protect is the foreclosure value of the property and not the fair market value of the property."), *aff'd in part*, *In re SCOPAC*, 624 F.3d 274, 285–86 (5th Cir. 2010).

creditors.<sup>28</sup> It makes little sense when, as in the case of equity receiverships, the capital structure consists almost exclusively of secured debt, some of which extends to all the assets of the firm. The pervasiveness of secured debt in large-firm Chapter 11s makes them more like equity receiverships. It may be for this reason that *Sexton* plays such a small role in modern reorganization law.

To return to the hypothetical, the creditor in the position of Lender is often a second lienholder. The only general creditors are a handful of trade creditors, and everyone may agree it makes sense to pay them in full. The reorganization is about the capital structure. The Chapter 11 process will be largely invisible to the rest of the world. Firm once again can be sold outside of bankruptcy for only \$100 but is worth \$100, \$200, or \$300 inside. It would seem odd to hold that, even though Bank is owed \$150, it should receive only a package of rights worth \$100 and that it should have to share whatever is realized in excess of that amount with Lender.<sup>29</sup> At the moment the petition is filed, Bank and Lender both understand that the best way to maximize Firm's value is to reorganize it in Chapter 11. That Firm is worth only \$100 outside of bankruptcy is neither here nor there. No one thinks that course is sensible.

From this perspective, assuming still that one is committed to taking stock of things at the moment of the petition, Bank's secured claim is worth \$150. At the time the petition is filed, Firm is worth, in expectation, \$200, and Bank is first in line. To provide Bank with adequate protection, it must be given a package of rights worth \$150. Indeed, if Bank were owed \$200 and the law mandated benchmarking rights at the time of the petition, the debtor must give Bank the entire upside in order for Bank to have a bundle of rights equal to the value of its secured claim. As long as one is committed to treating the filing of the petition as a recognition event, this result follows.

This approach to assessing the rights of the secured creditor suffers from conspicuous weaknesses. Under these facts, neither Lender nor anyone other than Bank would trigger the bankruptcy in the first place. Moreover, it requires a valuation of Firm at the outset of the case. It may make more sense that Bank should have no right to assert its priority over Lender until the reorganization runs its course. Doing this would require rejecting *Sexton* and put off the day of reckoning until the time of the reorganization.

This idea can be illustrated with one more variation. Firm is again worth \$100, \$200, or \$300 with equal probability, but Bank is owed \$250 and a going-concern sale is not possible. In expectation, Firm is not worth enough to pay Bank in full. The most sensible reorganization regime, or at least the one most similar to today's regime, is one in which

---

28. See *Sexton v. Dreyfus*, 219 U.S. 339, 345–46 (1911).

29. Bank and Lender might have an intercreditor agreement that subordinates Lender to Bank. This would reproduce the original division, but it begs the question: why should there be a bankruptcy rule that parties would negate if they could?



Lender has a continuing stake in Firm, even though in expectation Firm will not be able to pay Bank in full. The option value of Lender's claim is not extinguished until the plan is confirmed.

As long as the collateral is not declining in value and a reasonable reorganization is in prospect, the relative positions of Bank and Lender remain in place throughout the reorganization. If Firm turns out to be worth \$300, Bank will be paid in full, and Lender will receive \$50. Bank stands to lose if Firm proves to be worth only \$100 or \$200, but this is also true outside of bankruptcy as long as there is no foreclosure or other event that forces a reckoning. We take stock only at the time the plan is confirmed.

This way of looking at Chapter 11 is largely consistent with modern practice. It does, however, ignore a fundamental characteristic of security interests under nonbankruptcy law.<sup>30</sup> We conventionally talk about the rights of a senior creditor in terms of its position within the capital structure of the firm as a whole. There are different tranches, and those in the higher tranches are entitled to be paid before those in the lower ones. The law, however, allows priority to be established only with respect to each of its assets, not with respect to the firm as a whole.<sup>31</sup>

A secured creditor's right is asset-based.<sup>32</sup> A creditor is truly senior to another creditor in a firm only to the extent that it has perfected a security interest in each and every asset of the firm. Moreover, even if assets are not valued until the plan is confirmed, the secured creditor's priority is limited to assets in which it had a perfected security interest at the time the petition was filed or assets acquired with the proceeds of that security interest.<sup>33</sup>

