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Secured Credit and Effective Entity Priority

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Secured Credit and Effective Entity Priority

CHRISTOPHER W. FROST

The historical and doctrinal development of secured transactions and bankruptcy law has created a priority system that is asset based. Secured creditor priority is tied to the value of specific assets that constitute the secured creditor’s collateral and not to the value of the debtor itself. And yet, in corporate bankruptcy cases, lenders and their attorneys often assert broad claims to the entire enterprise value of the entity—that is, to the present value of the cash flows that the entity will generate as a going concern. The doctrinal basis for such claims is often unstated, however, and several commentators have criticized the breadth of those claims under existing law. This article answers those commentators and provides an argument that secured creditors can establish a broad enough security interest to create an “effective entity priority.”
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Secured Credit and Effective Entity Priority

CHRISTOPHER W. FROST *

INTRODUCTION

For about the past two decades, debates about the corporate bankruptcy process have focused heavily on the role of secured credit in corporate capital structures and the dominant position secured creditors are thought to occupy in corporate reorganizations. The enactment of the Bankruptcy Code in 19781 originally ushered in an era of management/equity dominated bankruptcies. Early scholarship on the Code focused on governance debates that envisioned corporate managers as the center of decision-making and reorganization strategy.2 Chapter 11 strategy shifted from traditional reorganizations to the use of Chapter 11 as a process by which entire companies could be sold and the proceeds distributed, largely, to secured creditors.3 As a result, that early view gave way to commentators’ recognition of the role that dominant secured creditors play in bankruptcy.

* Everett H. Metcalf Jr. Professor of Law, University of Kentucky College of Law. I thank Chris Bradley, Ted Janger, Bob Lawless, Thomas Rutledge, and Hon. Tracy Wise for their thoughtful comments and criticisms. I also thank the University of Kentucky College of Law for research support contributing to this Article.


Whether this transition from management to secured creditor dominance is supported by the vast range of Chapter 11 cases—and the evidence is not entirely clear\(^4\)—the dominant role of secured creditors seems pervasive in large bankruptcies. Indeed, the recent American Bankruptcy Institute Commission on Reform of Chapter 11\(^5\) focused extensively on the role of secured creditors in the bankruptcy process. A number of prominent bankruptcy scholars weighed in with their views—pro and con—in connection with that study regarding the value and place of secured credit both in corporate capital structures and in bankruptcy reorganizations.\(^6\)

The debate has proceeded along two branches: one largely theoretical and the other principally doctrinal. The theoretical branch of the debate focuses on the economic justifications for secured credit, or, more precisely, on the economic justifications for the priority accorded secured creditors. Scholars writing in this vein have focused on the effect secured creditor priority has on managerial decision-making, creditor monitoring, and liability-proofing, and have sought to balance the perceived benefits of priority against its social costs.\(^7\) More recently, these theoretical scholars have turned to questions on the timing of priority determinations, including discussions of absolute versus relative priority,\(^8\) options theory,\(^9\) and other

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\(^4\) See Jay Lawrence Westbrook, *Secured Creditor Control and Bankruptcy Sales: An Empirical View*, 2015 U. ILL. L. REV. 831, 833 (2015) (“Our data strongly suggest that secured creditor control is less pervasive than has been asserted . . . and that secured creditor dominance is not closely related to 363 sales.”).

\(^5\) The American Bankruptcy Commission to Study the Reform of Chapter 11 was a comprehensive review of the Chapter 11 process. Over 250 bankruptcy professionals participated in the study over a three-year period and the commission’s work resulted in an extensive report containing numerous recommendations. AMERICAN BANKRUPTCY INSTITUTE, ABI COMMISSION TO STUDY THE REFORM OF CHAPTER 11, at 13, 67–73 (Am. Bankr. Inst. 2014) [hereinafter ABI COMMISSION REPORT], http://commission.abi.org/full-report (discussing at length recommended principles to protect a secured creditor’s interest in a debtor’s property).


mechanisms that might preserve value for unsecured creditors. These works ask whether secured creditors should receive full priority as of a fixed date (absolute priority) or should instead be required to compensate non-priority creditors for the option value of their claims (relative priority). The debates are not new, but they are being waged with a renewed vigor.

The other branch of the debate, the doctrinal branch, focuses instead on the legal source and validity of the secured creditor’s claim, with a principal focus on how that claim is limited by bankruptcy and non-bankruptcy rules that closely associate priority with particular assets. These scholars remain interested in the economic justifications for secured credit but view those questions alongside broader questions about how expansive security interests affect the bankruptcy process. A significant question raised by these scholars is whether a secured creditor can legitimately claim priority in all of the value of the business as a going concern (the “enterprise value”). This position is an operating assumption of most, if not all, of the theoretical analysts, but one that is challenged by those writing in the doctrinal branch.

One way to frame this doctrinal debate over the scope of secured credit is to ask whether secured transactions law creates entity-based or asset-based priority. Corporate capital structures are comprised of a mix of debt and equity instruments creating priority in either the entity or the assets of the entity. In large part, financial instruments and corporation laws create entity priority. Debt is commonly understood to be prior to equity; preferred stock is granted priority over common stock. Classes of debt can be contractually subordinate to other classes. This entity-based priority extends to all of the value within the entity and creates a waterfall type of distribution; each level of priority receives all of the value up to the full amount of that level’s claims against the entity and remaining value spills over to lower classes. In contrast, secured credit, governed by Article 9 of the Uniform Commercial

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11 Baird, supra note 8, at 786–87 n.3 (discussing early debates over absolute and relative priority).


Code ("U.C.C.") and state real estate law, appears on the face of those laws to be asset-based, with priority extending only to the value of particular assets within the entity.\textsuperscript{14}

This distinction has complicated debates over the bankruptcy process for many years.\textsuperscript{15} Bankers and the attorneys representing them often think about priority on an entity basis. The terms “blanket lien” and “first-position” imply that the secured creditor’s priority claim extends to the cash flow of the entity, rather than to the assets comprising the entity.\textsuperscript{16} The firm’s assets are simply a means to generate that cash flow and the overall value of the entity is determined by discounting that cash flow.\textsuperscript{17} In a world of entity priority, there is little reason to deconstruct that value and attribute it to the particular assets that contribute to its production. The firm is simply a box of undifferentiated assets that produces cash for its owners. Firm value is real, but the value of a particular machine tool or piece of unfinished inventory within the firm is merely theoretical.\textsuperscript{18}

In a similar vein, academic debates over the bankruptcy process sometimes rely on entity priority as a simplifying assumption.\textsuperscript{18}

As several scholars have illustrated, however, the law of secured transactions and the bankruptcy provisions that implement that law are asset-specific. Under non-bankruptcy law, security interests and mortgages attach to specific items of property.\textsuperscript{19} Under the Bankruptcy Code, security interests are “interests in property” and the priority rights appurtenant to that interest are respected only insofar as they relate to the specific property.\textsuperscript{20} The Code distinguishes between priorities in the “estate”—entity-based priorities in the overall value of the debtor\textsuperscript{21}—and interests in “property of the estate,”\textsuperscript{22} relegating secured claims to the latter status.

The distinction between entity and asset priority is an important one, not only when considering the ultimate distribution in a bankruptcy, but also in

\textsuperscript{14} Id. at 687 (discussing realization on real property).
\textsuperscript{15} See Douglas G. Baird, The Rights of Secured Creditors After ResCap, 2015 U. ILL. L. REV. 849, 860 (2015) [hereinafter ResCap] (“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.”).
\textsuperscript{16} See Erin Casey & Randy Klein, The Pre-Petition Right to Post-Petition Income Streams and the Misinterpretation of § 552, 29 AM. BANKR. INST. J., Dec.–Jan. 2010, at 58 (“Cash-flow lenders . . . take blanket pre-petition liens, basing loans not on the value of hard assets but on the present value of future income streams. Value is not divvied up by asset, but is supported by the economic capacity of the assets taken as a whole.”).
\textsuperscript{17} Id.
\textsuperscript{18} See Baird, supra note 8 at 792–93 (discussing priority schemes on an entity basis).
\textsuperscript{19} See U.C.C. § 9-102(a)(12) (AM. LAW INST. & UNIF. LAW COMM’N 2017). (‘‘Collateral’’ means the property subject to a security interest or an agricultural lien.”).
\textsuperscript{21} See id. § 507 (providing priorities in the estate).
\textsuperscript{22} See id. § 506 (providing a method for determining secured status).
allocating control rights during the reorganization. A secured creditor with a claim to particular assets has priority that is limited to the value of those assets and can assert a special claim to control over decisions made during the proceeding only to the extent that the proceeding threatens to erode the value of those assets. If a secured creditor can lay claim only to particular assets, other sources of value, including the intangible value of the going concern itself, are available to satisfy unsecured claimants who should have some say in the conduct of the case. Thus, the right to adequate protection of the secured creditor’s collateral is limited to erosions in the value of the collateral. Beyond this, the secured creditor is entitled to no control—over either the proceeding or the debtor—that is unique or distinct from that of other creditors. If a secured creditor can assert a priority right in the entire entity, however, that creditor can insist on full payment and, in the absence of protection of that right, can assert control to the exclusion of the remaining creditors.

Merely observing that non-bankruptcy secured credit laws create an asset-based priority system does not necessarily foreclose a secured creditor from taking what amounts to entity priority. If the scope of the security interest is sufficiently broad, the secured creditor might be able to claim that all of the enterprise value is subject to the priority claim. For the secured creditor, converting asset priority to an effective entity priority is desirable for two reasons. First, and most obviously, entity priority enhances the secured party’s total distribution. If the secured creditor holds only an asset-based priority, determining the secured creditor’s distributional entitlement requires some method of allocating the total value of the debtor to the particular assets serving as collateral for the secured lender. Amounts appropriately attributed to assets that do not serve as collateral or that are not identifiable proceeds of collateral are shared with all of the creditors. Entity priority, if it can be approximated, avoids thorny questions of value allocation—particularly the allocation of going concern surplus generated during the course of the case. The secured creditor with entity priority is awarded everything up to the value of its claim.

Perhaps equally important is the reality that effective entity priority provides an under-secured creditor with extraordinary control over the course of the bankruptcy case. Because the blanket lien creditor claims a lien over all of the property of the bankruptcy case at its full going concern value, the debtor’s use of the property in its ongoing business operations requires that the debtor either obtain the secured creditor’s consent or provide adequate protection. If an under-secured creditor claims all that the debtor owns, there will be no unencumbered assets available to provide that adequate protection. This leaves the secured creditor in control over the

23 See id. § 361 (providing methods of adequate protection where the stay, use, sale, or lease of collateral results in a decrease in the value of the secured creditor’s interest).
debtor’s use of the assets—that control is often extensive enough to permit the secured creditor to make decisions that are critical to both the debtor’s future and the other creditors’ possible distributions.

This Article develops the argument that a secured creditor may cast a net over assets that is broad enough to capture all of the value of the entity—what I will call “effective entity priority.” The argument for effective entity priority relies on the secured creditor creating a “closed system”—a claim that every asset generated after the initiation of bankruptcy was generated through the use of the secured creditor’s collateral. This closed system approach requires that several conditions be satisfied. First, the secured creditor must acquire the broadest possible security interest. Second, courts must broadly construe the concept of proceeds of collateral, such that it includes property resulting from any use of collateral. Third, the valuation of collateral in a bankruptcy case must be conducted on a going-concern value, not a liquidation value. A few cases have recognized this logic, holding that the secured creditor’s lien extends broadly to all of the value of the entity, but other cases reject such an analysis. Thus, confusion over the exact scope of secured claims reigns. This confusion, unfortunately, occupies considerable space in bankruptcy cases, and the issue should be clarified.

Section I provides a brief primer on the provisions of Article 9 and the Bankruptcy Code that establish the asset-based priority structure governing secured claims. Under those rules, the bankruptcy petition effectively freezes secured claims, limiting priority to the assets existing at the time of the petition and to the proceeds that can be linked, or “identified,” to those assets. New assets created post-bankruptcy are encumbered by the security interest, unless they fall within the definition of “proceeds.” Section II introduces the closed-system analysis that might permit a secured creditor to obtain an effective entity-based priority by arguing that all of the assets contributing to the value of the debtor derive from the secured creditor’s collateral at the beginning of the case. Through a successful application of this analysis, a secured creditor can avoid difficult questions regarding the allocation of value among secured and unsecured claims. Put simply, the secured creditor would be entitled to full payment of its entire claim prior to the distribution of any value to unsecured creditors. Section III pokes holes in this closed-system theory by examining sources of value that cannot be captured by the secured creditor’s pre-bankruptcy liens and post-petition value that comes from sources other than the assets of the business itself. Section IV explores some of the ways in which doctrinal arguments regarding effective entity priority have been obscured by the nature of the bankruptcy process and discusses legislative proposals that would restrict secured creditors’ claims to effective entity priority. Section V provides a

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24 See cases discussed in Sections I and II, infra.
preliminary, normative case for providing direct entity priority. Allowing secured creditors the ability to directly assert priority in all of the value of the entity raises some distributional questions, but that might provide for more efficient and certain bankruptcy distributions than are achievable under the current, uncertain, legal regime.

I. BANKRUPTCY AND U.C.C. TREATMENT OF SECURED CLAIMS

Both the Bankruptcy Code and the U.C.C. (and related real estate law) were designed as asset-based priority systems that accommodate traditional commercial loans—such as floor-plan financing, purchase money security interests, accounts receivable, and working capital loans. These asset-based loans generally are one of two types: fixed asset-based or floating asset-based. Fixed asset-based lending is designed to finance relatively permanent or long-term assets on a term basis, with repayment extending no further than the useful life of the asset serving as collateral. Although the borrower’s general creditworthiness is an important consideration in making and pricing the loan, the value of the collateral throughout the life of the loan serves as a critical backstop against default losses. Covenants in the loan agreement typically relate to maintenance of the collateral, prohibitions against sale, and insurance against casualty loss. The most straightforward of these loans is the purchase money security interest, which relates to a single purchase of assets that does not contemplate future advances and is not secured by after-acquired property.

Floating asset-based security is designed to finance working capital—inventory or accounts receivable—assets that turn over on a relatively frequent basis. Such working capital loans contemplate repayment and reborrowing and are often of somewhat indeterminate length. Total loan amounts are tied to the value of the inventory or receivables, and the loan agreement covenants relate to both the maintenance of the value of the collateral and control over the proceeds of the loan. Floor-plan financing of an automobile dealer provides the archetype of these types of loans.

