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Postpetition Interest Under the Bankruptcy Code

David Gray Carlson

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ARTICLE

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DAVID GRAY CARLSON*

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I. INTRODUCTION

Bankruptcy trustees hate liens and would like to destroy them. If they succeed, the general creditors will be enriched (and the trustee's fees will be increased). Let us suppose, however, that a trustee has done everything in her power to destroy a secured party's lien, but has been unable to do it. Given that the secured and unsecured creditors now have to live with each other,¹ the trustee's second-best strategy is to steal as much value from the secured credi-

1. This is not to say that the trustee is entitled to hold a secured party's collateral arbitrarily. Even if the trustee supplies adequate protection to a secured party, the trustee must abandon the collateral to the secured party, unless (a) the debtor has equity in the collateral, 11 U.S.C. § 362(d)(2)(A) (1982 & Supp. IV 1986), or (b) even if the debtor does not have equity, the collateral is necessary to an effective debtor reorganization, *id.* § 362(d)(2)(B), or (c) the trustee claims the secured party's liens are voidable. *First State Bank of Crossett Arkansas v. W.E. Tucker Oil, Inc.* (*In re W.E. Tucker Oil, Inc.*), 42 Bankr. 897, 903 (Bankr. W.D. Ark. 1984). If none of these conditions is true, the secured party is entitled to have the automatic stay lifted. 11 U.S.C. § 362(d)(2) (Supp. IV 1986). *But see In re Missimer*, 44 Bankr. 219, 219 (Bankr. E.D. Pa. 1984) (court claimed discretion to keep stay in effect, even though there was no reorganization and no equity, provided debtor met scheduled mortgage payments). If the debtor has equity in the collateral, the trustee may retain the collateral on the theory that the bankruptcy trustee will maximize the value of the equity for the benefit of the general creditors. In contrast, a profit-maximizing secured party will cease to maximize value when she recovers her own claim. If the trustee retains the collateral in order to maximize the debtor equity, then the interest of the secured party is maximized automatically when the interests of the general creditors are maximized. *See Carlson, Simultaneous Attachment of Liens on After-Acquired Property*, 6 CARDOZO L. REV. 505, 532-33 (1985).

For burdens of proof under Section 362, see *In re Planned Systems, Inc.*, 78 Bankr. 852, 858-60 (Bankr. S.D. Ohio 1987); Kennedy, *The Automatic Stay in Bankruptcy*, 11 U. MICH. J.L. REF. 177, 226-27 (1978) [hereinafter Kennedy, *Stay Under Old Act*]; Miller, *The Automatic Stay in Chapter XI Cases—A Catalyst for Rehabilitation or an Abuse of Creditors' Rights?*, 94 BANKING L.J. 676, 702-16 (1977) [hereinafter Miller, *The Stay in Chapter XI*]. For a discussion of the meaning of "necessary to an effective reorganization," see *In re Planned Systems, Inc.*, 78 Bankr. at 864-66; *In re Belton Inns, Inc.*, 71 Bankr. 811, 817-18 (Bankr. S.D. Iowa 1987). Generally, such questions will not be addressed in this Article.

Assuming that the trustee *can* retain the collateral for one of the above reasons, the trustee must supply adequate protection—entitlements that assure a secured party's claim will not be prejudiced over the life of the bankruptcy. If the trustee fails to do this, the secured party is entitled to have the stay lifted for cause. 11 U.S.C. § 362(d)(1) (Supp. IV 1986).

tors as possible.² Standing in the way of the trustee, however, is the rule that the trustee must give "adequate protection" to any security interest.³

The idea of adequate protection, however, presupposes a knowledge of the property right to be protected. One of the most difficult issues in bankruptcy is whether the security interest to be protected includes the right to "postpetition interest"—interest that accrues after the bankruptcy petition is filed and before the proceeding is terminated by liquidation or confirmation of a Chapter 11 plan. In a variety of ways, adequate protection is intricately tied up with this question of "postpetition interest." There are several issues. First, should *undersecured* parties—secured parties whose total claim has a higher face value than the value of the collateral—receive postpetition interest to which general creditors are not entitled?⁴ Or should *undersecured* parties receive postpetition interest because *oversecured* parties receive it?⁵ Or should we ignore such analogies and instead choose a rule on instrumental grounds of public policy? Second, with regard to *oversecured* parties, should the debtor's equity in the collateral serve as a limit on how much interest an *oversecured* party can get? Or should an *oversecured* party receive regular interest beyond the amount of debtor equity, so long as at least *some* debtor equity exists when the bankruptcy commences.