These legal principles are long settled, and, for this reason, *ResCap's* treatment of postpetition goodwill is unremarkable. The secured creditor group in *ResCap* did not have a security interest (or, at least, not an in-the-money security interest) in the principal assets of the business that was sold.<sup>34</sup> It enjoyed a senior security interest only in the goodwill of the business.<sup>35</sup> Money spent to generate postpetition goodwill did not come from (or at least was not shown to come from) its collateral.<sup>36</sup>

A simple hypothetical captures these dynamics. Bank has a security interest in Firm's goodwill. For its part, Lender has a security interest in some cash and in a highly specialized machine that is worthless unless Firm is kept intact. Lender desperately wants Firm to remain in business with its reputation intact. If Firm loses its customers, Lender's own col-

---

30. See Janger, *supra* note 1, at 592.

31. *Id.*

32. *Id.*

33. U.C.C. § 9-203 (2002).

34. Official Comm. of Unsecured Creditors *ex rel.* the Estates of the Debtors v. UMB Bank, N.A. (*In re Residential Capital, LLC*), 501 B.R. 549, 582 (Bankr. S.D.N.Y. 2013).

35. See Janger, *supra* note 1, at 612.

36. *In re Residential Capital*, 501 B.R. at 612.

lateral is worthless. Lender is quick to agree that the debtor can use its cash collateral to preserve the good reputation of Firm. Doing so is money well spent. It enhances the value of Lender's collateral. As a result, the value of Firm's goodwill rises. Bank should not be able to assert any rights in this goodwill created postpetition with Lender's cash.

The increase in goodwill does not flow from Bank's prepetition security collateral, but rather from Lender's. The facts of *ResCap* are considerably more complicated, but the same dynamic was at work. There is some language in the opinion that seems to limit the right of secured creditors only to postpetition accretions of value due *entirely* to their prepetition collateral,<sup>37</sup> but this is neither necessary to the result of the case nor is it the major thrust of the opinion. Other stakeholders held senior security interests in assets (such as ResCap's servicing rights) whose value turned in large measure on ResCap continuing as a going concern.<sup>38</sup> They had every reason to have their collateral invested in enhancing ResCap's goodwill, and the junior noteholders could not show that *any* of their own prepetition collateral was responsible for increase in the value of the goodwill. Given this failure, the extent to which a secured creditor can enjoy accretions in the value of postpetition goodwill when it is only partially responsible for them was not in play.

*ResCap* underscores the principle that priority attaches to discrete assets, not to a firm's assets as a whole.<sup>39</sup> To the extent that a secured creditor cannot show that an asset that was acquired postpetition arises from its collateral, it cannot claim a security interest in it. Because *ResCap* involved a case of a junior secured creditor who did not have a security interest in all of Firm's assets, this feature of the law was manifest. In many cases, however, it is not.

Revised Article 9 went a long way to making it possible to take a security interest in all of a firm's personal property. Creditors can also be confident of priming others through structural priority.<sup>40</sup> An operating company can be dropped into a subsidiary.<sup>41</sup> A creditor can take a security interest in the equity of the subsidiary and insist that other institutional debt be incurred at the parent level.<sup>42</sup> Once a creditor perfects its security interest in the parent's equity in the operating company, it can be confident it is senior to other institutional creditors.<sup>43</sup> With respect to some types of collateral, such as FCC licenses or patents or copyrights or real property, perfecting security interests is difficult or uncertain. In such cases, a subsidiary can be created to hold just these assets and the

---

37. *Id.*

38. *Id.* at 594.

39. See Richard M. Hynes, *Reorganization as Redemption*, 6 VA. L. & BUS. REV. 183, 230 n.214 (2011); see also *In re Residential Capital*, 501 B.R. 549.

40. George H. Singer, *The Lender's Guide to Second-Lien Financing*, 125 BANKING L.J. 199, 202 (2008).

41. See Douglas G. Baird, *Security Interests Reconsidered*, 80 VA. L. REV. 2249, 2257 (1994).

42. *Id.*

43. See *id.*

secured creditor can take a security interest in the equity and ensure that no one extends credit to the subsidiary.