Article 9 of the U.C.C. is well-designed to accommodate both types of loans through a regime of asset-based perfection and enforcement. The perfection and proceeds-protection provisions generally work well to assure secured creditors with continuing priority in the collateral. Article 9’s provisions—permitting priority in after-acquired property and extending priority to future advances—assure that a secured creditor can efficiently and effectively obtain liens on floating collateral. In addition, the default provisions are designed specifically for asset-based enforcement, allowing

25 See U.C.C. § 9-322(a) (AM. LAW INST. & UNIF. LAW COMM’N 2001) (stating general priority rules); id. § 9-322 cmt. 5 (explaining “[t]he application of the priority rules to after-acquired property”).
26 See id. § 9-323 (stating priority rules for future advances); id. § 9-323 cmt. 2 (“A security agreement may provide that collateral secures future advances.”).
the secured creditor to possess and sell tangible collateral and to collect on intangible collateral such as accounts.

The Bankruptcy Code provisions relating to secured claims follow the U.C.C.’s asset-based approach to the recognition and enforcement of priorities. The cornerstone of this asset-based regime is section 506(a), which bifurcates claims secured by a lien on property into secured and unsecured claims based on the value of the collateral securing each claim.\(^\text{27}\) The secured claim designation carries through to the distributional provisions of the Code, which require payment of the secured claim in cash or property prior to the payment of unsecured claims.\(^\text{28}\) The determination of a secured claim under section 506(a) is dependent on both the scope of the security interest and the value of the collateral securing the claim. Putting aside the valuation question for a moment,\(^\text{29}\) the question of scope is often readily determinable by the security agreement documenting the transaction.\(^\text{30}\) The Bankruptcy Code itself neither enlarges nor restricts the scope of a non-avoidable security interest.\(^\text{31}\) Thus, in a simple one-off loan on fixed assets, the security interest is determined by the description of the collateral in the security agreement.

The scope problem becomes somewhat more complicated in floating loan transactions that contemplate asset turnover. In those transactions, an asset-based lender views its collateral as a shifting mass without identifying the precise assets composing that mass. The U.C.C. accommodates this approach by permitting priority to attach to after-acquired property.\(^\text{32}\) and

\(^{27}\) See 11 U.S.C. § 506(a)(1) (2012) (“An allowed claim of a creditor secured by a lien on property in which the estate has an interest, or that is subject to setoff under section 553 of this title, is a secured claim to the extent of the value of such creditor’s interest in the estate’s interest in such property, or to the extent of the amount subject to setoff, as the case may be, and is an unsecured claim to the extent that the value of such creditor’s interest or the amount so subject to setoff is less than the amount of such allowed claim.”).

\(^{28}\) In a Chapter 7 case, property securing the secured claim is distributed prior to the payment of estate proceeds. Id. § 725. In a Chapter 11 case, secured creditors are entitled to payment in cash or property of the total amount of their secured claims. Id. § 1129(b)(2)(A).

\(^{29}\) The value of the collateral often presents a closer factual question, and the standard for valuation of the collateral is somewhat unsettled. As discussed in more detail below, courts are somewhat divided over the question of whether collateral should be valued under a liquidation, replacement value, or going concern standard.

\(^{30}\) See U.C.C. § 9-203(b)(3) (AM. LAW INST. & UNIF. LAW COMM’N 2001) (requiring a description of collateral under the security interest).

\(^{31}\) Butner v. United States, 440 U.S. 48, 55 (1979) (“Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding.”), superseded in part by statute, Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, 108 Stat. 4106 (1994).

\(^{32}\) See U.C.C. § 9-204(a) (AM. LAW INST. & UNIF. LAW COMM’N 2001) (permitting a security interest in after-acquired property); id. at § 9-322(a)(1) (dating priority from the earlier of the filing of a financing statement or perfection of a security interest).
extending that priority to proceeds of collateral. By carefully structuring and monitoring a secured loan, a secured creditor can have a reasonable assurance that its priority will extend to all of the items constituting the particular types or categories, without regard to the date on which each particular item was acquired by the debtor. Also, by taking a security interest in deposit accounts and by assuring that cash generated by the entity is deposited in those accounts, the secured lender can assert priority over the entire stream of assets as that stream flows through the debtor’s working capital cycle.

Outside of bankruptcy, it does not matter whether a secured creditor acquires its priority in newly acquired property through a proceeds analysis or through an after-acquired property analysis. Either method of obtaining priority is equally serviceable. In bankruptcy, however, the distinction between the two methods is critical. Section 552(a) of the Code provides that the filing of a petition cuts off the effectiveness of an after-acquired property clause, while section 552(b) generally allows a security interest to extend to post-petition proceeds of collateral. Thus, after a petition is filed, a secured party is entitled only to the value of its collateral and any proceeds that can properly be identified as deriving from that collateral.

As Melissa Jacoby and Ted Janger have observed, by cutting off the effect of after-acquired property clauses, section 552 of the Bankruptcy Code creates an “[e]quitable [s]napshot” that fixes the assets included within the secured creditor’s claim. The value of those assets is subject to the requirements of adequate protection, and the actual realization of the secured creditor’s claim is delayed until the end of the case. Post-petition increases in value accrue to the secured creditor only where those increases are a result of an increase in the market value of assets owned on the petition date. Once those assets are disposed of, the creditor’s secured claim is fixed and the creditor obtains a replacement lien on the proceeds.

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33 See id. § 9-203(f) (“The attachment of a security interest in collateral gives the secured party the rights to proceeds.”); id. § 9-315(a)(2) (“[A] security interest attaches to any identifiable proceeds of collateral.”); id. § 9-315(d) (providing for continuous perfection of a security interest in proceeds under various conditions).
35 See Bankrupt Proceeds Rule, supra note 12, at 523 (“[T]he main non-[b]ankruptcy difference between future assets that qualify as proceeds and those that do not is that the secured party must contract for a security interest in future non-proceeds, but acquires a security interest in proceeds without the need for a term in the security agreement.”).
37 Id. § 552(b).
38 Tracing Equity, supra note 13, at 688–89.
Most courts hold that proceeds do not include the general business revenue of the debtor because proceeds must be linked to specific assets. Linkage is established in two ways: through the definition of proceeds and through the requirement that proceeds be identifiable. Historically, proceeds have been defined as “whatever is received upon the sale, exchange, collection, or other disposition of collateral.” Where an item of equipment or inventory is sold, the proceeds are the consideration paid to the seller. Similarly, where an account is collected, the funds paid are proceeds of the account. Thus, the historical concept of proceeds relies on the notion that the item in question serves as a substitute for the collateral. This limitation is illustrated by the Fifth Circuit’s opinion in In re Value-Added Communications, Inc. There, the secured creditor held an interest in telephone equipment used to provide state prison inmates with telephone service. The creditor also claimed an interest in the revenues earned through the provision of the service as proceeds of the equipment. The court rejected the argument that the revenues were proceeds, stating:

Use is not a disposition of the collateral within the meaning of the definition of “proceeds.” If fruits and products from the use of collateral were treated as proceeds, every creditor with a security interest in equipment would have a security interest in all items produced from the equipment as well as the revenues earned by the equipment.

This limited, replacement-based approach to proceeds arguably has been broadened by the 2001 revision of Article 9. The 2001 definition of “[p]roceeds” includes not only amounts received on sale, exchange, or collection, but also expressly incorporates amounts paid on long or short-term leases of collateral and “rights arising out of collateral.” The import of these changes is not entirely clear, but some commentators view the effect

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39 See id. at 698–99 (discussing 1st Source Bank v. Wilson Bank & Tr., 735 F.3d 500, 504–05 (6th Cir. 2013) (holding that accounts receivable are not proceeds of a security interest in tractors and trailers that were used to create those accounts), Helms v. Certified Packaging Corp., 551 F.3d 675, 678–79 (7th Cir. 2008) (holding that business-loss insurance is not proceeds of a security interest in equipment, although a claim for the value of the equipment would constitute proceeds), and In re Gamma Ctr., Inc., 489 B.R. 688, 695–96 (Bankr. N.D. Ohio 2013) (holding that accounts receivable were not proceeds of security interest in equipment used to create those accounts)).

40 In re Value-Added Commc’ns, Inc., 139 F.3d 543, 546 (5th Cir. 1998).

41 Id. at 545.

42 Although the security agreement between the debtor and secured party described the revenues as collateral, the financing statement failed to refer to those revenues, or the contract with the prison system, as original collateral. Thus, the secured creditor’s only priority claim to the revenues was as proceeds. Id. at 545–46.

43 Id. at 546.

44 U.C.C. § 9-102(a)(64)(A) (AM. LAW INST. & UNIF. LAW COMM’N 2001) (including lease payments as property that is within the definition of “[p]roceeds”); id. § 9-102(a)(64)(C) (including “rights arising out of collateral” as property that is within the definition of “[p]roceeds”).
as moving from a “replacement model” to a “[value] ‘generation’ model.”

The inclusion of proceeds of short-term leases particularly seems to augur in favor of such an expanded model, because such a lease does not dispose of the collateral but rather represents a payment for the use of collateral. Further, the 2001 addition of the phrase “rights arising out of collateral” arguably expands the definition of proceeds to cover value resulting from the use of collateral, in addition to value resulting from the disposition of collateral. The reach of the phrase is controversial, however. Although only a handful of courts have interpreted the phrase, some courts have continued to hold that the concept of proceeds remains tied to some loss or disposition of collateral.

But even if the definition of proceeds is broad enough to include property generated through the use of collateral, the U.C.C.’s requirement of identifiability further limits the reach of the secured creditor’s claim. Indeed, most of the cases that limit the reach of the term “proceeds” could as easily have been decided by focusing on the need to tie proceeds directly to the original collateral. One often cited case, In re Skagit Pacific Corp., makes the point clearly. There, the secured creditor claimed an interest in cash an account debtor had paid on a post-petition account. The security agreement granted a security interest in “owned or after-acquired equipment, inventory, accounts receivable, chattel paper, general intangibles, and all proceeds of such collateral.” Because section 552 of the Code cut off the effectiveness of the after-acquired property clause, the secured creditor’s claim turned on whether the new account could be identified as proceeds of the pre-petition collateral. The secured creditor argued that the account was

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47 Bankrupt Proceeds Rule, supra note 12, at 522.
48 See Tracing Equity, supra note 13, at 698–99 (discussing cases). Compare 1st Source Bank v. Wilson Bank & Tr., 735 F.3d 500, 504 (6th Cir. 2013) (finding “rights arising out of collateral” does not include assets obtained by use of collateral), with In re Weirsma, 283 B.R. 294, 304 (Bankr. D. Idaho 2002) (finding “rights arising out of collateral” includes all claims, including punitive damages and extra labor costs, that are associated with the loss of collateral), aff’d in part, rev’d in part, 483 F.3d 933 (9th Cir. 2007) (reversing on jurisdictional issue and affirming on all other grounds).
49 Tracing Equity, supra note 13, at 700–03.
50 The U.C.C. provides that this transactional link can be found through any number of mediate transactions by making clear that the proceeds of proceeds are also proceeds. U.C.C. § 9-102(a)(64) (AM. LAW INST. & UNIF. LAW COMM’N 2017).
52 Id. at 332–33.
53 Id. at 333.
54 Id. at 335–37.
proceeds because the debtor spent funds that clearly were proceeds in the completion of the contract that created the post-petition account.\textsuperscript{55} The bankruptcy court accepted that argument and the debtor’s documentary support behind it,\textsuperscript{56} but the Bankruptcy Appellate Panel reversed.\textsuperscript{57} The panel noted first that while the state law definition of “proceeds” should be given a flexible and broad content, “the requirement that the proceeds be identifiable requires the showing of a “transactional link between the proceeds and the collateral.”\textsuperscript{58} Thus, where proceeds are commingled with non-proceeds, some method of tracing, such as the lowest intermediate balance rule, must be applied to show that the proceeds truly arose on the sale or other disposition of the original collateral.\textsuperscript{59} This identifiability requirement is sufficient to deny proceeds characterization in many cases in which a secured creditor holds a security interest in some, but not all, of the collateral. In re Residential Capital, LLC (“ResCap”)\textsuperscript{60} illustrates this effect. There, a group of secured creditors with a security interest in some, but not all, of the assets of the debtor\textsuperscript{61} claimed an interest in goodwill generated in connection with a sale of assets during the case.\textsuperscript{62} The court rejected that claim, noting that even if the secured creditors could show that their collateral was used to create some of that goodwill, other assets of the estate also contributed to its creation.\textsuperscript{63} The existence of other sources of value interfered with the ability of the secured creditor to satisfy the identification requirement.\textsuperscript{64} The court stated, “[e]ven if a portion of the goodwill was directly attributable to JSN Collateral, without any other additional resources, the JSNs have failed to separate the value of that goodwill. Thus, the JSNs have not met their burden of establishing a lien on goodwill generated post[-]-petition.”\textsuperscript{65} ResCap points out the consequences of the asset-based character of security interests under Article 9.\textsuperscript{66} An asset-based security interest will only extend to value acquired by the debtor after the bankruptcy petition if the secured creditor can show that only its collateral was used to acquire or

\textsuperscript{55} Id. at 334.
\textsuperscript{56} Id.
\textsuperscript{57} Id. at 342.
\textsuperscript{58} Id. at 337–38.
\textsuperscript{59} Id. at 338. Perhaps more precisely, the link must be to original collateral or to proceeds of original collateral. Collateral can go through any number of proceeds-based transformations so long as there remains a series of transactional links.
\textsuperscript{61} Id. at 581–85.
\textsuperscript{62} Id. at 608.
\textsuperscript{63} Id. at 612.
\textsuperscript{64} Id.
\textsuperscript{65} Id.; see also ResCap, supra note 15, at 856–57 (discussing this aspect of ResCap).
\textsuperscript{66} In re Residential Capital, LLC, 501 B.R. at 614–15.
create that asset.\textsuperscript{67} For assets like goodwill that are not attributable to any particular asset, but rather to the value of the entity itself, demonstrating that link will often be impossible.

