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REMEMBERING *PINE GATE*

DOUGLAS G. BAIRD*

This year marks the twenty-fifth anniversary of Chapter 11. Before it went into effect, the law governing corporate reorganizations in the United States was largely dysfunctional.¹ Old Chapter X was slow, expensive, and unwieldy. Old Chapter XI did not allow for the restructuring of secured debt. Chapter XII for real estate bankruptcies brought its own set of problems.² The Bankruptcy Reform Act³ set about changing all of this. Now that we have had twenty-five years of learning, we can ask whether Chapter 11 has lived up to its expectations and what role, if any, it is filling.

Today we are focusing on real estate bankruptcies. The number of real estate bankruptcies has been in decline as of late. These are the lean years, but there is no reason for gloom. There is a lot of construction going on. A lot of high yield loans are being made. Defaults and bankruptcies are just around the corner. What kind of ride should we expect when we find ourselves in the next round of real estate bankruptcies?

I. PINE GATE

This morning I start at the beginning and look at where we were twenty-five years ago when the Bankruptcy Code came into effect. There have been only a handful of amendments to the Code that affect real estate bankruptcies. Most of these amendments have the effect of changing the procedures in a way that is supposed to make things happen more quickly. Congress, for

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1. See DAVID A. SKEEL, JR., *DEBT'S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA* 131-83 (2001).

2. See generally Jan Z. Krasnowiecki, *The Impact of the New Bankruptcy Reform Act on Real Estate Development and Financing*, 53 AM. BANKR. L.J. 363 (1979).

3. Pub. L. No. 95-598, 92 Stat. 2549 (1978) (codified at 11 U.S.C. §§ 101-109 (2000)).

example, added a set of rules for single-asset real estate cases with secured debt of less than \$4 million that force debtors who do not produce a plan within ninety days to start paying interest.⁴ In the grand scheme of things, however, not that much has happened. The Bankruptcy Code itself is now entering a comfortable middle age and does not seem likely to change.

But the Bankruptcy Code and bankruptcy practice are two different things. The world of real estate bankruptcies has changed utterly. Even if the text of the Bankruptcy Code remains a constant, much else is in flux. The judges are different. Tax rules are different. The economy is different. All of these and other changes have made 2004 quite different from 1979. How did we get from there to here?

Let's start at the beginning. Let's go back to the world of 1979. It is a world of leisure suits, *Maude*, *Mork and Mindy*, and the Iranian hostage crisis. Skylab returns to earth and crashes into the Indian Ocean. How did we think about real estate bankruptcy then? There is a short answer to this question—*Pine Gate*.⁵ It was the case of the hour. You could not go to a cocktail party in those days and not have a real estate lender who had been drinking too much complain about *Pine Gate*. What was the fuss about?

We have to go back even farther in time. It is 1973. This is history. Ancient history. Paul Newman and Robert Redford are starring in *The Sting*. *Bonanza*, *Gunsmoke*, and *Laugh-in* are still on prime time. Secretariat becomes the first horse in twenty-five years to win the Triple Crown. Two reporters for the *Washington Post* are making nuisances of themselves about something called Watergate. But for one real estate developer, the big news is *Pine Gate*.

I am a real estate developer in Georgia. I gather a group of limited partners to create the Pine Gate Apartments. It is a great deal. The limited partners, perhaps doctors and dentists, are facing a fifty percent tax on their earned income and seventy percent tax on investment income.⁶ They need a tax shelter and Pine Gate is just the ticket. This was before passive investor rules were put in place.⁷ They invest a modest amount of money and get the benefit of accelerated depreciation. They will have to pay it back if the property is sold, but as long as it isn't, each dollar of

4. The Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, 108 Stat. 4107, 4119, 4122, 4128, 4132, 4141, 4142, 4144 (adding 11 U.S.C. § 362(d)(3)).

5. *In re Pine Gate Assocs., Ltd.*, No. B75-4345A, 1976 U.S. Dist. LEXIS 17366 (N.D. Ga. Oct. 14, 1976) [hereinafter *Pine Gate*].

6. See *Top US Marginal Income Tax Rates, 1913–2003*, at <http://www.truthandpolitics.org/top-rates.php> (last updated Feb. 15, 2004).