If a secured creditor has a fully perfected security interest in everything of value to Firm, including all of its cash, any assets acquired post-petition necessarily are proceeds of its collateral. To be sure, the proceeds might have been derived in part from the work of Firm's employees, but this work was paid for with the cash in which the senior creditor had a security interest. The secured creditor may not be able to show exactly how Firm generated value prepetition, but as only assets in which it had a security interest were responsible for the value generated postpetition, it does not need to.

It is as if Firm consisted of robotic machines on a desert island. No person and no thing ever comes or leaves, apart from fungible raw materials bought at market price and final products shipped to customers. As long as a creditor has a senior security interest in everything at the moment the petition was filed, any increase in value during the bankruptcy belongs to this creditor. There is no other source from which the value might have come.

Because priority is tied to discrete assets, complications can arise. It is rarely possible to lock up all the assets. Some liens may be contested or doubtful. There is a long-standing undercurrent in both the case law and the scholarship that blanket security interests compromise the rights of general creditors.<sup>44</sup> In the view of some, gaps in the coverage of a secured creditor are to be celebrated.<sup>45</sup> Firms are greater than the sum of their parts. There is synergy among the assets that the bankruptcy preserves. One can argue that this synergy is not "property" at the time the petition is filed. The secured creditor lacks any means to levy upon it, and it makes sense for others to be able to lay claim to it. The secured creditor is entitled only to its collateral and perhaps the discrete assets that are associated with it. The secured creditor should not be able to lay first claim to anything more.<sup>46</sup> There is no reason for it be able to advance its position absolutely to the exclusion of other stakeholders.

As noted, this argument may overstate how much value bankruptcy adds and how much is left for other stakeholders in the typical case. Nonbankruptcy rights are too often equated with piecemeal liquidation in a foreclosure sale. Nevertheless, this view is firmly rooted in traditional accounts of bankruptcy. The opposite view starts with the notion that the asset-based view of bankruptcy is a bug rather than a feature. From an investor's perspective, a firm is itself a black box that produces a stream of cash over time.

---

44. See, e.g., *Zartman v. First Nat'l Bank of Waterloo*, 82 N.E. 127, 128 (N.Y. 1907) (finding that a security interest in future earnings would "deprive the unsecured creditor of the fund, upon the faith of which he may have given credit").

45. See Michelle M. Harner, *The Value of Soft Variables in Corporate Reorganizations*, 2015 U. ILL. L. REV. 509.

46. For a forceful defense of this idea, see *id.*

Different investment instruments are simply different divisions of this income stream. That the firm consists of many different components makes it no different from a machine. Those who invest their capital should be able to divide the income stream that comes from other components without having to trouble themselves with what is inside the black box. That unsecured institutional investors are left with nothing in bad states of the world should not be troubling. They should enjoy a market rate of return and can protect themselves by holding a diversified portfolio.

A firm in economic distress affects many stakeholders, but, according to this view, carving something out of a secured creditor's collateral in bankruptcy for redistribution to others makes little sense. In large corporate reorganizations, the beneficiaries of a carve-out will be other institutional investors.<sup>47</sup> Rates of return will be adjusted, and all will continue to enjoy a market return. Such a carve-out does little for small stakeholders, given that the vast, vast majority of firms that fail never file for Chapter 11.<sup>48</sup> One likely effect of a carve-out is to reduce the number of bankruptcies. Small stakeholders are left no better off. Indeed, they may be worse off if the firm's chances of surviving outside of bankruptcy go down.

The question whether the secured creditor's right attaches to the whole or has to be broken into its discrete components can arise in many ways. Indeed, it arose explicitly in *ResCap* in an altogether different context. *ResCap* operated as a single economic unit, but its legal structure was intricate. It was a complicated network composed of many legal entities.<sup>49</sup> The junior secured creditors' collateral package was spread throughout these firms.<sup>50</sup> The sort of adequate protection it received turned on whether each legal entity was looked at separately or whether each was treated along with the others as part of a common pool.