II. THE CLOSED SYSTEM ANALYSIS AND EFFECTIVE ENTITY PRIORITY

Although the bankruptcy and non-bankruptcy laws governing security interests seem clearly to create only asset-based priority, secured creditors continue to argue that their “blanket liens” create a first-priority security interest in the value of the entire entity.\textsuperscript{68} Creditors assert this priority to support what they refer to as cash-flow loans.\textsuperscript{69} Cash-flow lending takes traditional asset-based lending a step further by combining fixed and working capital asset-based lending and attempting to extend the security interest to all of the assets of the debtor.\textsuperscript{70} This extension is thought to provide the lender another way to evaluate the risk of loss from default. Rather than basing the loan solely on the value of individual assets securing the debt, the cash flow lender looks to the present value of the future cash flow of the business, or, put differently, the enterprise value of the entity itself.\textsuperscript{71} Essentially, the legal position of cash flow lenders is that their blanket liens cover everything, before and after bankruptcy.\textsuperscript{72}

The basic idea behind this claim is that if the secured creditor holds an interest in all of the pre-petition assets of an entity, any assets acquired by the debtor post-bankruptcy, by definition, must be proceeds of that pre-petition collateral. The debtor operates as a closed system where all increases in value following the bankruptcy petition can only be attributable to the pre-bankruptcy assets. As Douglas Baird put it:

\begin{verbatim}
67 Id.
68 See, e.g., Mark B. Wessman, Purchase Money Inventory Financing: The Case for Limited Cross-Collateralization, 51 OHIO ST. L.J. 1283, 1289–90 (1990) (“If [a] secured party is the first to perfect his security interest, his interest in the initial pool of collateral is already superior to lien creditors (including the bankruptcy trustee), certain classes of buyers, unperfected secured creditors, and (with some exceptions) secured creditors who perfect subsequently.”); CHAPMAN AND CUTLER LLP, YOUR BLANKET (LIEN) MAY HAVE HOLES: PROPOSED AMENDMENTS MAY FURTHER ERODE SECURED LENDERS’ RIGHTS 1 (Feb. 2, 2015), https://www.chapman.com/media/publication/479_Chapman_Blanket_Lien_Secured_Lenders_ABI_C hapter_11_Reform_020215.pdf (“Secured creditors have long assumed that if they possess a blanket lien on all of a borrower[‘]s assets, such liens will capture a debtor’s overall enterprise value, whether such value is created prior to or after the commencement date of a borrower’s bankruptcy proceeding . . . .”);
69 Casey & Klein, supra note 16.
70 Id.
71 Id.
72 Id. (“When an asset-based lender takes a security interest in every conceivable type of collateral under revised Article 9 and real property law, the reasonable expectation of the parties is that pre-petition liens attach to all post-petition sale considerations under § 552 of the Bankruptcy Code. Cash-flow lenders similarly take blanket pre-petition liens, basing loans not on the value of hard assets but on the present value of future income streams. Value is not divvied up by asset, but is supported by the economic capacity of the assets taken as a whole.”).
\end{verbatim}
It is as if Firm consisted of robotic machines on a desert island. No person and nothing 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.\(^\text{73}\)

Through this analysis, a secured creditor might argue that its asset-based claims effectively create an entity-based priority which extends to all of the value of the debtor. The secured creditor’s claim therefore is entitled to full satisfaction prior to the payment of any other claims. This argument requires three conditions to be satisfied. First, the scope of the security interests providing asset-based priorities must be sufficiently broad to include all, or very nearly all, of the pre-bankruptcy assets of the entity. Second, the concept of proceeds must be sufficiently broad to encompass all of the assets that arise from the use of collateral, as well as assets that arise from a disposition of collateral. Finally, the value of the secured creditor’s collateral (and, accordingly, the value of the secured creditor’s secured claim) must be determined under a going concern assumption. If each of these conditions holds, all of the debtor’s inputs to production (raw materials, labor, machinery, intellectual property, and other intangible assets), and thus the debtor’s output, will be either collateral or proceeds of collateral by virtue of the fact that they are purchased with assets that are collateral or proceeds.

\textit{Qmect, Inc. v. Burlingame Capital Partners II, L.P.}\(^\text{74}\) provides an example of this sort of reasoning. In that case, the secured creditor claimed a security interest in cash collateral that included payments made on accounts receivable acquired by the debtor post-petition.\(^\text{75}\) The bankruptcy court concluded that all of the assets, both pre- and post-petition, were collateral for the secured creditor’s loans.\(^\text{76}\) On appeal, the district court agreed without requiring the secured creditor to engage in a strict tracing analysis or other method of identifying the post-petition payments to the secured creditor’s collateral.\(^\text{77}\)

In so doing, the \textit{Qmect} court distinguished the facts before it from those in \textit{Skagit Pacific}, finding that the demonstration of a transactional link required in \textit{Skagit} was unnecessary.\(^\text{78}\) Because the secured creditor claimed

\(^{73}\text{ResCap, supra note 15, at 858.}\)
\(^{74}\text{373 B.R. 682 (N.D. Cal. 2007).}\)
\(^{75}\text{Id. at 685.}\)
\(^{76}\text{Id.}\)
\(^{77}\text{Id. at 688.}\)
\(^{78}\text{Id.}\)
an interest in all of the property, “there were, in effect, no sources to which the post-petition accounts receivable could be traced other than the secured lenders’ collateral.” But, because the secured creditor had a security interest in all of the debtor’s assets, “[n]othing other than secured lender’s collateral could have generated revenue, so all assets, even those acquired post-petition, were proceeds of the secured lenders’ collateral.”

Although the closed-system analysis relies on the secured creditor’s pre-bankruptcy interest in all of the debtor’s assets, at least one court has used entity priority concepts even where the secured creditor’s interest extended to most, but not all, of the assets: in In re Hawaiian Telcom Communications, Inc., the debtor’s secured creditor had a security interest in substantially all of the debtor’s assets, except for motor vehicles and certain real estate and fixtures. The debtor proposed a reorganization plan that was premised on an enterprise value derived from a combination of methods, each of which reflected the total going concern value of the debtor. Even at the enterprise value, the secured creditor was undersecured and so the plan awarded the secured creditor the enterprise value of the business less the enterprise value attributed to the unencumbered assets, which was allocated to the unsecured creditors.

The decision effectively converted the secured creditor’s priority claim from one that was asset-based to one that was effectively entity-based. Rather than determining the amount of the secured creditor’s secured claim in particular assets and providing priority treatment for that amount, the court assumed that the secured creditor’s liens extended to all of the enterprise value—except the small (less than 10%) value attributable to those assets that clearly were not collateral. The court noted that its approach dispensed with the need to value the assets encumbered by the secured claim, stating that “[g]iven the extent of the Secured Parties’ liens

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79 Id. Although the debtor had received a post-petition loan that was not subject to the secured creditor’s interest, the proceeds of that loan were used by the debtor to pay other pre-petition obligations. Id. at 684.
80 Id. at 688; see also Unsecured Creditors Comm. v. Marepcon Fin. Corp. (In re Bumper Sales, Inc.), 907 F.2d 1430 (4th Cir. 1990). In In re Bumper Sales, the debtor had stipulated that post-petition operations of the debtor were financed exclusively with cash collateral. In re Bumper Sales, 907 F.2d at 1433. Because the debtor’s cash collateral was the sole source of funds used to acquire new inventory after the petition, the court found that the new inventory was second generation proceeds that were “conclusively identifiable.” Id. at 1437.
82 Id. at 575.
83 Id. at 578. The valuation experts relied on a combination of a comparable company analysis, a precedent transaction analysis, and a discounted cash flow analysis. Id. These analyses respectively sought to determine the overall value of the company to the stock market in a mergers and acquisition context and based on a more traditional present value of total cash flows. Id. Thus, each valued the company as a going concern under various assumptions.
84 Id. at 586–87.
85 Id. at 575.
as well as the proper enterprise valuation, there is no need to determine the exact value of the encumbered assets.\footnote{Id. at 584.}

\textit{Hawaiian Telcom} provides a significant departure from cases like \textit{Skagit Pacific} in which the court required a transaction-based tracing of post-petition assets from pre-petition collateral.\footnote{Skagit Pac. Corp. v. Frontier Asset Mgmt., LLC (\textit{In re} Skagit Pac. Corp.), 316 B.R. 330, 338–39 (B.A.P. 9th Cir. 2004) (noting the insufficient tracking methods used by the creditor who should have instituted proper procedures to have documents showing the “transactional link” between pre- and post-petition collateral).} \textit{Hawaiian Telcom}’s enterprise valuation by definition incorporated the future cash flows of the firm—cash flows that would accrue only post-petition. By awarding the secured creditor the lion’s share of that value,\footnote{Hawaiian Telcom, 430 B.R. at 577–78 (noting that the total enterprise value of Hawaiian Telcom was calculated, in part, on the discounted cash flows analysis based on “projected future cash flows”).} the court effectively found that the secured claim included all of those post-petition revenues and valued the claim on a going concern basis.\footnote{See id. at 573, 577, 586–87 (recognizing the debtors’ proper allocation with the secured creditors’ claim of $300 million on a total enterprise value of $387.5 million and the class five unsecured creditors’ claim at only $12.5 million).} The court dispensed with the difficult questions regarding the identifiability of proceeds and included in the secured claim all of the cash flows that could not be attributed to unencumbered property.\footnote{See id. at 603–04 (“There is no precedent that supports the conclusion that a secured creditor with a lien on a debtor's primary assets is not entitled to the debtor's enterprise value when the debtor proposed to use that collateral in its business under a plan of reorganization.”).}

The question under this analysis is whether a secured party can show that all, or at least substantially all, of the assets at the start of the case are subject to the creditor’s security interest, and also whether the system can continue to remain sealed against non-collateral contributions to the success of the debtor during the reorganization. Both pieces of the argument are necessary to avoid the equitable snapshot that fixes the value of the secured creditor’s interest at the beginning of the case and fixes distributions at the end of the case based on that value. Put simply, if the secured creditor is entitled to everything at the start of the case, the secured creditor is entitled to everything at the end of the case.

\section*{III. Leaks in the System: Post-Bankruptcy Non-Collateral Contributions to Value}

The ability of secured creditors reliably to achieve effective entity priority through a closed system analysis is far from clear. A number of commentators have pointed out flaws in the notion that a secured creditor with priority in assets can ever achieve entity or near-entity based priority.\footnote{See id. at 573–74 (noting the secured creditors pre-petition collateral claim of $300 million without any discussion as to tracing of proceeds post-petition).}
As noted above, the closed system argument requires that the secured creditor’s interest encompass all of the assets of the business and that these assets provide all of the inputs to the production and profit functions of the business.\textsuperscript{92} The system must be sealed against non-collateral infiltrating the debtor’s production processes and comingling with collateral as a source of enterprise value.

There are a number of potential ways in which the closed system might be infiltrated by non-collateral. Non-bankruptcy law places some limits on what types of rights are subject to a security interest. Thus, taking a true pre-petition blanket lien may be difficult, if not impossible. During the case, the contribution of labor or efforts of managers might also be a source of value that comes from outside of the system. Other non-collateral sources of value have been identified by commentators. Michelle Harner has posited that the enterprise value of a corporation is comprised partly of “soft variables” that cannot serve as collateral either before or after the filing of a petition.\textsuperscript{93} Melissa Jacoby and Ted Janger assert that the bankruptcy system is itself a source of value separate from pre-bankruptcy assets\textsuperscript{94} and this value should be partially available to satisfy unsecured creditor’s claims.\textsuperscript{95} This section addresses each of these arguments—concluding that the case for effective entity liability is a plausible one, despite these potential leaks in the closed system.

A. Limited Scope of Security Interests

In order to avoid the thorny identification problems that often derail claims to post-petition value, the secured creditor in \textit{Qmect} was able to claim a security interest in all of the debtor’s pre-bankruptcy property.\textsuperscript{96} Several

\textsuperscript{92} See supra Part II (explaining this argument and its implications).

\textsuperscript{93} Harner, supra note 12, at 519–20, 526 (explaining that soft variables include a company’s people, the synergies created by operational efficiencies, strategic decisions, business plans, and relationships among the company’s people—all of which are not a company’s personal property and so cannot serve as collateral).

\textsuperscript{94} Ice Cube Bonds, supra note 10, at 892, 894 (“[W]e acknowledge that asset sales are an important source of Bankruptcy-Code-created value . . . . Bankruptcy sales offer two distinct options that improve on coercive state law remedies: preserving going-concern value through reorganization or through a going-concern sale, under a plan or under § 363. This going-concern premium is a product of the federal bankruptcy regime. Sometimes, the going-concern premium can only be obtained by acting quickly. Thus a Bankruptcy Code created speed premium exists . . . .”).

\textsuperscript{95} Id. at 917–18 (questioning the assumption that the senior secured creditor owns the speed premium because in the absence of a bankruptcy filing, the secured creditor would have to foreclose under state law, so “a secured creditor asserting a blanket lien should have to purchase the option value of the unsecured creditor’s claim if it is pursuing a sale”).

\textsuperscript{96} Qmect, Inc v. Burlingame Capital Partners II, L.P., 373 B.R. 682, 687 (Bankr. N.D. Cal. 2007); see also In re Bumper Sales, Inc. 907 F.2d 1430, 1437 (4th Cir. 1990) (concluding that the proceeds used by the debtor are identifiable to the creditor’s security interest because the debtor stipulated that all of the post-petition inventory was acquired using the proceeds of pre-petition inventory and accounts, thus eliminating the need for tracing).
commentators, however, have argued that obtaining a security interest in everything that contributes to post-petition earnings is impossible. Article 9 itself has a number of exclusions. More significantly, some licenses and governmental permits necessary for the debtor’s operation as a going concern cannot reliably serve as collateral because of limitations on transfer and use that are contained in the contract or regulation creating the right.

Consider, for example, a debtor’s right to conduct business under a government license that prohibits assignability. Prior to the revision of Article 9, this non-assignability provision facially precluded secured creditors from taking an interest in the agreement. The inability of the secured creditor to assert an interest in the license—and the cash flows associated with that right—beyond the reach of the secured creditor.

The 2001 revision of Article 9 dramatically expanded the scope of property that may be claimed as collateral by permitting secured creditors to take security interests in a broad array of licenses and contract rights that are generally non-assignable. Under U.C.C. section 9-408, contractual, legal, or regulatory prohibitions on assignability are ineffective to prevent the creation of a security interest. Although a limitation on assignment is effective to prohibit the secured creditor’s direct enforcement or control over the rights constituting collateral, the provision accomplishes the goal of permitting a direct security interest over the collateral that is effective before a bankruptcy petition is filed.