7. See 26 U.S.C. § 469 (added by the Tax Reform Act of 1986 § 501(a), Pub. L. No. 99-514, 100 Stat. 2233).

depreciation is a dollar less of income. The general partner finds an insurance company to put up \$1.45 million to build the apartments.⁸ It is a nonrecourse loan.⁹ The doctors and dentists have the best of both worlds. The insurance company can look only to the property itself; it can't even come after the general partner. Life is good.

But a number of things go wrong. First, in building Pine Gate, I violated the first three rules of real estate investment (location, location, location). Pine Gate is not close enough to Atlanta to get the kind of renters that they want—or indeed very many renters at all.¹⁰ Pine Gate is not going to do well until there is additional development in the area and it looks like we are going to have to be very patient.¹¹

Our costs of maintaining the property are also rising. Gerald Ford tries to fight inflation with WIN buttons (short for, “Whip Inflation Now”), but thinking positive thoughts does not help. Meanwhile, I cannot raise the rent fast enough and I have to cut corners on maintenance. Deferred maintenance makes the property less attractive and occupancy goes down.¹² Worse yet, to be really honest, I'm not really that good at running this operation.

By December 1975, it is obvious Pine Gate is not going to be able to make its payments to the insurance company. I file a Chapter XII petition.¹³ You—the insurance company—try to persuade the bankruptcy judge to allow you to foreclose on the property. You point out that Pine Gate as is currently managed is now worth considerably less than what you are owed. Based on Pine Gate's sorry current earnings, your experts peg its value at \$850,000.¹⁴ Pine Gate is really yours and you should be able to take it.

As was often the case in those days, this argument goes nowhere. The judge allows me to use operating revenues to pay for the deferred maintenance and otherwise put the property in better shape.¹⁵ In the meantime, I come up with a plan of reorganization.

This is where you get your biggest surprise. I propose a plan of reorganization that extinguishes your claim with a cash payment of \$1.2 million.¹⁶ You don't like this. Why is not clear. Why don't you just take the money and run? Perhaps you offered

8. See *Pine Gate I*, 1976 U.S. Dist. LEXIS, at *27.

9. See *id.* at 4.

10. See *In re Pine Gate Assocs., Ltd.*, 12 Collier Bankr. Cas. (MB) at 607, 627 (Bankr. N.D. Ga. Mar. 4, 1977) [hereinafter *Pine Gate II*].

11. See *id.* at 627, 633-34.

12. See *id.* at 626-27.

13. See *Pine Gate I*, 1976 U.S. Dist. LEXIS, at *1.

14. See *id.* at *58; *Pine Gate II*, 12 Collier Bankr. Cas. (MB) at 628.

15. See *Pine Gate II*, 12 Collier Bankr. Cas. (MB) at 614, 614 n.18.

16. See *Pine Gate I*, 1976 U.S. Dist. LEXIS, at *58.

a low-ball valuation when you argued that you should be allowed to foreclose. Perhaps you just don't like being stripped down.

You decide to fight, but you do it by contesting the valuation. This is a mistake on your part. Your expert is not able to persuade the judge that the property is worth more than \$1.2 million. After all, this expert had told the identical judge that Pine Gate was worth only \$850,000 just six months ago.¹⁷ No one feels sorry for you. Using the same guy to give two completely different valuations to the same property within six months in front of the same judge is like dousing yourself with gasoline and lighting a match.

But now you have to live with yourself as a human being and hold your head up along with all of your real estate lending buddies. Forget about Pine Gate. What is the general principle that the law has now adopted thanks to you? This is where the bad news really is. Debtors can keep the property, strip down your lien, and go on as if the loan had been for \$1.2 million, rather than \$1.45 million.

This is ridiculous. If the property is really not worth what you as the senior lender are owed, you should get it. The debtor should not be able to snap his fingers and make \$250,000 of principal disappear. Now, thanks to you, real estate debtors can strip down nonrecourse loans in bankruptcy. The nightmare scenario for the lender is that whenever the economy goes into a downturn, every two-bit real estate developer like me will use bankruptcy to write down debt. When the market comes back, I will enjoy the upside. If things continue to get worse, you still bear the downside. Heads I win; tails you lose. The general principle is enough to make any lender choke on his Chateaubriand.