A variation on the facts illustrates one of the possible issues that can arise.<sup>51</sup> Imagine that there is a holding company with three subsidiaries. Bank loans \$30 to the corporate group. Each of the subsidiaries is liable for the entire debt and grants Bank a senior security interest in all its assets. At the time of the petition, Sub *A* is worth \$20, Sub *B* is worth \$10, and Sub *C* is worth \$5. Each of the subsidiaries is hopelessly insolvent. If one looks at Firm as a whole, Bank has collateral worth \$35 and is owed \$30. It is entitled to interest on its \$30 loan until its cushion is exhausted.

---

47. See, e.g., *id.* at 529–30 n 94.

48. More than 500,000 firms fail each year; fewer than 10,000 enter Chapter 11. See Morrison, *supra* note 18, at 255.

49. See Official Comm. of Unsecured Creditors *ex rel.* the Estates of the Debtors v. UMB Bank, N.A. (*In re* Residential Capital, LLC), 501 B.R. 549, 561 (Bankr. S.D.N.Y. 2013).

50. *Id.* at 558.

51. Here I am drawing explicitly on Tony Casey's work. See Anthony J. Casey, *The New Corporate Web: Tailored Entity Partitions and Creditors' Selective Enforcement*, YALE L.J. (forthcoming 2015) (manuscript at 37), available at <http://ssrn.com/abstract=2510204> (examining variations on the common theme in Part II.B).

This was the reasoning of the court in *ResCap*.<sup>52</sup> It is consistent with a number of recent opinions that focus on the corporate enterprise, rather than the discrete legal entities that constitute it.<sup>53</sup> But one could take quite a different view. None of the entities has enough assets to pay off the entire debt of \$30. One can argue that each subsidiary owes Bank \$30 and none has assets equal to that amount. Hence, Bank is undersecured with respect to each of its debtors and is entitled to no interest.<sup>54</sup>

Whether one looks at a secured creditor as holding the discrete parts worth less than the going concern or whether it enjoys a right to the first cashflows of the firm is a debate that will undoubtedly continue. Resolving these competing views is virtually impossible. Both sides cling to their views as if they were articles of religious faith. On the one hand are those who believe that when stock is taken in bankruptcy, no one should be able to enjoy the assets to the absolute exclusion of other stakeholders. On the other hand are those who believe that stakeholders have a place in line, and the bankruptcy reckoning should respect it. The gap between these two views is likely unbridgeable.<sup>55</sup> Ironically, the common ground between these two views—that bankruptcy itself is a day of reckoning—is itself suspect.

#### IV. OPTION VALUE AND BANKRUPTCY

Instead of having a day of reckoning at the time of the petition or at the time of the reorganization, consider a world in which bankruptcy is not considered a recognition event at all.<sup>56</sup> Without a day of reckoning, there is never a time at which Bank's rights need to be valued for purposes of adequate protection. Bank remains a participant in the venture. As long as Firm continues, Bank enjoys the right to take advantage of Firm's value as a going concern (even if it could not realize this value outside of bankruptcy). But, the benefit comes with a catch; unless Bank can persuade the court that a reorganization is not in prospect, Bank must continue to accept Lender as a co-venturer. Lender is not wiped out even if, at the time the plan is confirmed, the discounted present value of Firm leaves nothing for Lender.

To return to our example, Firm is worth \$100, \$200, or \$300 with equal probability, and Bank is owed \$200. At the time the plan is con-

---

52. *In re Residential Capital*, 501 B.R. at 561.

53. *In re Gen. Growth Props., Inc.*, 409 B.R. 43, 63 (Bankr. S.D.N.Y. 2009); see *JPMorgan Chase Bank, N.A. v. Charter Commc'ns Operating, LLC (In re Charter Commc'ns)*, 419 B.R. 221, 251 (Bankr. S.D.N.Y. 2009). Treating the corporate group as the relevant entity for bankruptcy purposes benefits any creditor whose claim is against the corporate group and to the disadvantage of those creditors, especially secured creditors, whose rights are against only one entity.

54. Making this argument, however, is not as easy as it might seem. The \$30 debt can be collected only once, and the assets of each of the subsidiaries include rights of equitable subrogation and contribution. As long as Bank can assert a security interest in these, it may end up in the same place even if the entities are viewed as distinct.