The task of describing the entitlement to postpetition interest has

2. I am assuming that the trustee is performing her fiduciary duties in order to maximize the bankrupt estate for the general creditors. The trustee therefore is portrayed as wanting to steal from the secured creditors in order to benefit the general creditors. If the trustee is *purely* self-interested, she will want to steal for herself, and both the secured *and* unsecured creditors will be her victims. See *infra* text accompanying note 262.

It might be also added that when the trustee is the "debtor in possession" (DIP)—and this will *very* commonly be the case at the start of a proceeding in a business bankruptcy—the secured party might have a strong bargaining position against DIP speculations if the secured party is the most likely supplier of future capital infusions.

3. 11 U.S.C. § 363(e) (Supp. IV 1986). Even security interests that are challenged as voidable preferences must be adequately protected, pending the outcome of the challenge. See *Greives v. Bank of Western Indiana*, (*In re Greives*), 81 Bankr. 912, 967 (Bankr. N.D. Ind. 1987); *Hoyt, Inc. v. Born*, (*In re Born*), 10 Bankr. 43, 47 (Bankr. S.D. Tex. 1981). In addition, the trustee must devise the plan for adequate protection, not the court. *Travelers Ins. Co. v. American AgCredit Corp.*, (*In re Blehm Land & Cattle Co.*) 859 F.2d 137, 139 (10th Cir. 1988). Adequate protection plans, however, require court approval, unless the secured party assents. *Id.*

4. Section 502(b) states that a general creditor is allowed only "the amount of [a] claim . . . as of the date of the filing of the [bankruptcy] petition." 11 U.S.C. § 502(b) (Supp. IV 1986). Section 502(b)(2) also bars claims for unmatured interest. 11 U.S.C. § 502(b)(2) (Supp. IV 1986). The combination of these ideas means general creditors do not receive postpetition interest. But see 11 U.S.C. § 726(a)(5) (Supp. III 1985) (After all other claims are paid, general creditors may get postpetition interest, but only at the mediocre "legal rate.").

5. See 11 U.S.C. § 506(b) (Supp. IV 1986).

been complicated recently by the Supreme Court in *United Savings Association of Texas v. Timbers of Inwood Forest Associates*.⁶ In *Timbers of Inwood Forest*, the Supreme Court held that a security interest belonging to an undersecured party does *not* include postpetition interest; therefore "adequate protection" does not include the protection of this right.⁷ It remains true, however, that *oversecured* parties remain entitled to postpetition interest.⁸ But as postpetition interest accrues all oversecured parties will become undersecured parties, if the bankruptcy proceeding lasts long enough. The problem is that the principal device that protects secured parties—the excess value in the collateral beyond the amount of the secured claim—also serves as the measure for the amount of postpetition interest an oversecured party can get.

This Article explores both the doctrinal and ethical complexities of the collision between postpetition interest entitlements and the adequate protection doctrine. Section II of this Article commences with a brief look at "adequate protection" under the old Bankruptcy Act⁹ and the new Bankruptcy Code.¹⁰ Section III examines postpetition interest both under the 1898 Act¹¹ and under the new Bankruptcy Code. As it turns out, the Bankruptcy Code is profoundly unable to determine whether undersecured parties should receive postpetition interest as part of adequate protection.¹² Section III also examines

6. 108 S. Ct. 626 (1988).

7. *Id.* at 635.

8. See 11 U.S.C. § 506(b) (Supp. IV 1986).

9. Ch. 541, § 1, 30 Stat. 544 (1898) (supplemented in 1938 by the Chandler Act, ch. 575, § 1, 52 Stat. 840 (1938)). It is collectively referred to as the Bankruptcy Act.

10. Pub. L. No. 95-598, 92 Stat. 2549 (1978) (codified as Title 11 of U.S.C. (1982)).

11. Ch. 541, § 1, 30 Stat. 544 (1898).

12. The commentators are vociferous that Section 361, 11 U.S.C. § 361 (1982 & Supp. IV 1986), has a clear meaning with regard to postpetition interest, but they disagree as to what that meaning is. Compare O'Toole, *Adequate Protection and Postpetition Interest in Chapter 11 Proceedings*, 56 AM. BANKR. L.J. 251, 262 (1982) ("close attention to section 361 and related provisions can leave little doubt that no such protection is contemplated by the Code") with *Crocker Nat'l Bank v. American Mariner Indus., Inc. (In re American Mariner Indus., Inc.)*, 734 F.2d 426, 430 (9th Cir. 1984) (stating the opposite is the "plain meaning" of the Bankruptcy Code); see also Note, "Adequate Protection" and the Availability of Postpetition Interest to Undersecured Creditors in Bankruptcy, 100 HARV. L. REV. 1106, 1115 (1987) ("The words of the Bankruptcy Code by themselves compel no answer to the issue of postpetition interest; the legislative history of the sections dealing with adequate protection provides only incoherent and unhelpful guidance.").