In the 1970s, this became known as the "*Pine Gate* problem." The people who worried about bankruptcy reform had to worry about what to do with this case. During the 1970s, special interests had not yet gotten their claws into bankruptcy reform.¹⁸

17. Judge Norton in *Pine Gate II* stated that:

The secured Creditors take the position that the court should appraise the "cram down" value . . . at no less than the full amount now owing . . . because Dr. Andrews testified [in November 1976] that assuming 95% or more occupancy at some point in the future, the project will at that time have a value approximating or in excess of the current debt Such argument is unacceptable. It is based on speculation and assumptions, not relevant facts. The testimony of Dr. Andrews, based upon the facts of the occupancy and earnings record in April 1976, was that the value of the property is \$853,000.

12 Collier Bankr. Cas. (MB) at 629.

18. See, e.g., Elizabeth Warren, *Philosophy and Design of Modern Fresh Start Policies and Consumer Proposals: The Changing Politics of American Bankruptcy Reform*, 37 OSGOOD HALL L.J. 189, 190-92 (1999).

Those involved were, to a very large extent, bankruptcy lawyers and judges, and academics who wanted to get it right.¹⁹ We look at bankruptcy reform today, and we see a swamp of special interests and mindless confusion. The 1970s was perhaps the last time we had to get the law right. In any event, the way in which they thought about *Pine Gate*, which is to say the way they thought about real estate bankruptcy generally, would be with us for a long time.

The people who wrote the Bankruptcy Code tried to deal with *Pine Gate* in three ways:²⁰

- They made nonrecourse debt recourse in Chapter 11.²¹
- They gave the secured creditor the right to elect to have its entire claim treated as secured.²²
- They insisted that real estate lenders get the benefit of the absolute priority rule and the right to get the indubitable equivalent of the value of their collateral.²³

19. *Id.* at 191-92.

20. See 680 Fifth Ave. Assocs. v. Mut. Benefit Life Ins. Co. (*In re* 680 Fifth Ave. Assocs.), 156 B.R. 726, 730-731 (Bankr. S.D.N.Y. 1993).

21. 11 U.S.C. § 1111(b)(1) provides:

(A) A claim secured by a lien on property of the estate shall be allowed or disallowed under section 502 of this title the same as if the holder of such claim had recourse against the debtor on account of such claim, whether or not such holder has such recourse, unless

(i) the class of which such claim is a part elects, by at least two-thirds in amount and more than half in number of allowed claims of such class, application of paragraph (2) of this subsection; or

(ii) such holder does not have such recourse and such property is sold under section 363 of this title or is to be sold under the plan.

(B) A class of claims may not elect application of paragraph (2) of this subsection if

(i) the interest on account of such claims of the holders of such claims in such property is of inconsequential value; or

(ii) the holder of a claim of such class has recourse against the debtor on account of such claim and such property is sold under section 363 of this title or is to be sold under the plan.

22. 11 U.S.C. § 1111(b)(2) provides: "If such an election is made, then notwithstanding section 506(a) of this title, such claim is a secured claim to the extent that such claim is allowed."

23. 11 U.S.C. § 1129(b)(2) provides:

For the purpose of this subsection, the condition that a plan be fair and equitable with respect to a class includes the following requirements:

(A) With respect to a class of secured claims, the plan provides—

(i)(I) that the holders of such claims retain the liens securing such claims, whether the property subject to such liens is retained by the debtor or transferred to another entity, to the extent of the allowed amount of such claims; and

(II) that each holder of a claim of such class receive on account of such claim deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property;

The drafters believed that these three ideas, working together, would solve the *Pine Gate* problem and put real estate bankruptcies on a sensible course. Let's see if they were right.

Let us start with turning nonrecourse debt into recourse debt. What is the point of doing this? There is a certain logic here. Let us assume we have a single-asset real estate case and the nonrecourse secured lender is owed \$100. Miscellaneous twelve-year-old lawn mowers are owed \$5. The market has taken a turn for the worse. If we did not have § 1111(b) to make the debt recourse, what happens? The bankruptcy court values the property at \$60. The secured creditor is forced to take a note secured by the property for \$60. The general creditors who are owed \$5 get all the equity of the business. The property is sold a year later for \$90.

How do we divide up the cash, assuming that the nonrecourse loan remains nonrecourse in bankruptcy? The note the secured creditor has is only for \$60. Thus, the secured creditor gets \$60, and the \$30 balance goes to the twelve-year-old lawn mowers. Allowing the lawn mowers to get this \$30 windfall makes no sense. By making the nonrecourse loan recourse, we fix this problem. The secured creditor gets a deficiency claim and therefore shares in the equity with the general creditors. The \$30 gained from the sale goes back primarily to the senior lender, which is where it should go. This is the logic that undergirds § 1111(b).