55. These conflicting views of bankruptcy are analyzed in Douglas G. Baird, *Bankruptcy's Uncontested Axioms*, 108 YALE L.J. 573 (1998).

56. See Casey, *supra* note 21, at 772.

firmed, however, Firm's fate is still unknown. Firm's expected value is only \$200, but if bankruptcy is not a day of reckoning, then Lender is entitled to the value associated with the possibility that Firm might be worth \$300 some day. There still exists the possibility that there will be enough to pay Bank in full and still leave something for Lender. A plan could recognize the option value of Lender's out-of-the-money interest by giving Lender cash or a share of Firm equal to the value of the option. The plan could also do it by giving Lender a warrant. In the former case, Bank would have to pay Lender \$33 or give it a one-sixth stake in Firm. In the second case, Lender would be given a call option to buy the equity of Firm with a strike price of \$200. The option would not expire until Firm's fate was clear and everyone knew whether it was worth \$100, \$200, or \$300.

This treatment of Lender cannot be done under existing law over Bank's objection. The absolute priority rule requires extinguishing junior claims at the time of plan confirmation unless the assets are worth more than what Bank is owed.<sup>57</sup> Nevertheless, consensual plans regularly recognize the option value of junior interests through the issuance of warrants and other junior securities.<sup>58</sup> There is a growing tendency, at least among law-and-economics scholars, to think it sensible to recognize option value in bankruptcy.<sup>59</sup> Moreover, the American Bankruptcy Institute's *Commission to Study the Reform of Chapter 11* included the protection of option value of junior creditors as one of its principal recommendations.<sup>60</sup>

A day of reckoning produces a tension between junior and senior stakeholders that is often counterproductive.<sup>61</sup> Giving options to junior stakeholders is a way of minimizing this tension. Once the option value of their interests is respected, junior stakeholders have no incentive to delay the time of the reorganization. Moreover, if the entity that emerges will be publicly traded, there is no need to have any judicial valuation in the bankruptcy at the time the firm is reorganized.<sup>62</sup>

It is possible, at least conceptually, not to treat the reorganization as a moment of reckoning at all. The benefits and costs of bankruptcy can be distributed among investors in the same way as the costs and benefits of any other decision. Bank and Lender have a stake in a common ven-

---

57. See 11 U.S.C. § 1129(b) (2012).

58. Douglas G. Baird & Donald S. Bernstein, *Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain*, 115 YALE L.J. 1930, 1966 (2006); Casey, *supra* note 21, at 803.

59. Casey, *supra* note 21, at 777.

60. See AMERICAN BANKRUPTCY INSTITUTE, COMMISSION TO STUDY THE REFORM OF CHAPTER 11 2012–2014: FINAL REPORT AND RECOMMENDATIONS 207–11 (2014), available at <https://abiworld.app.box.com/s/vvircv5xv83aav14dp4h>.

61. Baird & Bernstein, *supra* note 58, at 1939.

62. Donald Bernstein has pointed out that giving warrants to junior creditors can eliminate the need for valuations even when the warrants must be exercised as soon as Firm is publicly traded and the market has had a chance to assess Firm's value.

ture. We see the same principle at work in admiralty. In admiralty law, there is the rule of the general average.<sup>63</sup>

During the middle of a storm at sea, it is in everyone's joint interest that the heaviest and least valuable cargo is dumped overboard, but the owner of this cargo will want to keep it from happening. The rule of the general average shares the losses incurred when the captain throws cargo overboard, and these losses are ratably shared by all those whose cargo is being transported.<sup>64</sup> The rule of the general average naturally flows from the *ex ante* bargain that those entrusting their cargo would have with the captain. It is in everyone's joint interest that the captain acts in a way that maximizes the value of the entire ship.<sup>65</sup>

There is no particular reason to change the priority rights of two investors in a venture *vis à vis* each other in the venture merely because the debtor needs a new capital structure. To anyone familiar with modern corporate finance, it should not seem at all strange to have a reorganization regime in which the claims of a senior creditor are converted into equity subject to a call option. An investor who holds equity and has sold a call option at a particular price is in the same economic position as a lender who has lent a fixed amount of money. A reorganization regime that transforms the capital structure in this fashion allows a firm to gain a capital structure that better suits its circumstances and keeps the financial position of the senior creditor the same. This point—that those with senior positions have effectively sold junior investors call options—has long been a commonplace of modern finance theory.<sup>66</sup> Less appreciated, however, is the way in which the ability to transform investment instruments in this fashion undercuts much of the case for the absolute priority rule.