If there is one person who should know what is intended by the Bankruptcy Code, it is the man who co-wrote it: Kenneth Klee, a former counsel to the House Judiciary Committee. Klee recently has declared that Congress intended that undersecured creditors get *no* postpetition interest. Klee & Merola, *Ignoring Congressional Intent: Eight Years of Judicial Legislation*, 62 AM. BANKR. L.J. 1, 29-36 (1988). In an unguarded moment, however, Klee admits, "the issue was never raised." *Id.* at 34. Therefore, even assuming that congressional

the Supreme Court's recent opinion in *Timbers of Inwood Forest* which takes a strong position against a postpetition interest entitlement.¹³ An examination of this opinion will show the Supreme Court to be unpersuasive in its statutory analysis.

Since *Timbers of Inwood Forest* does not clearly preclude postpetition interest as a matter of judicial discretion,¹⁴ Sections IV and V look at the efficiency and fairness of postpetition interest entitlements for undersecured creditors. By way of preview, I will show that the efficiency argument has no good empirical basis and is therefore not credible. The fairness arguments tend to fail because they assert that undersecured creditors deserve to be compensated for their loss, without explaining why *unsecured* creditors do not deserve the same treatment. Section VI examines oversecured creditors and the postpetition interest entitlement. Finally, Section VII asks whether regulation against postpetition interest is even possible, or whether the cleverness of lawyers will always be one step ahead of such regulative efforts.

We commence with a look at the historical origins of adequate protection.

II. ADEQUATE PROTECTION

A. Under the 1898 Act

Under the Bankruptcy Act of 1898, courts could stay the enforcement of security interests.¹⁵ The Bankruptcy Act contained

intent and Klee's intent are the same thing, it would appear that the question is not determined by the words of the Bankruptcy Code.

13. 108 S. Ct. 626 (1988).

14. *Id.* at 635. Nothing in the opinion clearly precludes postpetition interest in *every* case. Nevertheless, it has proved tempting to read the Supreme Court's opinion as ruling that undersecured parties should *never* get postpetition interest. See *Cimarron Investors v. Wyid Properties (In re Cimarron Investors)*, 848 F.2d 974, 976 (9th Cir. 1988) ("considerations based on alleged fairness and equity are not relevant when the statute, as interpreted by the Supreme Court, bars [such an] interpretation"); *Fairfax Savings v. Sherwood Square Assocs. (In re Sherwood Square Assocs.)*, 87 Bankr. 388, 391-92 (Bankr. D. Md. 1988) (past postpetition interest actually paid but now deemed improper was deemed to have reduced the secured claim *pro tanto*); Schorer, *The Right of the Undersecured Creditor to Postpetition Interest in Bankruptcy on the Value of Its Collateral: Implications of Recent Cases*, 21 U.C.C. L.J. 61, 62 (1988).

15. Ch. 541, Sec. 11, 30 Stat. 549 (1898). For a description of the power of bankruptcy courts to stay lien enforcement under the 1898 Act, see Countryman, *Real Estate Liens in Business Rehabilitation Cases*, 50 AM. BANKR. L.J. 303, 304 (1976); Kennedy, *Automatic Stays Under the New Bankruptcy Law*, 12 U. MICH. J.L. REF. 3 (1978) [hereinafter Kennedy, *Stay Under New Law*]; Kennedy, *Stay Under Old Act*, *supra* note 1, at 177; Miller, *The Stay in Chapter XI*, *supra* note 1, at 676; Peitzman & Smith, *The Secured Creditor's Complaint: Relief from the Automatic Stays in Bankruptcy Proceedings*, 65 CALIF. L. REV. 1216, 1217-19 (1977); Murphy, *Restraint and Reimbursement: The Secured Creditor in Reorganization and Arrangement Proceedings*, 30 BUS. LAW. 15 (1974); Murphy, *Use of Collateral in Business*

no requirement of adequate protection during the pendency of this injunctive restraint. A secured party in a liquidation could ask that the stay be lifted if the debtor had no equity in the collateral. But if the stay was not lifted, then no provision was made for adequate protection of the secured party's position. The secured party simply took her chances and hoped to collect from the cash proceeds. If the proceeds were insufficient to cover the senior sales expense of the trustee and the secured party's claim, that was just too bad for the secured party.