But in practice the nonrecourse secured lender does not enjoy

(ii) for the sale, subject to section 363(k) of this title, of any property that is subject to the liens securing such claims, free and clear of such liens, with such liens to attach to the proceeds of such sale, and the treatment of such liens on proceeds under clause (i) or (iii) of this subparagraph; or

(iii) for the realization by such holders of the indubitable equivalent of such claims.

(B) With respect to a class of unsecured claims—

(i) the plan provides that each holder of a claim of such class receive or retain on account of such claim property of a value, as of the effective date of the plan, equal to the allowed amount of such claim; or

(ii) the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property.

(C) With respect to a class of interests—

(i) the plan provides that each holder of an interest of such class receive or retain on account of such interest property of a value, as of the effective date of the plan, equal to the greatest of the allowed amount of any fixed liquidation preference to which such holder is entitled, any fixed redemption price to which such holder is entitled, or the value of such interest; or

(ii) the holder of any interest that is junior to the interests of such class will not receive or retain under the plan on account of such junior interest any property.

this protection. This protection turns crucially on the junior creditors taking equity in the reorganized venture. Reorganization plans are not usually structured this way. Instead of equity, the twelve-year-old gets a side payment (along with an informal promise of continued employment). Section 1111(b) does not provide that much protection here when the bank lends \$100 and the bankruptcy court says the property is worth \$60. The dentists and doctors propose a plan that gives the lawn mowers a token amount of cash and provides that they retain the equity on account of new value that they contribute to the reorganized debtor. Under the plan, the bank gets a note worth \$60 for its secured claim, and its \$40 unsecured claim is extinguished for a few cents on the dollar. When the property is sold a year later for \$90, the entire benefit goes to the dentists and the doctors.

Treating the nonrecourse claim as recourse does not protect the secured creditors when the property is flipped. As it has played out over the last twenty-five years, whether foreseen or not, the ability to transform the nonrecourse claim into a recourse claim has little substantive value. But it does have value. In bankruptcy, procedure matters. Possessing a general claim, even one that is out of the money, improves the negotiating hand of the bank.

Section 1129(a)(10) requires that at least one impaired class approve the plan.²⁴ If we give the nonrecourse creditor a deficiency claim and if this deficiency claim is put in the same class as the general creditors, then the real estate developer will not be able to confirm a plan over the bank's objection.

But there is a catch here. Everything depends on the recourse claim being in the same class as the other general claims for voting purposes. This isn't the law in the Seventh Circuit. *Woodbrook* tells us that the deficiency claim cannot be put in the same class as general claims.²⁵ The deficiency claim does not exist outside of bankruptcy. Indeed, it does not exist in Chapter 7. Because it has different legal attributes, it must be in a class by itself. This defangs the power associated with holding a deficiency claim. If the debtor can cram down his plan on you as the holder of the \$60 secured claim, it can cram down its plan on you as the holder of a \$40 unsecured claim as well. So much for this response to *Pine Gate*, at least in the Seventh Circuit.

What about the second solution to *Pine Gate*, one that is also embedded in § 1111(b)? A secured creditor is given the right to waive its unsecured claim and have its entire claim treated as

24. 11 U.S.C. § 1129(a)(10) reads: "If a class of claims is impaired under the plan, at least one class of claims that is impaired under the plan has accepted the plan, determined without including any acceptance of the plan by any inside."

25. *In re Woodbrook Assocs.*, 19 F.3d 312, 319 (7th Cir. 1994).

secured.²⁶ Much is unknown about the consequences of making the § 1111(b) election, but identifying what is at stake is not difficult. Consider again a bank that lends \$100 to a real estate developer. The loan is secured by Blackacre.

How does the election make the creditor better off? If the election is made, the creditor is deemed to have a secured claim for the entire amount of the debt, irrespective of the collateral's value. Thus, in the above example, the bank would have a secured claim of \$100, not \$60. The bank does not, however, receive a stream of payments worth \$100. Under § 1129(b)(2)(a)(i)(II),²⁷ the bank would be given a stream of payments with a present value of only \$60. (The section provides that the stream of payments must equal "the value of such holder's interest in the estate's interest in such property." The court has valued the property at \$60.)