Recognizing the option value of junior interests would be a radical change from existing law. Nevertheless, it is important to understand that existing Chapter 11 practice already moves in this direction. It recognizes option value up until the moment of plan confirmation. This is itself a significant departure from the principle of *Sexton v. Dreyfus*. In many instances, postpetition assets are part of the adequate protection package. Questions about whether other assets were used to enhance the value of the collateral do not arise because of the section 506(c) waiver<sup>67</sup> given when the carve-out is negotiated.

---

63. See *CIA. Atlantica Pacifica, S.A. v. Humble Oil & Ref. Co.*, 274 F. Supp. 884, 887–88 (D. Md. 1967).

64. See, e.g., *id.* at 898 (stating general average is “*prima facie* proof of (1) the losses, damages and expenses which . . . are the direct consequence of a general average act, (2) the values attaching to such losses, damages and expenses, and (3) the computations proportioning these losses, damages and expenses between the parties to the venture”).

65. Thomas Jackson and Robert Scott were the first to show the parallel between the rule of the general average and priority rules in bankruptcy. See Thomas H. Jackson & Robert E. Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain*, 75 VA. L. REV. 155, 164–78 (1989).

66. Casey, *supra* note 21, at 759–60.

67. 11 U.S.C. § 506(c) (2012).

The reorganization creates a new capital structure among those who sit down at the table to negotiate. One does not assess the value of anyone's rights using that person's rights under state law as a benchmark. Filing of the petition is not a day of reckoning. We allow the bankruptcy process to be run for the benefit of the senior creditor and allow it to enjoy upside, but at the same time the junior creditor also enjoys upside until the plan of reorganization is confirmed. Many of the critiques of Chapter 11 over the years have failed to recognize that the day of reckoning is already postponed.

The court in *ResCap*, of course, did not explore this foundational question about reorganization law directly. It is worth noting, however, that the argument justifying departing from *Sexton*—that making a restructuring a recognition event can be counterproductive—is at the heart of the court's analysis of another issue in *ResCap*.<sup>68</sup>

The secured creditors held notes that had previously been restructured.<sup>69</sup> The principal amount of their notes was reduced from \$1000 to \$800, but these notes traded at \$613.75 on the day they were issued.<sup>70</sup> If the notes had been issued in exchange for a new loan, the difference between the \$800 and \$613.75 would be treated as unmatured interest. The junior secured bondholders argued, however, that treating notes in a restructuring in this fashion discouraged nonbankruptcy workouts.<sup>71</sup>

The court agreed. The Second Circuit had already held that a note could have been restructured in any number of ways that would alter the rights of the parties without triggering the rules governing original issue discount, even if the new notes traded at a substantial discount. This was a case in which the face amount of the principal did not change.<sup>72</sup> Changing the face amount of the note, in addition, should not make a difference. When notes are restructured, it is important that the face amount of principal, even if reduced, should still be the amount of the claim in bankruptcy. By refusing to apply the Original Issue Discount (OID) rules, the court preserved the option value of the noteholders' principal claim to the extent of \$800.<sup>73</sup> Doing this made sense because it facilitated the nonbankruptcy restructuring. Preserving option value might also facilitate bankruptcy restructurings for the same reason. Junior creditors need not resist a reorganization on the ground that it will trigger a reckoning that lowers the value of their stake.

---

68. Official Comm. of Unsecured Creditors *ex rel.* the Estates of the Debtors v. UMB Bank, N.A. (*In re Residential Capital, LLC*), 501 B.R. 549, 577 (Bankr. S.D.N.Y. 2013).

69. *Id.* at 576.

70. *Id.* at 576–77.

71. *Id.* at 579.

72. The Second Circuit established this principle in *LTV Corp. v. Valley Fid. Bank & Trust Co.* (*In re Chateaugay Corp.*), 961 F.2d 378 (2d Cir. 1992).

73. See *In re Residential Capital*, 501 B.R. at 585–87.