The innovation underlying the U.C.C. is to separate the right to operate the business or use licensed rights from the right to the proceeds resulting from the sale of the license—if a sale is permitted by the licensor. The use rights remain subject to the licensor’s right to refuse to recognize an assignment. The right to payment, however, is a separate property interest, albeit one that is contingent on the licensor’s permission for the debtor to

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97 See Logic and Limits, supra note 12, at 598–99 (noting the difficulty in tracing and valuating proceeds of collateral because of the various forms the collateral may take after its sale, disposal, or transformation, particularly when it comes to intellectual property developments post-petition); see also ResCap, supra note 15, at 858 (discussing the complications which may arise because while priority is tied to discrete assets, a company is greater than the sum of its parts).

98 See U.C.C. § 9-109(d) (AM. LAW INST. & UNIF. LAW COMM’N 2001) (listing transactions excluded from Article 9). However, state or federal law might provide alternate means for a creditor to obtain a security interest in property excluded from the scope of Article 9.

99 ResCap, supra note 15, at 857 (“With respect to some types of collateral, such as FCC licenses or patents or copyrights or real property, [tracing a secured creditor’s pre-petition] security interests is difficult or uncertain.”).

100 See U.C.C. app. AA § 9-408 (AM. LAW INST. & UNIF. LAW COMM’N 2010) (noting that amendments to this section made restrictions on assignment “generally ineffective”).

101 U.C.C. § 9-408(c) (AM. LAW INST. & UNIF. LAW COMM’N 2001).

102 See id. § 9-408 cmt. 2 (AM. LAW INST. & UNIF. LAW COMM’N 2001) (stating that this section makes ineffective any attempt to restrict the assignment of a general intangible which “leaves the account debtor’s or obligated person’s rights and obligations unaffected”).
assign the license. Because the right to payment exists separately, the right to receive it arises even before the licensed thing is sold—that is, pre-petition. This designation permits the value of the license to be proceeds rather than after-acquired property, thereby including the value of the license in the secured creditor’s secured claim.

This approach codified a line of pre-revision cases which held that future income streams tied to a license or franchise were separate property that, although unrealized, constituted personal property that could be pledged as collateral apart from the underlying franchise or license. In one such case, In re SRJ Enterprises, Inc., the debtor, a Nissan dealer, arranged a sale of all of its assets as a going concern. The terms of the sale required the debtor to terminate its rights under its Nissan franchise so that the buyer could obtain a new franchise at that location. The debtor’s motion for approval of the sale allocated a portion of the sale price to the “Goodwill in Nissan Agreement”—and the secured creditor claimed the amount as proceeds of its security interest in general intangibles. Although the secured creditor did not hold a security interest in the non-assignable franchise itself, the court found that the proceeds attributed to the franchise were proceeds of its pre-petition rights in the market share or goodwill represented by the franchise:

An automobile floor planning financier may contemplate a bankruptcy filing by its borrower and take security in the inherent value of its borrower's market share. There is no reason why this value, or general intangibles such as goodwill and going concern value, cannot be deemed collateral separate from and derivative of the franchise.

Thus, value represented by a right, opportunity, or advantage, even one that is not separately transferable by the debtor, may exist as a general intangible before the petition—and proceeds from the sale of that right are included within the scope of the secured claim.

Similarly, in In re Tracy Broadcasting Corp., the Tenth Circuit recognized that one could take a security interest in the future right of a licensee to receive proceeds from the sale of an FCC broadcast license.

105 Id.
106 Id. at 940 (emphasis omitted).
107 Id. at 940 (emphasis omitted).
108 In re Tracy Broad. Corp., 696 F.3d 1051, 1061 (10th Cir. 2012) (“If the security interest could not attach before there was a contract for the sale of the license, the interest would have little value, particularly when the sale results from financial problems of the licensee, the very circumstance for which
without having an interest in the use of the electromagnetic spectrum that
the license granted the licensee. The court held that, although the secured
creditor does not obtain an enforceable right to use the spectrum, it can
obtain a present (pre-petition) right to proceeds that may arise on the sale of
the debtor’s rights under the license. Turning to the U.C.C., the court held
that the secured creditor’s interest in pre-petition general intangibles extended
to the future right to receive the proceeds of the license. The court concluded that value generated from the sale of the license constituted
“proceeds” for purposes of section 552 of the Code and not after-acquired
property. Thus, the secured creditor’s lien extended to the amounts that
were (or would be) received from such a sale.

The importance of such analysis to a secured creditor’s claim of
effective entity priority is highlighted by In re Ridgely Communications,
Inc., another case involving a broadcast license. There, following the sale
of all of the assets of the debtor to a third party, the debtor filed a motion to
value the collateral and non-collateral and claimed that that valuation would
leave substantial proceeds available to satisfy unsecured claims. The
broadcast license, the debtor argued, could not be encumbered by the
security interest and thus the secured creditor should receive only the
liquidation value of the hard assets serving as collateral. The court concluded:

"Because Ameritrust had a perfected security interest in all of
the assets covered by the court-approved sale, the Court finds
it unnecessary to address the issue of the valuation of the
individual assets. The station was sold as a going-concern in

a creditor desires protection. We can see no policy reason to prevent the attachment of a security interest in the right of the licensee (the right to proceeds of the license’s sale . . . . ").

Id. at 1055 ("[A] licensee has no ownership rights in a channel of radio transmission or a frequency of the electromagnetic spectrum . . . .").

Id. ("[T]he FCA does not prohibit a licensee from making money from its license—say, when a licensee sells a license (albeit only with FCC approval) and realizes a profit because of the value of listener loyalty to the frequency used by the licensee.").

Id. at 1064 ("[U.C.C.] Section 9-408 implicitly recognizes (and the comments to the section explicitly endorse) that a lien on the right to sale proceeds of a government license can attach when a lender extends credit to a licensee.").

Id. at 1060 ("In our view, Nebraska law recognizes the attachment of an interest in the right to proceeds of a sale of an FCC license when the licensee enters into a security agreement.").

Id. at 1052. It is unclear from the decision whether the license was, in fact, ever sold because the case sought a declaratory judgment of a creditor’s interest.

See id. at 1053 (“We conclude that despite the FCA restrictions on license transfers, Tracy Broadcasting could grant a security interest in its right to the proceeds of the sale of the license.”).


Id. at 376.

Id. at 375–76.
an arms-length transaction and Ameritrust is entitled to the proceeds from the sale as approved by the Court.118

Although this analysis provides a compelling response to claims that prohibitions on transfer render impossible the pre-petition grant of an interest in the economic value of certain licenses, the approach is not foolproof. Some courts have outright rejected the approach of Tracy Broadcasting and Ridgely.119 Other courts have held that the U.C.C. 9-408 analysis cannot apply to governmental licenses that are not “property” under state law.120 Although these cases threaten to limit the ability of a secured creditor to achieve effective entity priority in some cases, not every debtor relies heavily on governmental licenses or other non-assignable property. In any event, the weight of authority appears in favor of broad pre-petition security interests in cash-flows resulting from the sale of such licenses.

B. Contributions of Labor and Managerial Effort

For some, the logic underlying the closed system unravels when considering the fact that assets do not create other assets without the application of labor and other factors of production. The introduction of such efforts into the production process renders dubious the claim that all of the value of the enterprise is subject to the secured creditor’s pre-bankruptcy security interest. The introduction of non-collateral requires post-petition value to be allocated on the basis of the relative contributions of collateral and non-collateral.121

_in re Cafeteria Operators, L.P._ provides an example of the problem.122 There, the debtor operated cafeteria-style restaurants and a commercial food preparation, processing, and distribution center.123 The court was called upon to consider whether cash that had accumulated post-petition was subject to the secured creditor’s interest.124 The court observed that the restaurant business is principally a service industry in which most of the revenues are paid as a result of services provided by the debtor’s employees.125 The inventory, in which the creditor claimed a lien,

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118 Id. at 380.
119 See _In re_ Tak Commc’ns, Inc., 138 B.R. 568, 577 (W.D. Wis. 1992), aff’d sub nom. Matter of Tak Commc’ns, Inc., 985 F.2d 916, 918 (7th Cir. 1993) (declining to adopt the holding of Ridgely).
121 See _In re_ Cafeteria Operators, L.P., 299 B.R. 400, 402 (Bankr. N.D. Tex. 2003) (finding that, because the use of pre-petition collateral “undoubtedly makes up part of a debtor[‘s] post-petition income, such income is, in part, the secured lender’s cash collateral”).
122 Id.
123 Id.
124 Id. at 403.
125 Id. at 407–08.
constituted only a portion of the total price customers pay for a meal.\footnote{126}{Id. at 408.} Further, the court found that the secured creditor’s interest in the fixtures and equipment did not extend to post-petition revenues as proceeds because those items were not consumed in the business.\footnote{127}{Id.} The court noted that the services in the restaurant business comprise the bulk of the revenue and because those services were generated by the “time and energy expended by the Debtors’ employees,”\footnote{128}{Id.} they were not proceeds of the secured creditor’s admittedly broad lien. The court was, however, willing to permit the bank to show what portion of the post-petition cash was generated through the sale of inventory and to claim that amount as collateral.\footnote{129}{In re Cafeteria Operators, 299 B.R. at 409; see also Delbridge, 61 B.R. 484, 490–92 (Bankr. E.D. Mich. 1986) (explaining cash collateral and dividing the post-petition value of milk produced by cows, which were collateral, and the debtor’s labor, which was not).}

The court’s analysis rested on the proposition that “[f]rom a plain reading of section 552, revenues generated post-petition solely as a result of the debtor’s labor are not subject to a pre-petition lender’s security interest.”\footnote{130}{In re Cafeteria Operators, 299 B.R. at 405 (quoting Smoker v. Hill & Assocs., 204 B.R. 966, 974 (N.D. Ind. 1997)).} If the debtor had been an individual, this claim would undeniably be true. In\footnote{131}{Local Loan Co. v. Hunt, 292 U.S. 234, 245 (1934).} Local Loan Co. v. Hunt, quoted extensively by the court in\footnote{132}{In re Cafeteria Operators, 299 B.R. at 405.} Cafeteria Operators,\footnote{133}{Id. at 404–05.} the Supreme Court struck down a wage assignment to the extent that it sought to create a security interest in an individual’s future wages, finding that otherwise, the debtor would be unable to obtain the fresh start offered by bankruptcy.\footnote{127}{Id.} Quoting another case involving an individual debtor, the Cafeteria Operators court stated, “[i]t is beyond question that in enacting section 552, Congress sought to preserve the ‘fresh start’ policy so eloquently stated by the Supreme Court in Local Loan by requiring that only security interests in after-acquired property ‘arising from, or connected with, preexisting property’ be preserved in bankruptcy.”\footnote{133}{Id. at 404–05.}

The problem with the court’s analysis is that Cafeteria Operators was an entity and not an individual. Local Loan focused on post-bankruptcy services provided by the individual debtor, noting:

The power of the individual to earn a living for himself and those dependent upon him is in the nature of a personal liberty quite as much as, if not more than, it is a property right. To

\begin{thebibliography}{9}
\bibitem{126}Id. at 408.
\bibitem{127}Id.
\bibitem{128}Id.; see also Premier Golf Props., LP v. U.S. Tr. (\textit{In re} Premier Golf Props., LP), 477 B.R. 767, 776 (B.A.P. 9th Cir. 2012) (“Revenue generated post-petition solely as a result of a debtor’s labor is not subject to a creditor’s pre-petition interest.” (quoting \textit{In re} Skagit Pac. Corp., 316 B.R. 330, 336 (B.A.P. 9th Cir. 2004))).
\bibitem{129}\textit{In re} Cafeteria Operators, 299 B.R. at 409; see also \textit{In re} Delbridge, 61 B.R. 484, 490–92 (Bankr. E.D. Mich. 1986) (explaining cash collateral and dividing the post-petition value of milk produced by cows, which were collateral, and the debtor’s labor, which was not).
\bibitem{130}\textit{In re} Cafeteria Operators, 299 B.R. at 405.
\bibitem{131}Id. at 404–05.
\bibitem{127}Local Loan Co. v. Hunt, 292 U.S. 234, 245 (1934).
\bibitem{133}\textit{In re} Cafeteria Operators, 299 B.R. at 405 (quoting Smoker v. Hill & Assocs., 204 B.R. 966, 974 (N.D. Ind. 1997)).
\end{thebibliography}
preserve its free exercise is of the utmost importance, not only because it is a fundamental private necessity, but because it is a matter of great public concern.\textsuperscript{134}

In Cafeteria Operators, however, the rights of an individual were not at issue, and therefore the Local Loan reasoning was inapposite. The services were not provided by the debtor itself but, instead, by its employees—employees who may have been paid for those services with the secured creditor’s collateral.\textsuperscript{135} If those employees were in fact paid from the collateral, the value contributed by those services would be no less proceeds of collateral than would be inventory or a piece of equipment that was purchased out of the secured creditor’s cash collateral.\textsuperscript{136}

The court in In re Package Design & Supply Co. applied this reasoning to find that the secured creditor’s interest extended to post-petition revenue.\textsuperscript{137} The court found that there were no unencumbered assets at the time of the petition and that there were no contributions or obligations post-petition that had not been fully satisfied.\textsuperscript{138} Thus, the court concluded, “all of the value added by others was completely paid for by the lender’s collateral, and only by the lender’s collateral, without reference to an after-acquired property clause.”\textsuperscript{139} The court noted, however, that this would not be the case if there had been significant assets purchased on post-petition credit, where there were substantial unencumbered assets that contributed significant value to the assets, or where the secured creditor was over-secured and thus post-petition assets were purchased with equity that would have been available to unsecured creditors.\textsuperscript{140} Thus, some courts recognize that where the secured creditor holds a security interest in all of the assets of the debtor at the petition date and where there is no other source for cash to operate the business, all of the value accruing post-petition is proceeds of the collateral.

C. Section 552(b) and the Equities of the Case Exception

Section 552(b) includes a proviso that allows a court to limit claims to proceeds “based on the equities of the case.”\textsuperscript{141} The breadth of this equities

\textsuperscript{134} Local Loan, 292 U.S. at 245.