In this respect, the bank is treated neither better nor worse than if it had not made the election. By making the election, the bank gives up its deficiency claim of \$40, and in return it receives the right to a stream of payments with a face amount equal to \$100. Moreover, the stream of payments is secured by a lien of \$100 instead of \$60. In many cases, the term of the loan is long enough that a note can have a present value of \$60 and still have a stream of payments over \$100. In such a case, the § 1111(b) election benefits a secured creditor only if the court undervalues the property and there is likely to be either a default in the near future or a sale that would accelerate the \$100 obligation. If this conjunction of events is not likely, then the election has little value and again little will have been done to solve the *Pine Gate* problem.

If the bankruptcy judge accurately values the property and if nothing happens to the real estate markets, making the election gives up whatever leverage you might have as the holder of a deficiency claim, and you get nothing in return. Even if the debtor flips the property quickly, you are still going to get only the value of the property, which is \$60.

The election has value only if the judge seriously undervalues the property. Even here the benefit is modest. If the judge seriously undervalues the property, the debtor should not have any problem paying the note which, by assumption, is worth considerably less than the property. Put all the pieces together and the election is likely to have value only when two conditions are met—the bankruptcy judge comes up with a low-ball valuation and the property is flipped. This happens, but the § 1111(b) election is not something we see that often.

26. 11 U.S.C. § 1111(b)(2).

27. For the relevant portions of § 1129(b)(2), see *supra* note 23.

II. THE VALUATION PROBLEM

The big problem here is one that is hard to solve through statutory language. The basic problem is a valuation problem. Strip-down is not a big deal in a world in which the secured creditor gets cash or cash equivalents equal to what it could get in the event of foreclosure. In such a world, the bankruptcy process does not leave the nonrecourse real estate lender worse off. The *Pine Gate* problem arose because judges were thought not to be good at making valuations. Moreover, they were not merely bad, but they were systematically biased in the direction of the debtor.

But what do you do to get the valuations right? This is hard to legislate. The Supreme Court decided a Chapter 13 case in this year called *Till v. SCS Credit Corp.*²⁸ It is a Chapter 13 case involving an individual debtor and his truck. The question was how the Court should go about setting the appropriate interest rate. The Court settled on the prime rate, adjusted upward to take account of the likelihood the debtor would default.²⁹ It's a strange 4-1-4 decision, but eight of the nine justices agreed that you have to set the interest rate in a way that fully accounts for the likelihood of default.³⁰

In theory, the starting place should not matter as long as the judge is adept at setting an interest rate that takes account of the risk of default. But the facts of *Till* make plain that the starting place matters a lot. We live in a world in which seventy percent of all Chapter 13 debtors fail to complete their plans and nothing suggests that *Till* is more likely than average to succeed. It is hard to believe that 150 basis points above prime is enough to account for a default risk that is many, many times what one sees in an ordinary consumer loan, where the default rate is less than ten percent.³¹

Till is a Chapter 13 case. But this is like saying that *Erie Railroad v. Tompkins*³² is just a railroad case. The valuation principle the Court adopted applies with full force to every case, including every real estate bankruptcy. This case underscores what is the crucial issue in real estate bankruptcy—valuations. If you have a judge who is cold-blooded about valuations and who uses markets to get a realistic feel for what is going on, then *Pine*

28. 124 S. Ct. 1951 (2004).

29. *Id.* at 1961-62 (Stevens, J., plurality).

30. *Id.* at 1961 (Stevens, J., plurality); *id.* at 1968 (Scalia, J., dissenting).

31. *See id.* at 1957 (“The proposed plan also provided that petitioners would pay interest on the secured portion of respondent’s claim at a rate of 9.5% per year. Petitioners arrived at this ‘prime-plus’ or ‘formula rate’ by augmenting the national prime rate of approximately 8% (applied by banks when making low-risk loans) to account for the risk of nonpayment posed by borrowers in their financial position.”).

32. 304 U.S. 64 (1938)

Gate is not a big deal. If you have judges who always have a thumb on the scale for the debtor, the solutions to *Pine Gate* in the Bankruptcy Code—and frankly any other solutions you might devise—are not going to get you anywhere.