\textsuperscript{135} See ResCap, supra note 15, at 858 (providing an example of the payment model).

\textsuperscript{136} Id.

\textsuperscript{137} In re Package Design & Supply Co., 217 B.R. 422, 427 (Bankr. W.D.N.Y. 1998). The court in In re Package Design confronted the trustee’s claim that the secured creditor had lost its claim on cash collateral by failing to obtain a timely cash collateral order. The trustee’s argument was that the cash collateral existing at the time the secured creditor had filed its motion for such an order comprised funds received post-petition, and therefore the lender’s collateral had “rolled out from underneath the lien during the first six months of [the] case.” Id. at 423.

\textsuperscript{138} Id.

\textsuperscript{139} Id. at 426.

\textsuperscript{140} Id. at 427.

\textsuperscript{141} 11 U.S.C. § 552(b) (2012).
exception to the proceeds rule might appear to provide a bankruptcy court with authority to limit the secured creditor’s claim simply to rebalance control rights or distributional outcomes in favor of unsecured creditors. The exception might be invoked to counter the proposition that one creditor might be entitled to all of the value of the debtor in derogation of the broader rehabilitative purposes of Chapter 11. Indeed, in one reference, the legislative history of section 552(b) states that the equities of the case exception “is designed, among other things, to prevent windfalls for secured creditors and to give the courts broad discretion to balance the protection of secured creditors, on the one hand, against the strong public policies favoring continuation of jobs, preservation of going concern values and rehabilitation of distressed debtors, generally.”

Although this statement seems to grant courts a relatively broad warrant to adjust claims to proceeds based on the needs of the debtor, other legislative statements regarding the purpose of the exception are much more closely circumscribed. In the House and Senate reports that accompanied the introduction of what would become the Code, the exception was explained in more limited terms:

[The equities of the case exception] is designed to cover the situation where the estate expends funds that result in an increase in the value of collateral. The exception is to cover the situation where raw materials, for example, are converted into inventory, or inventory into accounts, at some expense to the estate, thus depleting the fund available for general unsecured creditors.  

Although there are few cases considering the scope of the exception, the courts have not indulged the temptation to use the exception as a warrant to rebalance bankruptcy distributions. For example, most courts have held that “the principal purpose of the equities of the case exception is to prevent secured creditors from reaping unjust benefits from an increase in the value of collateral during a bankruptcy case resulting from the (usually) reorganizing chapter 11 debtor’s use of other assets of the estate or from the investment of non-estate assets.”

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This application of the equities exception is best understood through the facts of In re Delbridge. There, the debtor, an individual in Chapter 11, challenged the claim of its secured creditor to milk produced by the debtor’s cows (the secured creditor’s collateral) post-petition.\textsuperscript{145} The problem, of course, was that while the milk was clearly a product of the cow, it could not be produced without the labor of the farmer.\textsuperscript{146} Using the equities exception, the court fashioned a remedy that allocated the cash proceeds of the milk to the secured creditor and to the farmer based on their relative inputs.\textsuperscript{147} Put differently, the court recognized that the milk, and the cash proceeds of the milk, were collateral but that the equities of the case required reduction of that collateral based on the labor and expenditures of the farmer.\textsuperscript{148}

Thus, the equities exception does little that a clear understanding of the principles of proceeds identifiability can do. Indeed, the Cafeteria Operators court invoked the equities exception as an alternative basis to its holding that the post-petition revenues of the business included not only the value of the food inventory, but also the value of the labor.\textsuperscript{149} Of course, the two cases are quite dissimilar in that the labor of the farmer was truly unencumbered under the principles of Local Loan. In a case involving an entity, however, the principles of Local Loan do not apply, and one must ask instead about the source of cash used to pay for that labor. If there is no source other than the secured creditor’s collateral, the contribution of labor or any other input should not provide a basis to limit the secured creditor’s claim under the equities of the case exception.

In re Laurel Hill Paper Co. provides an example. There, following a sale of all of the debtor’s assets, the debtor sought to allocate $1,000,000 of the sale proceeds to the unsecured creditors based on the equities of the case exception.\textsuperscript{150} The debtor argued that the allocation reflected the increase in value of the assets attributable to the efforts of the debtor’s Chief Restructuring Officer (“CRO”).\textsuperscript{151} The court agreed that both the debtor and the CRO had undertaken substantial efforts to protect the value of the assets and eliminate uncertainties that would result in a depressed sale price, but also noted that all of the costs of these activities were paid from funds that

\textsuperscript{146} Id. at 489.
\textsuperscript{147} Id. at 491.
\textsuperscript{148} Id.
\textsuperscript{151} Id. at 91.
were subject to the secured creditor’s interests.\textsuperscript{152} The court therefore denied the allocation, stating that “[p]ayments at the expense of secured creditors rather than at the expense of the estate do not support an equities of the case award to the unsecured creditors.”\textsuperscript{153} The case is a good example of closed-system reasoning. Because the secured creditors claimed an interest in all of the assets at the beginning of the case, the increases in value during the bankruptcy process (up to the amount of the secured creditor’s claims) were proceeds of the collateral used to generate those increases.

D. Soft Variables

Michelle Harner has observed that the value of a business entity includes not only the value of its traditional assets—equipment, inventory and payment intangibles—but also the value of its “soft variables.”\textsuperscript{154} These soft variables include the traditional components of goodwill—the human capital of a firm, its operational efficiencies and strategic decisions and plans, and its relationships with other actors.\textsuperscript{155} In Harner’s view, because these soft variables do not fit easily within traditional definitions of property, the secured lender cannot claim an interest in them as original collateral.\textsuperscript{156} Harner argues that because these soft variables are not collateral, the value flowing from them is after-acquired property and not proceeds.\textsuperscript{157} Thus, soft variables included in the enterprise value cannot be included within the scope of the secured lender’s blanket lien, and at least some of the value attributable to those variables should remain available to pay unsecured claims.\textsuperscript{158} Harner’s argument then is that a secured creditor can never truly obtain a lien in all of the assets of the debtor.\textsuperscript{159}

If Harner is correct and a secured creditor cannot obtain an interest in these soft variables until they have been realized, the contribution they make to the cash flow of the debtor represents a leak in the closed system that would defeat the secured creditor’s claim to effective entity priority. No longer could a blanket lienholder claim that all of the value accruing post-
petition is subject to the security interest, and thus, bankruptcy distributions would necessarily allocate some of the going concern value to general unsecured claimants. Doing so would require some way of valuing these variables. Harner advocates this result, reasoning that such an undertaking would improve the bankruptcy process by giving employees and others “a potential interest in the outcome and perhaps a seat at the negotiating table.”

Harner relies on traditional conceptions of property, accounting treatment, and constitutional concerns for her conclusion that soft variables are not property and therefore cannot become collateral until the value of those variables is realized—that is, until they actually produce tangible value in the form of cash flow. She notes that a company cannot control, possess or transfer the way its people “think, behave, or perform, or the relationships they maintain.” Because the company cannot own or control those assets, and because the benefits are not measurable, soft variables cannot find their way onto a balance sheet until they are identified in a merger or other reorganization. Finally, she provides constitutional and policy arguments respecting individual autonomy and prohibiting involuntary servitude to bar the treatment of human capital as property of a corporation.

It is true that a business entity cannot control its human capital in the sense of forcing its employees to continue to work, think, or maintain relationships in particular ways. It is, of course, also true that a business entity cannot realize the value of its human capital through a sale of that capital separate from the sale of the entity itself. But it does not necessarily follow that there is nothing there against which a security interest can attach. The company does not have a right to its employees’ labor, but it is free to contract for that labor and those contracts—even though they are normally at will and, even if not, cannot be specifically enforced—have value. Similarly, the company does not have a right to the loyalty of its customers, but the investments made by the company have created that loyalty and it remains a valuable asset while it exists. The fact that the company does not control the behavior of other actors does not mean that the web of relationships the company created and maintained over the years with employees, suppliers, customers, governmental regulators, a sympathetic community and all of the other contributors of soft variables is not itself property of the company—intangible property, to be sure, but nevertheless property.

[160] Id. at 534.
[161] Id. at 522.
[162] Id. at 523.
[163] See id. at 534–35 (arguing that constitutional and policy considerations must be “balanced in determining the proper treatment of soft variables in bankruptcy”).
The fact that the value of these soft variables has not been “realized”—in the sense that these factors have not been separately valued and placed on the financial statements of the corporation—does not necessarily mean that they cannot serve as collateral. Goodwill, as an accounting principle, simply represents the difference between the price paid for a business entity and the value of all of the measurable tangible and intangible assets of the entity.\(^{164}\) Because a business’s internally generated goodwill is inherently difficult to measure, it is not included on the balance sheet until an event occurs (a business combination or restructuring) that provides an objective basis for such measurement. The fact that accountants do not represent goodwill on financial statements until such objective basis is revealed does not mean that goodwill does not exist as an asset until that time occurs. Businesspeople understand that value exists even if accountants do not record it until after a business combination or reorganization occurs. Our core concepts of property and value in bankruptcy have nothing to do with accounting treatments or other formal principles.\(^{165}\) Given the Code’s focus on real economic values and interests, it seems wrong to allow accounting principles to control.

Harnar argues that the constitutional prohibition against involuntary servitude and public policies respecting individual autonomy strongly argue against the recognition of soft variables as property of the company and therefore as potential collateral.\(^{166}\) She notes that soft variables arise from “people and their time, talents, and efforts”—human capital that cannot be alienated.\(^{167}\) While it is, of course, true that the company cannot sell its people or their services, this observation misses the point. No one suggests that the company can force its employees to work for the company or for an assignee of their employment contracts. Future services are not the asset being conveyed. Instead, the asset represented by soft variables is the network of contracts, relationships, and perhaps even good feelings that exist at any given point in time. That network is a result of investments by the business in supplier, customer, and employee relationships that may, to a greater or lesser extent, solidify and preserve those relationships. That network is alienable through a sale of the business assets as a going concern.

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\(^{164}\) See id. at 533 (defining a company’s goodwill as being calculated based on “the difference in the book or liquidation value and the market value of the company”).

\(^{165}\) Accounting principles generally hold no sway in bankruptcy cases. For example, “[p]roperty of the estate” under the Code is broadly defined to include “all legal or equitable interests . . . in property,” without regard to formalities such as accounting realization. 11 U.S.C. § 541(a)(1) (2012). Section 506(a) makes clear that value of collateral is a judicial determination that is not dependent on accounting concepts. The definition of insolvency calls for assets and liabilities to be compared “at a fair valuation.” 11 U.S.C. § 101(32) (2012); see also In re Lease-A-Fleet, Inc., 155 B.R. 666, 679 (Bankr. E.D. Pa. 1993) (“Courts are not required to rely upon GAAP standards when determining the issue of insolvency.”).

\(^{166}\) Harnar, supra note 12, at 534–35.

\(^{167}\) Id. at 535.
The fact that the employee may reject a successor employer’s offer of employment, like the right of the non-debtor to refuse to acknowledge the assignment of a personal services contract, is beside the point. The asset is the potential ability to sell or use the network of people and relationships. Like non-assignable contracts and licenses, that ability has a value that exists prior to the petition.

E. Collateral Valuation and Value Provided by the Bankruptcy System

Even if a secured creditor is successful in claiming a security interest in all of the pre- and post-petition assets of a debtor, effective entity priority requires that those assets be valued on a going concern rather than a liquidation basis. The proper assumptions under which the bankruptcy court should value the secured creditor’s collateral is the subject of substantial controversy.

Valuation under a going concern assumption is essential if the secured creditor is to capture the entire cash flow of the business because the asset-based approach of the bankruptcy process limits priority to the value of the collateral. Some, perhaps much, of the potential cash flow of the debtor is dependent on maintaining the assets in a going concern, and a liquidation assumption would disregard that added value by fixing the secured creditor’s priority at the amount that the secured creditor would have received had it foreclosed on the assets and sold them. The value added by keeping the assets together, on this assumption, would be non-collateral that would contaminate the closed system and would render the secured creditor’s effective entity priority claim untenable.

The question of collateral valuation is relevant at two stages in a bankruptcy case. Throughout the case, collateral valuation sets the secured creditor’s entitlement to adequate protection. During the case, the secured creditor is entitled to have the value of its interest in the collateral

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168 See supra text accompanying note 101 (discussing the treatment of non-assignable licenses or contract rights).
170 See 11 U.S.C. § 506(a) (2012) (fixing the value of a creditor’s secured claim to the value of the underlying collateral); supra notes 20–23 and accompanying text.
171 See Carlson, supra note 169, at 75–76 (addressing the differences between liquidation and going concern value, focusing on the low value of liquidation versus the increase in value brought by utilizing going concern value).
172 See id. at 79 (“In the end, the choice between liquidation or going concern value is based on whether you think that secured parties or general creditors should own the bonus that adheres to the idea of a going concern.”).
At the end of the case, collateral valuation fixes the secured party’s distributional rights under the plan confirmation standards or distributional scheme.\textsuperscript{175}

Effective entity priority usually requires that the collateral be valued under a going concern standard at both stages. A going concern measurement of the secured creditor’s priority at the end of the case is essential, lest the secured creditor lose its claim to the bonus that accompanies a going concern. But the mechanics of the bankruptcy process also require that the secured creditor’s entitlement to adequate protection during the case be measured on a going concern basis. Adequate protection requires that a secured party be protected against deterioration in the value of its collateral resulting from its use, sale, or lease, and a failure to provide such protection is cause for lifting the automatic stay to permit foreclosure.\textsuperscript{176} Adequate protection requires one or some combination of interim cash payments, replacement liens in unencumbered property, or some other protection that results in the indubitable equivalent of the secured creditor’s interest.\textsuperscript{177} If an under-secured creditor’s claim extends to all of the collateral, there will be no unencumbered source of funds for adequate protection. To the extent that the secured creditor’s protected interest is reduced to liquidation value, the value to be protected is less, and accordingly, the ability of the debtor to retain the property, without regard to the desires of the secured creditor, is enhanced. More importantly, if the secured creditor’s claim is fixed at liquidation value early in the case, the debtor might attract necessary third-party financing by pledging going concern value that would otherwise go to the secured creditor.\textsuperscript{178} Thus, even if a secured creditor’s distributional entitlement was based on a going concern value, the third-party, post-petition lender would effectively prime the pre-petition creditor’s lien.


\textsuperscript{175}See 11 U.S.C. § 1129(b)(2)(A) (setting out secured creditors’ baseline distributional entitlements).

\textsuperscript{176}See 11 U.S.C. § 362(d)(1) (2012) (allowing the court to “grant relief from the stay . . . for cause, including the lack of adequate protection”).

\textsuperscript{177}Interim payments and replacement liens are self-explanatory. Indubitable equivalence, however, is more difficult to explain. Abandonment of collateral may be one form of indubitable equivalence, but that defeats the purpose of the debtor’s effort to retain the property. \textit{In re} L.B. Bryant, 439 B.R. 724, 747 (Bankr. E.D. Ark. 2010). An equity cushion may also provide indubitable equivalence. \textit{In re} Sugarleaf Timber, LLC, 529 B.R. 317, 335 (M.D. Fla. 2015). Our focus here, however, is on under-secured creditors.

\textsuperscript{178}See Suntrust Bank v. Den-Mark Constr., Inc., 406 B.R. 683, 700 (E.D.N.C. 2009) (noting that an equity cushion may constitute adequate protection for granting a priming lien); \textit{In re} Timber Prods., Inc., 125 B.R. 433, 436–37 n.11 (Bankr. W.D. Pa. 1990) (collecting cases in which an equity cushion has been found to constitute adequate protection); \textit{In re} Snowshoe Co., Inc. v. Shenandoah Fed. Sav. & Loan Ass’n, 789 F.2d 1085, 1090 (4th Cir. 1986) (noting that equity cushion and independent financial analysis are sufficient protection for the grant of a priming lien).
As David Carlson has pointed out, valuation in bankruptcy is usually an exercise in determining subjunctive facts.\textsuperscript{179} Asset value is only objectively observed in the context of an exchange. One can tell how much something is worth by what someone will pay for it.\textsuperscript{180} In bankruptcy, however, market exchange is usually delayed and in some cases never happens at all. In the absence of a real exchange, valuation requires a hypothetical exchange and requires the court to make some assumptions about the circumstances under which such a hypothetical exchange would occur.\textsuperscript{181} The basic question is whether the hypothetical exchange would occur under non-bankruptcy foreclosure rules or as an arm’s length sale of all of the debtor’s assets. This is a substantive legal question and not a question of fact.

The Bankruptcy Code is not entirely clear regarding the appropriate assumption a court should make when determining the value of the collateral. Section 506(a) provides that value “shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property.”\textsuperscript{182} The legislative history of section 361 (providing adequate protection) is particularly ambivalent, noting that the method of determining the value and the timing of that determination is unspecified and stating:

> These matters are left to case-by-case interpretation and development . . . . [It is not] expected that the courts will construe the term value to mean, in every case, forced sale liquidation value or full going concern value. There is wide latitude between those two extremes although forced sale liquidation value will be a minimum.\textsuperscript{183}

The Supreme Court, in Associates Commercial Corp. v. Rash, addressed this question in the context of a Chapter 13 plan.\textsuperscript{184} The secured creditor held a security interest in a truck owned by the debtor, which the debtor proposed to satisfy by paying the amount of the allowed secured claim.\textsuperscript{185} The debtor proposed to pay the foreclosure value of the truck while the secured creditor claimed a right to the higher replacement value.\textsuperscript{186} The Court focused on section 506(a)’s admonition that the value of property, for the purpose of determining a secured claim, is to be determined in light of the proposed

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\footnote{179} See Carlson, supra note 169, at 70 (discussing how a bankruptcy judge must hypothesize the historical facts to determine value).
\footnote{180} See id. at 75.
\footnote{181} See, e.g., Assoc. Commercial Corp. v. Rash, 520 U.S. 953, 953 (1997) (deciding between a replacement-value standard and a foreclosure-value standard for the appropriate valuation); In re Heritage Highgate, Inc., 679 F.3d 132, 141 (3d Cir. 2012) (observing Congressional intent to give courts flexibility when determining the standard of valuation most appropriate on a case-by-case basis).
\footnote{183} S. REP. No. 95-989, at 54 (1978).
\footnote{184} Rash, 520 U.S. at 953.
\footnote{185} Id.
\footnote{186} Id.
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disposition or use of the collateral. That language, the court held, contemplates a valuation assumption that tracks the debtor’s actual use of the collateral, rather than an assumption that contemplates a purely hypothetical foreclosure by the secured creditor.

The court in ResCap applied the Supreme Court’s reasoning in the context of a Chapter 11 dispute regarding adequate protection. There, a secured creditor sought a priority claim based on the diminution in value of its collateral over the course of the case. The unsecured creditors’ committee argued that there was no diminution in value because the secured creditor’s claim should be “valued at the Petition Date” under a foreclosure standard. The District Court rejected that argument, noting that the parties had never contemplated a liquidation of the collateral by a foreclosure sale. In addition, the court held that “the proper valuation methodology must account for the proposed disposition of the collateral.” Because the parties had intended to conduct a going concern sale on the date of the petition, the court adopted that state as its valuation assumption.

The result was not, however, a complete victory for the secured creditor—merely adopting a going concern assumption says nothing about the rest of the facts surrounding the sale. The timing of the hypothetical sale and the condition of the debtor at that time was critical to the court’s analysis. The question presented by the adequate protection dispute was the value of the assets on the petition date. The secured parties’ expert valued the collateral on that date by taking the sale price obtained in the bankruptcy

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187 See id. at 962 (“As we comprehend § 506(a), the ‘proposed disposition or use’ of the collateral is of paramount importance to the valuation question.”).
188 See id. (“Applying a foreclosure-value standard when the cram down option is invoked attributes no significance to the different consequences of the debtor’s choice to surrender the property or retain it. A replacement-value standard, on the other hand, distinguishes retention from surrender and renders meaningful the key words ‘disposition or use.’”).
189 Id. at 556.
191 Id. at 591.
192 Id. at 593.
193 Id. at 594; see also id. at 593–94 n.32 (citing cases adopting the going concern valuation assumption). But see id. at 594 n.33 (citing cases adopting a foreclosure assumption). The use of going concern or replacement value does not always result in a higher value, however. The Ninth Circuit adopted the rationale of Rash in a case in which a foreclosure sale would have resulted in a higher value because the foreclosure would have eliminated a deed restriction that limited the debtor’s use of the property as affordable housing. Because the debtor proposed to retain the property subject to the restriction, the court, following Rash, applied the lower value. In re Sunnyslope Hous. Ltd. P’ship, 859 F.3d 637, 644 (9th Cir. 2017).
194 ResCap, 501 B.R. at 595–96. Although the secured creditor succeeded in persuading the court to adopt its valuation assumption, it ultimately failed to carry its burden of proving that the value of the collateral had deteriorated during the case. Id.
195 See id. at 619 (explaining that the burden is on the plaintiff to prove that the defendants were not over-secured, and how the plaintiff’s expert’s calculations did not necessarily meet this burden).
auction of the collateral and discounting it back to the petition date by adjusting for transactions occurring during the case. This analysis ignored the fact that the pre-petition debtor would have had a significantly more difficult time obtaining required consents for sale, and that a sale by an insolvent pre-bankruptcy debtor would have resulted in substantially less proceeds than could be obtained through the bankruptcy process. The court stated:

"Even if the Court accepts that the assets were saleable on the Petition Date—before all of the work conducted during the bankruptcy necessary to make them saleable—the [secured creditors’ expert’s] valuation cannot be relied upon because it provides a fair market value of the assets in the hands of a solvent company. Most of the assets could not simply be turned over to a buyer who could instantly reap full value as if the assets were commodity products . . . . The [secured creditors’ experts’] valuation ignores the reality of the period leading up to this bankruptcy: ResCap was an insolvent company, over-burdened with debt, owning assets that had to be “fixed” before they were sold, and facing a real possibility of being shut down."

ResCap makes clear that valuation not only requires an understanding of the planned use or disposition of collateral, but must also account for the circumstances existing at the time of the valuation. Although the valuation issue arose late in the case, after the debtor had taken advantage of the bankruptcy process to fix problems with the assets, the court measured the secured party’s right to adequate protection by the value of the assets at the time of the bankruptcy petition. Put differently, at the outset of the case, the secured creditor’s claim does not extend to benefits provided by the bankruptcy process itself.

Ted Janger has made a similar point relying on the creditor’s bargain theory of bankruptcy law. This widely accepted theory was developed by

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196 Id. at 603–04.
197 Id. at 596.
198 See Ralph Brubaker, The Post-RadLAX Ghosts of Pacific Lumber and Philly News (Part 1): Is Reorganization Surplus Subject to a Secured Creditor’s Pre-Petition Lien?, 34 BANKR. L. LETTER, no. 6, June 2014, at 1–2 (“Judge Glenn . . . further refined the appropriate subjunctive scenario for that petition-date valuation by examining what kind of sale the debtor could have (in our counter-factual hypothetical-sale valuation universe) actually effectuated on the petition date.”).
199 See ResCap, 501 B.R. at 617 (reducing JSN’s collateral by the amount of cash in the “Avoidable Deposit Accounts as of the Petition Date”).
200 Logic and Limits, supra note 12, at 589; see also Tracing Equity, supra note 13, at 706–08 (presenting Janger’s perspective on the secured creditor’s entitlement of disposition of collateral under Chapter 11).
Thomas Jackson over thirty years ago, and later refined by Jackson and Douglas Baird. The theory views bankruptcy as a solution to a collective action problem created by inefficient state law debt collection remedies. Because state law remedies rely on a first-in-time distribution scheme, these remedies promote a destructive race to the courthouse and a destruction of value due to the uncoordinated and rule-bound nature of that race. Bankruptcy replaces these remedies with a collective proceeding that is better designed to maximize the value of the assets. Providing the conditions for a collective proceeding is the sole purpose of business bankruptcy cases, and in the view of Jackson and Baird, bankruptcy provisions should depart from non-bankruptcy entitlements only to the extent necessary to promote this collectivization. A reshuffling of priorities inside of bankruptcy that is not necessary to promote the collective nature of the proceeding simply introduces forum shopping and is an overall inefficient use of the bankruptcy process.

The creditors’ bargain theory has long been invoked to protect secured creditors from an erosion of their position in bankruptcy cases. Janger argues that, paradoxically, the net effect of the purported preservation of secured creditor rights has been to enhance their recoveries far beyond those available outside of bankruptcy, effectively turning the creditors’ bargain on its head. Janger’s central point is that bankruptcy law should take seriously the notion that the bankruptcy system should enforce non-bankruptcy entitlements, and that the secured creditor’s entitlement under non-bankruptcy law is to conduct a foreclosure. This would require that the secured creditor’s claim both for adequate protection and a distributional priority should be valued under a foreclosure standard determined at the outset of the case. As the facts of ResCap demonstrate, it seems clear that in many cases, the bankruptcy sale process provides significant advantages over non-bankruptcy sales by distressed businesses, particularly over foreclosure sales conducted by a secured creditor. Chapter 11 bankruptcy allows for

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203 See Jackson, supra note 201, at 859–60 (proposing bankruptcy as a system to effectuate the “creditors’ bargain”).
204 See id. at 866 (comparing collective remedies to an individualized remedies system).
205 Id. at 872.
207 Logic and Limits, supra note 12, at 591.
208 Id. at 602.
209 Id.
coordination of asset sales allowing, for example, the sale of realty and related personal property at a single time and to a single buyer.\textsuperscript{210} It eliminates, or at least limits, the ability of the debtor to interfere with sales, permits sales free and clear of property interests, and allows the trustee or debtor in possession, with the oversight of the court, to determine the best time and manner of conducting the sale.\textsuperscript{211} In Chapter 11, these benefits are magnified because the process contemplates a stabilization of the entire business, retention of management, and a process that is more conducive to the sale of the entire business as a going concern.

Permitting a secured creditor—even one with a security interest in all of the debtor’s assets—to claim the entire going concern value would effectively extend that creditor’s priority interest to that portion of the surplus generated by the bankruptcy process itself. This “bankruptcy-created value,”\textsuperscript{212} unlike the surplus resulting from Harner’s soft variables, does not arise from the debtor’s assets. It is instead generated by an efficient legal system and thus the distribution of this surplus appears to be up for grabs.\textsuperscript{213} In this sense, the point is another iteration of the scope question that is considered in this section. The decision to use a foreclosure assumption in valuing collateral is not so much a question of determining value; it is instead a question of who should benefit from the collective nature of the bankruptcy process. Janger’s view would limit the scope of the secured creditor’s security interest and permit a distribution of all or some portion of this bankruptcy-created value to unsecured or subordinated claimants. The end result would be to eliminate effective entity priority and to require the enterprise value to be allocated on an asset priority basis with the court fixing the secured creditor’s priority claim at the amount that the secured creditor would have received on liquidation and allocating the bankruptcy-created value to the unsecured creditors.

Although there is considerable logical force in Janger’s argument, it assumes that there is a substantial, measurable bankruptcy surplus. Baird has argued that “the distinction between values realized in bankruptcy and out is overdrawn.”\textsuperscript{214} He notes that going concern sales are possible outside of bankruptcy through receiverships and assignments for the benefit of creditors.\textsuperscript{215} In any event, even if the bankruptcy process creates value

\textsuperscript{210} See id. at 603 (“Two adjoining pieces of real property may be worth more sold together than separately. A building sold with everything in it, as well as all the tenants may be worth more than the same building sold empty (or vice versa).”).

\textsuperscript{211} See 11 U.S.C. § 363(f) (2012) (outlining provisions in which a trustee may sell property “free and clear of any interest”).

\textsuperscript{212} Logic and Limits, supra note 12, at 615.

\textsuperscript{213} See id. (“Secured creditors ‘own’ what they own outside of bankruptcy. If they get more through bankruptcy, either because the statute allocates value to them, or because of bankruptcy-created value, that is a gift, not property they are entitled to as a matter of right.”).

\textsuperscript{214} ResCap, supra note 15, at 853.

\textsuperscript{215} Id.
through introducing efficiencies, that fact is not itself an argument for any particular allocation of that value. If foreclosure is the baseline, it is the baseline for all of the parties—not just the secured creditor. A foreclosure would eliminate going concern surplus for the secured creditors and unsecured creditors alike and may eliminate any chance that a more efficient process might result in a value sufficient to provide a distribution to unsecured creditors.