This brings me to my main theme. You really cannot understand real estate bankruptcy, or the future of real estate bankruptcy, unless you have your pulse on the state of bankruptcy law today. There have been dramatic changes in bankruptcy practice since the time of *Pine Gate* and the enactment of the Bankruptcy Code. These have accelerated over the last ten years. When we have the next upsurge in real estate bankruptcies—as we surely will—the changes we have seen elsewhere in bankruptcy will come powerfully home in real estate bankruptcies and give you a dynamic utterly different from what you saw during the 1970s, '80s, and early '90s. But I am getting ahead of myself. What kinds of changes have we seen? How are bankruptcy judges going to understand *Till*?

III. THE NEW FACE OF CHAPTER 11

What does the world of Chapter 11 look like outside the real estate context? Boosters of Chapter 11 often talk as if the financially troubled and businesses in Chapter 11 were one and the same. Nothing could be further from the truth. More than a million businesses shut their doors each year in the United States.³³ Many more encounter financial distress. Of these, only 10,000 file for Chapter 11. The vast majority of these cases involve small businesses. We have dry wall subcontractors, mom-and-pop restaurants, small jewelry and clothing stores, and travel agents. Each of these businesses has only a few employees, and turnover of employees in these firms tends to be high.³⁴

Chapter 11 brings only modest benefits in these cases. The principal value of preserving such small firms is that it allows their owners to continue to enjoy the psychic benefit of running their own business. But the costs are small too. We do not see the owners of small businesses in hopeless condition use Chapter 11 to drag out the inevitable for very long. The creditors and the United States Trustee control the process. The failed businesses that last the longest are usually the ones where there is the most uncertainty about the debtor's prospects. In some cases, the

33. For U.S. Department of Labor Statistics on employment dynamics, see <http://data.bls.gov/servlet/surveyOutputServlet?jrnsessionid=1096866435715206311> (last visited Oct. 3, 2004) (showing that 1,310,000 private businesses closed in 2003).

34. For a discussion of the make-up of the Chapter 11 docket in a typical district, see Edward R. Morrison, *Bankruptcy Decision-Making: An Empirical Study of Small Business Bankruptcies* (2003) (unpublished Ph.D. dissertation, University of Chicago) (on file with author).

bankruptcy judge takes longer to act because active criminal fraud on the part of the debtor makes the business's true state harder to discern.

The benchmark by which to judge the bankruptcy system in small cases is not the sheer number of businesses saved, but their ability to sort effectively and quickly. Most important is identifying those cases in which the debtor is only playing for time. The evidence suggests that bankruptcy judges can do this job exceedingly well. Indeed, the data are consistent with the conjecture that bankruptcy judges perform this job as well as a market actor subject to the same constraints.³⁵

Small businesses and failed real estate deals make up the bulk of the Chapter 11 docket, but the megacases like Enron make the headlines. Here too, Chapter 11 is performing a new role.³⁶ During the 1980s, nine of ten large businesses that entered Chapter 11 followed the traditional pattern. While in Chapter 11, the old managers would negotiate with the creditors and settle on a plan of reorganization. After much give-and-take, the creditors would approve the plan and the business would emerge intact. In 2002, this pattern had largely disappeared. Today, Chapter 11 is often merely the forum in which a business is liquidated or merged with or acquired by another. Alternatively, the bankruptcy judge merely puts in place a restructuring of debt that the major investors have settled upon outside of bankruptcy.³⁷

Of the large publicly traded firms that exited Chapter 11 in 2002, the assets of more than half were sold in Chapter 11 or were transferred to a new owner under the plan of reorganization.³⁸ In some cases, the sales are more or less completed before the fact, and the Chapter 11 merely ensures that no one else will bid more.³⁹ In other cases, the bankruptcy judge conducts an auction in open court. Warren Buffet acquired Fruit of the Loom in this fashion.⁴⁰ However, the sale may involve more elaborate negotiations. Sterling Chemical sold half its assets in Chapter 11 and a third-party investor acquired control of what was left under

35. *See id.* at 7.

36. *See generally* Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751 (2002).

37. For an analysis of these changes in large Chapter 11 cases over the last twenty years, see Douglas G. Baird & Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 STAN. L. REV. 673, 674 (2003).

38. *Id.* at 675-76.