The secured and unsecured creditors’ bargain, then, might logically apply to the surplus created by the bankruptcy process. On this view, the secured creditors’ priority should extend to the value achievable through the most efficient realization process. To the extent that bankruptcy provides such a process, its use should be encouraged on an allocative efficiency basis notwithstanding the fact that the process benefits one group of creditors rather than another.216 Thus, the mere fact that Congress has provided such a process is not alone a baseline for allocating some or all of the benefits of that process to the unsecured creditors. Janger’s view that the value of the secured creditor’s priority claim should be fixed at a hypothetical foreclosure that not only has not happened, but also that no one wants to happen, seems an artificial way to force such a distributive result.217

IV. EFFECTIVE ENTITY PRIORITY AND THE BANKRUPTCY PROCESS

As the foregoing discussion illustrates, effective entity priority rests on a fragile footing, requiring the establishment of a closed system that begins and ends with all of the elements of the debtor’s value deriving from the secured creditor’s collateral. Both in theory and practice, the maintenance of such a closed system is difficult, and leaks in the system through non-collateral contributions often occur. Nevertheless, claims of blanket lien creditors to all of the value persist, and only rarely does the case law directly confront the question.

This should come as no surprise. The basic structure of the Bankruptcy Code has been in place for nearly forty years, over which time much has changed in the world of commercial finance. In 1979, when the Code became effective, secured debt was principally asset-based.218 The Bankruptcy Code and the U.C.C. were not designed with anything like

216 See id. at 853–54 (“[I]f 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 instance) to ensure that its non-bankruptcy alternative was more promising or was sufficient to pay it in full.”).

217 See id. at 854 (“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.”).

effective entity priority in mind—as previously discussed, such an idea was spawned instead by industry practices that employed an expansive cash-flow theory of secured lending. Although the 2001 amendments to the U.C.C. made possible much broader security interests (making effective entity priority arguments stronger), the Code was not changed to accommodate the sort of arguments blanket lienholders make.\footnote{See Bankrupt Proceeds Rule, supra note 12, at 534–553 (arguing that bankruptcy courts should interpret proceeds narrowly under bankruptcy law rather than adopt the broadened U.C.C. definition).} Thus, the basic legal arguments in favor of effective entity priority have a jury-rigged feel that creates substantial uncertainty.\footnote{See David A. Skeel, Jr., Rediscovering Corporate Governance in Bankruptcy, 87 TEMP. L. REV. 1015, 1028 (2015) (noting that several commentators have described the questions presented here as involving the most important and hotly debated issues in current bankruptcy practice).}

One reason for this continuing uncertainty is that arguments for and against effective entity priority are often not made directly, but instead underlie and are obscured by other questions that arise in bankruptcy cases. The right of a secured creditor to credit bid its claim in a going concern sale, a right affirmed by the Supreme Court in \textit{RadLAX},\footnote{RadLAX Gateway Hotel, LLC v. Amalgamated Bank (\textit{RadLAX}), 132 S. Ct. 2065, 2073 (2012).} provides one example. \textit{RadLAX} considered the question of whether a plan of reorganization could propose a sale of collateral without providing the secured creditor a right to credit bid its claim. The plan proposed an auction without credit bidding and a judicial valuation of the secured creditor’s collateral.\footnote{\textit{Id.} at 2069.} The plan was proposed as a cramdown, to be confirmed despite the secured creditor’s objection, and its confirmability was based on the claim that a judicial valuation of the secured creditor’s claim and payment of that amount from the proceeds of the sale would provide the secured creditor the “indubitable equivalent” of its secured claims.\footnote{\textit{Id.} at 2070; see also 11 U.S.C. § 1129(b)(2)(A)(iii) (2012) (establishing that for a plan to be fair and equitable, it must provide for the realization of the “indubitable equivalent of such claims”).} The Supreme Court held that a sale without credit bidding could not satisfy the indubitable equivalence basis for confirmation because such a sale would be in direct violation of an alternative basis—a sale that contemplated credit bidding.\footnote{RadLAX, 132 S. Ct. at 2073. The Code provides three alternative routes to confirmation in a cramdown plan. The basic alternatives are that the debtor retain the collateral, granting the secured creditor deferred cash payments equal to the value of its claim, or that the collateral be sold, granting the secured creditor a right to credit bid its claim. Indubitable equivalence is a third option. 11 U.S.C. § 1129(b)(2)(A).}

The \textit{RadLAX} opinion confined its analysis of the question to statutory interpretation and, at first blush, the controversy seems to be about little more than Chapter 11 strategy and bidding processes.\footnote{See \textit{RadLAX}, 132 S. Ct. at 2070–73 (discussing the “general/specific” canon of statutory interpretation).} But, as Ralph Brubaker has demonstrated, the credit bidding question raises concerns
regarding the right of a secured creditor to realize the going concern value of all of its collateral to the exclusion of unsecured creditors or, as this article has framed it, effective entity priority. Credit bidding works by permitting the secured creditor to use its claim, rather than cash, to purchase its collateral at a foreclosure sale. The sale price thus determines the value of the collateral and the amount of the allowed secured claim. In RadLAX and the principal cases preceding it, all of the assets of the debtor were sold as a going concern and the under-secured creditors claimed a security interest in the entirety of the going concern. A credit bid, under these circumstances, would allow the secured creditor to acquire all of the enterprise value of the debtor in satisfaction of its claim. Substituting this right with a right to payment of a judicially determined value would only benefit junior creditors if the judicially determined value were lower than the full enterprise value of the debtor. In such a circumstance, the difference between the two would be available for distribution to the unsecured creditors.

The question is also frequently subsumed in negotiations regarding debtor in possession (“DIP”) financing. A debtor with a secured creditor holding blanket liens in all of its assets is usually at the mercy of that secured creditor to provide financing throughout the case. The ease with which the secured creditor can obtain and maintain an interest in all of the cash of the debtor creates an immediate need for financing (or permission to use cash collateral), and the secured creditor can exploit that need to enhance its claim through a roll-up of its pre-petition debt and through other control provisions.

The scope of the secured creditor’s claim is an important

226 Ralph Brubaker, Credit Bidding and the Secured Creditor’s Baseline Distributional Entitlement in Chapter 11, 32 BANKR. L. LETTER, no. 7, July 2012, at 11–12; Brubaker, supra note 198, at 1–2.

227 In re Pac. Lumber Co., 584 F.3d 229, 236–37 (5th Cir. 2009); In re Phila. Newspapers, LLC, 599 F.3d 298, 298, 301 (3d Cir. 2010).

228 Brubaker notes that both the Philadelphia Newspapers and RadLAX plans contemplated payments to unsecured creditors—payments that would violate the absolute priority rule if the secured creditor’s claim extended to the debtors’ entire enterprise value. See generally Brubaker, supra note 226, at 12–13; Brubaker, supra note 198, at 1–2.

229 See Logic and Limits, supra note 12, at 613 (noting the problems created by RadLAX where the secured creditors’ liens do not extend to all of the collateral); Barry E. Adler, Priority in Going-Concern Surplus, 2015 U. ILL. L. REV. 811, 816 (noting that failure to allocate all of the going concern surplus to secured creditors would limit the secured creditor’s ability to credit bid).

230 A “roll-up” is a financing provision that converts pre-petition debt into post-petition debt that is secured by both pre- and post-petition assets. Such a provision obviates the need to rely on a proceeds analysis. Paul H. Zumbro, DIP and Exit Financing Trends and Strategies in a Changing Market Place, in Recent Trends in Debtor-in-Possession Financing: Leading Lawyers Analyze Bankruptcy Financing 3, 12 (Aspatore 2016).

component of these negotiations. If the secured creditor is limited to asset-based priority—and particularly if that priority is based on foreclosure value—the court may permit the debtor to obtain third-party financing based on the higher reorganization value of the assets. Such third-party financing might have the effect of priming the secured creditor’s claim to the enterprise value. The debtor, on the other hand, risks a complete loss of control over the course of the Chapter 11 by an early finding that the secured creditor has a claim to the entire entity. The result of these competing risks is often a compromise that simply gets baked into the remainder of the case.

So much of the bankruptcy process is based on early negotiations conducted with an incomplete understanding of the facts that the legal questions can become somewhat obscured. The system survives this incomplete understanding, however, through a compromise. Frequently, such a compromise takes the form of a carve-out in which the secured creditor permits the use of a specified amount of collateral to fund the costs of administrative and secured claims. Thus, the bankruptcy system can accommodate some uncertainty regarding the precise scope of the secured claim in many cases.

For some, this ability to accommodate uncertainty is a feature and not a bug. The incorporation of broad standards that produce uncertainty allow participants in the process, including the bankruptcy judge, room to fashion well-tailored and creative solutions to the myriad problems financial distress raises. The debate over precision versus flexibility is a long running one that is unlikely to be resolved here. Suffice to say it is my general position that uncertainty in commercial law is something to be avoided. Facts are messy enough, even under clear rules, and satisfactory solutions are most likely achieved when the participants are consulting the same rule book. The fact that the system muddles through on an incomplete understanding of the basic entitlements of the secured and unsecured creditors does not mean that the answer is unimportant, however. Certainly, all of the complex issues that arise in a bankruptcy case could be resolved


233 Id. (discussing the control of unsecured creditors).


more efficiently if everyone started with a shared understanding of the secured creditors’ entitlements. In fact, the issue is so fundamental that the most recent large-scale study of the Chapter 11 process, conducted under the auspices of the American Bankruptcy Institute, focused intensely on the effect of secured credit on the bankruptcy process.\textsuperscript{236} Front and center in that discussion was the question of cash flow lending using effective entity priority and the desire of those secured lenders to amend the Code to better support cash flow lending.\textsuperscript{237} The Commercial Finance Association and the Loan Syndications and Trading Association\textsuperscript{238} provided extensive testimony to the Commission in an effort to assure secured creditors’ full priority and recommended changes that would recognize the right of cash flow lenders to a broad priority in post-bankruptcy property. The conclusions of the Commission clearly disappointed the secured lending community on several fronts.

Although the Commission’s report called for secured creditors’ distributional rights to be measured by a going concern valuation of their collateral at the end of the case, the report also recommended steps that would limit the scope of the collateral securing that claim. The Commission recommended that adequate protection be based on the foreclosure value of collateral,\textsuperscript{239} a valuation standard which exposes the secured creditor’s ultimate right to going concern value to priming by third-party financiers.\textsuperscript{240} Another recommendation was that the “equities of the case” exception in section 552(b) be expanded to provide broader limits on the right of a secured creditor to claim post-petition assets as proceeds.\textsuperscript{241} Specifically, the Commission recommended that the exception could be satisfied without a showing of specific contributions of money or unencumbered property, but instead that the secured creditor’s right to proceed could be limited on any showing of the estate’s contribution of value—“whether through time, effort, money, property, other resources, or cost savings.”\textsuperscript{242} The expansion of the

\begin{footnotesize}
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\item[236] ABI COMMISSION REPORT, supra note 5, at 2–3.
\item[237] See id. at 71 n.283 (discussing Commercial Finance Association’s recommendations regarding cash flow lending including the recommendation that adequate protection rights be determined by using going concern value).
\item[238] The LSTA provided a critical response to the Commission Report. See LSTA RESPONSE, supra note 232, at 7, 39, 46.
\item[239] See ABI COMMISSION REPORT, supra note 5, at 67–73 (discussing that the amount of adequate protection required under the Bankruptcy Code “to protect a secured creditor’s interest in a debtor’s property should be determined based on the foreclosure value of the secured creditor’s collateral”).
\item[240] See LSTA RESPONSE, supra note 232, at 39 (“The upshot of the Report’s proposal is that debtors will have greater ability to use (and potentially dissipate or depreciate) collateral and to prime pre-petition lenders’ liens, to the detriment of secured creditors.”).
\item[241] See ABI COMMISSION REPORT, supra note 5, at 230 (recommending that the trustee not be required to “establish an actual expenditure of funds to show that the estate enhanced the value of a secured creditor’s collateral for purposes of the equities of the case determination under section 552(b)”).
\item[242] Id. at 234.
\end{enumerate}
\end{footnotesize}
equities exception threatens the secured creditor’s claim to effective entity priority by envisioning the bankruptcy process itself as providing a source for increased value that does not fall within the scope of identifiable proceeds.\(^\text{243}\)

V. A PRELIMINARY CASE FOR FULL ENTITY PRIORITY

Although the Commission Report has not resulted in Congressional action, the extensive discussions and commentary leading to the report lay bare the controversy over the extent of secured creditors’ priority. Arguments over entity-based versus asset-based conceptions of secured credit will likely continue to plague bankruptcy reorganizations until law reform tilts the playing field in one direction or the other. Relatively small changes, like those proposed by the Commission or the secured lending community, might provide some incremental clarity. But it is also possible to imagine wholesale changes that might push secured credit in one direction or the other.

One could imagine either a return of secured credit to its asset-based roots, or a complete capitulation to the desires of the secured lending community for entity priority. As Jacoby, Janger, and others have suggested, secured creditors’ claims might be limited to the liquidation value of their collateral and security interests where proceeds are limited to those that can be strictly tied to pre-petition collateral through some form of direct transactional link. In the alternative, commercial and bankruptcy law might fully embrace entity priority by making it possible for creditors to take full priority in the entity itself. Either path presents difficulties in balancing the cost and availability of capital with the desire to benefit junior creditors who are unable to negotiate for a preferred position.

Consider a change that would fully embrace entity priority by granting secured creditors a broad interest in the entity itself and therefore in the cash flows of the entity. It is not self-evident that a priority system that blends asset-based and entity-based priorities is superior to one that simply allocates priority to the entire value of the entity. Indeed, secured credit aside, distribution and control of the debtor is determined on an entity priority basis. The basic rules governing distribution to investors other than secured creditors call first for the distribution of value to pay the expenses of administration.\(^\text{244}\) Distribution then goes to a small group of favored

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\(^{243}\) See LSTA RESPONSE, supra note 232, at 46–47 (“The practical result of this proposal is that a significant portion of increases in the value of the secured creditor’s collateral during the bankruptcy case will go to the debtor’s estate and the junior stakeholders, not to the secured creditor, even where those increases are not the result of expending unencumbered assets that would have otherwise been available to unsecured creditors”).

creditors, and to unsecured creditors.\footnote{See id. § 507(a)(3)-(10) (priority claims); § 726 and 1129 (b)(2) (unsecured claims).} Finally, distribution goes to the debtor for the benefit of equity holders, who are also organized on an entity priority basis.\footnote{See id. § 1129(b) (providing the default priority rules in Chapter 11).} The evolution of secured lending from simple asset-based finance to full cash flow lending might be something to be embraced and facilitated, rather than forced into the ill-fitting doctrinal structure described here. There are some reasons why such a change might prove beneficial.