39. The sale of Budget to Avis is a representative example. *See id.* at 675 n.7.

40. *Fruit of the Loom Sale Procedure Is Given Approval*, N.Y. TIMES, Dec. 6, 2001, at C4; *Judge Approves Fruit of the Loom Recovery Plan*, N.Y. TIMES, April 4, 2002, at C4. *See also* DDJ Capital Mgmt, LLC v. Fruit of the Loom, Inc. (*In re* Fruit of the Loom, Inc.), 274 B.R. 631, 634 (D. Del. 2002).

a plan of reorganization.⁴¹ Of the large businesses whose assets are not sold in Chapter 11, more than half enter Chapter 11 with a prenegotiated plan.⁴² The judge usually confirms it within several months after only minor modifications.⁴³ The central issue in these cases is valuation and bankruptcy judges approach this issue with great sophistication and a faith in markets.

IV. REAL ESTATE BANKRUPTCY TODAY

What do these developments tell us about real estate bankruptcy today? The changes we have seen elsewhere in bankruptcy reflect on increasing realism on the part of judges and increasing attention to the realities of the market. Some might argue that these all point in the direction of ridding ourselves of real estate bankruptcies altogether. There is not the collective action problem that justifies the reorganization process in the first place. We have essentially a dispute between two people. We have a secured creditor with a right to foreclose, bargained for in advance, and we have an investor with a leaky tax shelter. For one reason or another, they cannot agree on a restructuring outside of bankruptcy.

They are both adults. The inability of two sophisticated parties to reach a mutually beneficial bargain has few effects on anyone else. If they can't reach a deal between themselves, why should we shed any tears? The secured creditor forecloses, credit bids, and takes the property. So what? To anyone who says that the foreclosure process is inefficient and that is why we need bankruptcy, I would say that bankruptcy is part of the problem. There is no incentive to fix a bad foreclosure law if bankruptcy is always there as a safety valve. The problem is a two-party problem with local real estate law. We do not need a federal law to handle it.

Real estate bankruptcy requires a leap of faith. But the new breed of bankruptcy judges that we see in action in small and large cases may give us a taste of what is to come. What is the lesson that these small cases tell us about the future of real estate bankruptcies? It is pretty simple. We have a hard time justifying what the Bankruptcy Code does in small cases, but the response from the bankruptcy judges is interesting and in a sense predictable. They do not question the rationale for the law, but they do insist that the small business that wants to reorganize gets its act together. Bankruptcy is not the same as free parking.

41. See *STERLING CHEMS., INC.*, 10-Q QUARTERLY REPORT (Aug. 13, 2003), available at <http://www.sec.gov/Archives/edgar/data/1014669/000095012903004147/0000950129-03-004147.txt>.

42. See Baird & Rasmussen, *supra* note 37, at 678.

43. *Id.*

You always have to be able to explain to the judge how you are going to get from here to there. If you cannot, your case is going to be dismissed, as long as someone remembers to make the proper motion.

The lesson for real estate bankruptcies is clear. Bankruptcy judges are not going to question the wisdom of having a real estate bankruptcy in the first place. That is why they are judges and I am an academic. But they do not have a lot of patience for losers either. If you don't have an exit strategy, the modern bankruptcy judge is going to show you the door.

The large cases provide a somewhat different lesson, one that is more directly connected with real estate bankruptcies. The basic message of the large cases is the way in which bankruptcy judges are becoming more like Delaware chancellors. To put it concretely, bankruptcy judges today have increasing sophistication about valuation. The first question that today's judge would ask about *Pine Gate* is the debtor's arithmetic.

If the bank is entitled to Blackacre, how can it be enough to give the bank only part of the income stream that Blackacre is going to generate over time? To say that Blackacre is worth \$60, is to say that its discounted cash flows from now until the end of time are worth \$60. If the bank is entitled to \$60, giving it anything less than all of Blackacre's future earnings is necessarily undercompensatory. Things can, of course, get complicated. The old limited partners may be willing to throw additional money in the pot to ward off the tax collector. But the numbers have to add up, and the days when bankruptcy judges could not do the math are over. Their thumbs are not on the scale anymore.

V. CONCLUSION

In sum, *Pine Gate* is bankruptcy's past, not its future. What we shall see in the next round of real estate bankruptcies is going to be different. The typical real estate bankruptcy will involve a debtor and a real estate lender who face some complicated problem that they have not been able to sort through in the time they had outside of bankruptcy. The debtor will try to use the bankruptcy forum in one last effort to sort things out. The bankruptcy judge will give them some time to negotiate and provide a dose of reality therapy in the process. But this window of opportunity will not last long and the shadow that is cast by the realities of the market will always be present. The days of *Pine Gate* are over.