Such a move to full entity priority might streamline the bankruptcy process by eliminating fights over asset values and permitting a single enterprise valuation to set a baseline for control and distributional rights. Control over the assets could be allocated on the basis of priority, and decisions regarding financing, asset sales, replacement of management, closure or enhancement of facilities, and other decisions about the future of the business could be made by the class of creditors who stand to gain or lose from those decisions. Full entity-based priority would make swift and certain the shift in ownership and control over assets that theoretically form the basis of the bankruptcy process.

For many, such a view is heretical when considering the distributional consequences that accompany secured credit. Naturally, any move that increases one creditor’s recovery necessarily impacts all of the other creditors. Thus, a move to entity-based priority that enhances a secured creditor’s recovery will come at the cost of distributions to other, more vulnerable and perhaps more sympathetic or deserving claimants.

Entity-based priority would have its greatest impact on unsecured, non-institutional creditors—the very group of creditors most affected by the presence of secured credit under the present system. As a number of commentators have observed, the risk of the business enterprise should normally be unaffected by the way in which that risk is distributed among the creditors and shareholders. A priority that reduces the risk of one class of creditors should normally be offset by a corresponding increase in the risk of other, non-favored classes.\footnote{The problem is an application of the Modigliani-Miller irrelevance hypothesis, which holds that the value of a firm is a function of the firm’s cash flow and that it is independent of the way in which its capital structure is ordered. See Alan Schwartz, Taking the Analysis of Security Seriously, 80 VA. L. REV. 2073, 2079–80 (1994) (discussing the application of the Modigliani-Miller hypothesis).} The problem, then, is to explain why the granting of priority adds value. Otherwise, a system that provides a priority might only be explained by the fact that it permits wealth transfers by allowing the firm and the secured creditor to externalize the risk of the business onto claimants who are unable to demand a return sufficient to compensate them for the added risk. Certainly, non-consensual creditors such as tort or governmental claimants are not compensated for the added risk priority claims place on them. But even consensual creditors may see
their uncompensated risk increased by priority claims. Small vendors, employees, and the like lack the ability to negotiate for priority themselves and may be unable to adjust their contracts to compensate for the risk that secured credit imposes on them.\textsuperscript{248}

Uncertainty over the scope of secured creditors’ claims provides bargaining leverage that unsecured creditors use to extract distributions—frequently in the form of a carve out from the secured creditor’s collateral.\textsuperscript{249} Thus, doubt over the scope of secured creditor’s claims accomplishes distributional goals.

Doubtless, unsecured creditors do benefit from rules that limit secured creditors’ claims.\textsuperscript{250} Again, some view the achievement of those benefits to be an advantage of uncertainty.\textsuperscript{251} It is less clear, however, that any increased distributions from uncertainty bear any relationship to the unsecured creditors’ needs or expectations, or any other criteria for such a distribution. For example, one may judge the contributions of trade creditors to the value of a debtor worthy of a distribution of a particular amount or a particular portion of their claims. Whether that creditor group obtains such a distribution is dependent not on the application of any particular criterion, but instead on the strength of the secured creditor’s claim and the negotiating leverage that that strength provides. Adding uncertainty and complexity to the bankruptcy process seems like a particularly bad way to vindicate such claims. A streamlined process—one that eliminates the difficult value allocation questions that asset-based priority requires—might provide a way to address directly the claims of various stakeholders to distributions.

Simply creating a system of entity priority for senior claimants says nothing about which claimants should occupy the senior class. A system of entity priority must elevate all of the expenses of administering the bankruptcy over the claims of all creditors.\textsuperscript{252} Currently, the bankruptcy system is thought to operate for the primary benefit of unsecured creditors.\textsuperscript{253} Therefore, the expenses of administration take priority over the entity priority accorded the unsecured creditors. Unless the trustee or debtor in possession can show that the estate expended funds that directly benefitted

\textsuperscript{248} See Lucian Arye Bebchuk & Jesse M. Fried, The Uneasy Case for the Priority of Secured Claims in Bankruptcy, 105 YALE L.J. 857, 882–91 (1996) (discussing various types of “non-adjusting” creditors, such as private involuntary creditors, government tax and regulatory claims, voluntary creditors with small claims, and prior voluntary creditors).

\textsuperscript{249} See Mooney, Jr., supra note 234 (discussing carve-outs for administrative expenses and to fund distributions to junior creditors).

\textsuperscript{250} See id. at 750–51 (describing how secured creditors may carveout from proceeds of a sale to “cover professional fees and other administrative expenses” and to fund distributions “for the benefit of general unsecured creditors”).

\textsuperscript{251} See discussion supra Part IV.

\textsuperscript{252} Cf. Bebchuk & Fried, supra note 248, at 862–63 (noting that the principle under current law of giving priority to secured creditors versus administrative expenses is “firmly established in the law”).

\textsuperscript{253} See supra Introduction.
the secured creditor, the secured claims are paid before administrative expenses. Entity priority would mean that any amounts expended in the bankruptcy proceeding would benefit the entity itself, and therefore all of the claimants. Thus, administrative claims should occupy the first priority.

Entity priority would also provide an opportunity to address directly distributions to various classes of prebankruptcy creditors. Commentators generally agree that tort and other involuntary claimants should receive priority over voluntary creditors, including secured creditors. Such priority should also be accorded in an entity priority to assure that contract claimants do not externalize the cost and risk of the business operations to those who are not parties to the bargain. Despite the arguments in favor of this priority, our current system leaves these involuntary claimants subordinate to the interests of the secured creditors. Granting involuntary claimants an entity priority would provide an effective way to accomplish this change.

Priorities for voluntary but vulnerable claimants might also be accomplished. Employee and vendor priorities might be instituted to allow a direct and predictable method by which distributions to these creditors might be provided. Carve-outs for preferred claims have off-and-on been a feature of the insolvency laws of the United Kingdom. The carve-outs have historically applied to floating charges—the U.K.’s version of security interests that provide for interests in accounts, inventory, and other collateral that is subject to a constant turnover and that provide the floating charge lender a high degree of control over the insolvency process. The U.K.’s experience with carve-outs has not been a complete success, however, owing to the fact that they could be defeated by asset-based priority provided by a fixed charge, and that secured lenders were able to manipulate their lending structure to defeat the claims. In part, however, the problems that the U.K. has experienced appear to be very similar to the types of difficulties that our own asset- and entity-based systems create. The difficulties that the U.K. has had in making carve-outs effective may largely be due to the design of the system, and those difficulties may not be insurmountable.

254 11 U.S.C. § 506(c) (2012) ("The trustee may recover from property securing an allowed secured claim the reasonable, necessary costs and expenses of preserving, or disposing of, such property to the extent of any benefit to the holder of such claim . . . .")

255 See Bebchuck & Fried, supra note 248, at 883 (noting that commentators argue that “tort creditors [should] be given priority over secured claims”).

256 Id. (noting that as long as tort creditors are not given a “superpriority” over other creditors, they will continue to be subordinate to other creditors).


258 Id. at 549–50.

259 See id. at 554–57 (discussing lenders’ reactions to the carve-out and the courts’ responses).

260 Id. at 559 ("[A] carve-out that applies to only one species of functional security is easy to avoid.").
Of course, no system of priority will completely and perfectly protect the interests of various creditor constituencies from the losses occasioned by financial failure. But a priority system that is tied to entity itself might provide more certain outcomes than one that relies on a mix of asset-based and entity-based priorities. In all likelihood, such a system would be preferable to the present one in which carve-outs from the secured creditor’s priority are based on negotiating leverage that results from legal uncertainty.

Entity priority could also have an effect on the administration of bankruptcy cases. As is the case with the distributional consequences outlined above, the effect on the bankruptcy process requires a cautious approach. Entity priority would eliminate costly battles over the allocation of value that are a feature of asset-based priority but would not eliminate the need for a process to deal with the significant control issues that bankruptcy raises. Fortunately, the bankruptcy process has at least the theoretical capability to allocate control rights efficiently even in an entity-based priority system.

The allocation of control rights is an important question for any insolvency system. Ideally, the bankruptcy process should allocate control over the use of the business assets to the group of claimants who have the best incentive to maximize the value of those assets. The holders of the fulcrum security—the claimants who stand to gain or lose from marginal decisions about the use of the assets—thus should have the ability to influence decisions regarding those assets. Our governance systems generally recognize this principle. In solvent businesses, control rights are allocated to shareholders. In the bankruptcy of an insolvent business, control generally shifts to the unsecured creditors, or to some class of under-secured creditors depending on the value of the assets and the amount of the secured claims.\(^\text{261}\) In this way, the system generally seeks to locate decision-making authority in the class of claimants who are in the best position to evaluate investment decisions. If the system fails and instead grants control rights to out-of-the-money claimants, the choice will lead to problems of overinvestment that manifest in prolonged reorganizations and increased risk. At the same time, if the system grants control rights to claimants who are assured of full payment—for example, the over-secured creditor—decisions will result in underinvestment and potential “fire-sales” of bankruptcy assets.\(^\text{262}\)

Commentators have long noted that the control rights broad based security interests grant to creditors creates a risk of fire-sales—or worse, a

\(^\text{261}\) See Tracing Equity, supra note 13, at 715 (discussing how creditors assert control rights in the bankruptcy process).

\(^\text{262}\) See Ice Cube Bonds, supra note 10, at 901 (“An over[-]secured creditor that would like to exit the case quickly may be indifferent to maximizing value beyond its own payment.”).
threat of actual misappropriation of value.\textsuperscript{263} Jay Westbrook, for example, has noted that a sale by a dominant secured creditor creates a “free-rider problem” in which the secured creditor lacks any incentive to realize more than the amount it is owed because any excess would have to be distributed to others.\textsuperscript{264} He further observed that the right of a secured creditor to credit-bid creates the possibility that secured creditors could bid in its debt in a poorly designed sale process and buy the assets at a substantial discount, profiting from its control at the expense of lower priority claimants.\textsuperscript{265} Jacoby and Janger have made similar observations, noting that blanket liens and credit bidding might defeat protections, such as the merger and true sale doctrines, which prevent secured creditors from squeezing out junior creditors whose interests might be “in the money.”\textsuperscript{266}

These incentive problems are largely independent of the type of priority structure (entity based or asset based) the system adopts. Any hierarchical priority structure requires some method of allocating control rights and creates a risk that control will be misallocated. Dismantling secured credit might have some effect on reducing the problem of underinvestment and fire-sales but might create the opposite effect—overinvestment and prolonged reorganizations. At the same time, strengthening secured credit by providing for entity-based priority does not eliminate the need for a judicial process to prevent fire-sales and, even worse, expropriation by fully secured creditors of value belonging to junior claimants. Entity priority (or at least the presence of a dominant secured creditor) is a necessary component of proposed contract-based bankruptcy systems that eschew judicial procedures for bankruptcy bargains based on ex-ante contracts.\textsuperscript{267} It does not follow, however, that entity-based priority requires such a system. Thus, adoption of entity priority does not eliminate the problem of allocating control—if anything it highlights it in a way that it might be directly handled. The adoption of a clear priority scheme might therefore be preferable to the existing scheme—which obscures control debates behind a veil of litigation over the scope of secured claims and the allocation of asset values.

CONCLUSION

If the history of secured lending shows anything, it shows a relentless trend toward expanding the scope of secured creditors’ priority through inventive commercial practice. As a consequence, debates over the scope of secured lenders’ priority have been a persistent feature of bankruptcy law—

\textsuperscript{263} See Westbrook, supra note 3, at 844–45 (noting that a bankruptcy system dominated by secured creditors may be problematic because it leads to free-riding and self-interested behavior).

\textsuperscript{264} Id.

\textsuperscript{265} Id. at 846–47.

\textsuperscript{266} Tracing Equity, supra note 13, at 714–16.

\textsuperscript{267} See Westbrook, supra note 3, at 830–37 (discussing “secured contractualism” as a contract-based bankruptcy system).
a feature that is often obscured by the operation of the bankruptcy system. The ability of a secured creditor to claim an interest in the entire value of the debtor as an entity and not just a collection of disparate assets is an example of such a debate. Blanket lien creditors often claim to have entity priority, but such claims rest on complicated doctrinal arguments that are not often made explicitly. This Article has attempted to cut through that obscurity and provide a doctrinal foundation upon which the asset-based approach of secured transactions law can provide effective entity priority.

That doctrinal foundation relies on the notion that the firm is a closed system in which the firm creates cash flow during bankruptcy solely through the use of secured creditor’s pre-bankruptcy collateral. If a secured creditor holds a security interest in everything at the beginning of the case, the value generated during the case is logically proceeds of that collateral. There are a number of ways the closed system might be factually defeated through the introduction of non-collateral into the firm’s production, and this Article has addressed those ways. In theory and practice, however, it remains possible for a secured creditor to cast a broad enough net prebankruptcy to obtain an effective entity priority.

Although effective entity priority is both practically and theoretically possible, the creation of that priority under an asset-based system relies on a doctrinal structure that is both ill-fitting and fragile. Several commentators have challenged the notion that secured creditors can obtain entity priority, and recent law reform activities have been directed at eliminating some of the foundations of the closed system theory in ways that would limit secured creditors’ priority to an asset basis. This Article provides a preliminary case for moving in the opposite direction, by directly embracing the ability of secured creditors to obtain priority in the entity and not just in the assets of the entity. By allowing secured creditors to obtain true entity priority, our debt collection system would be enhanced by eliminating costly battles over the allocation of value that are common to the asset-based priority structure.

The distributional effects of such a move might be directly addressed through a system of statutory carve-outs that would provide a predictable means of compensating involuntary and vulnerable claimants from the additional risks that entity priority might impose.

Although the normative case for full entity priority presented here is only preliminary, there is reason to believe that it would provide better outcomes than the current blend of asset and entity priorities. There is nothing inevitable about the current system, and reimagining the priority system along these lines is a project well worth undertaking.