In reorganization cases, the Chandler Act¹⁶ provided secured parties with adequate protection, but adequate protection meant something very different from the modern meaning. Today, adequate protection means protecting the value of a secured claim during the time the automatic stay is in effect¹⁷—that is, the time between the filing of the bankruptcy petition and the confirmation of the plan (or

Rehabilitations: A Suggested Redrafting of Section 7-203 of the Bankruptcy Reform Act, 63 CALIF. L. REV. 1483, 1486-95 (1975); Rosenberg, *Beyond Yale Express: Corporate Reorganization and the Secured Creditor's Rights of Reclamation*, 123 U. PA. L. REV. 509, 518-20 (1975). If you only have time to read one of these articles, choose Kennedy's first article. Kennedy, *Stay Under Old Act*, *supra* note 1. It is both accessible and encyclopedic in scope.

The situation may be summarized as follows. In the case of a straight liquidation, a bankruptcy court had no jurisdiction over property that the secured party had already repossessed. Foreclosures and repossessions already commenced by the time of the bankruptcy petition was filed could continue without interference. *Straton v. New*, 283 U.S. 318, 320-21 (1931). If foreclosure or repossession had not commenced, however, the property is within the jurisdiction of a federal court, *Isaacs v. Hobbs Tie & Lumber Co.*, 282 U.S. 734 (1931), and Former Bankruptcy Rule 601 stayed the commencement of any foreclosure proceeding. The stay might have been lifted, however, if the debtor has no equity in the property. *Knapp v. Seligson (In re Ira Haupt & Co.)*, 398 F.2d 607, 612-13 (2d Cir. 1968).

In reorganization, the Bankruptcy Act contained three different chapters. Chapter X provided for the appointment of a mandatory trustee if liquidated debts exceeded \$250,000. Chandler Act, ch. 575, § 156, 52 Stat. 888 (1938). This feature distressed corporate management, but this chapter allowed for altering the rights of secured parties, provided the secured parties received equivalent values. *Id.* at § 212, 52 Stat. 895. Chapter XI provided for the possibility of a debtor-in-possession (DIP), and therefore corporate management favored it. Chapter XI could not, however, affect any of the rights of a secured party. *Id.* at § 342, 52 Stat. 909. When a Chapter XI plan was confirmed, the stay was lifted and the secured parties were free to have it. *Id.* at § 367(4), 52 Stat. 912. Chapter XII covered noncorporate reorganizations in which the debt was primarily secured by real estate; it provided for DIPs and could affect the rights of mortgagees. *Id.* at § 444, 52 Stat. 920.

Originally, automatic stays were only in Chapters X and XII, but lawyers routinely asked for and obtained nonautomatic stays. *Id.* at § 112, 52 Stat. 884 (Chapter X); *id.* at § 414, 52 Stat. 917-18 (Chapter XII). By the mid-1970's, ongoing lien enforcement actions were automatically stayed in each of the Chapters, even after repossession.

16. Ch. 575, § 1, 52 Stat. 840 (1938). The original Bankruptcy Act contained no reorganization provisions. Instead, reorganizations were accomplished under equity receiverships. After 1933, legislation was enacted to cover reorganization, and in 1938, Congress passed the Chandler Act to make reorganization proceedings more effective. *See id.*

17. 11 U.S.C. § 362(a) (Supp. IV 1986).

liquidation sale). After the plan is confirmed or the liquidation sale¹⁸ is complete, the automatic stay lapses. Adequate protection is irrelevant to the post-plan or post-sale time period.¹⁹

Under the Chandler Act, adequate protection meant just the opposite. The phrase had no relevance to the time between the petition and the confirmation of a plan or liquidation sale. Adequate protection instead referred to what dissenting secured parties were entitled to in a reorganization plan. In other words, the plan itself had to protect the secured claim adequately.²⁰ Adequate protection therefore was shorthand for an equivalent exchange between a secured party's nonbankruptcy rights and the rights to be given under the reorganization plan.

Before the plan was confirmed, enforcement of all security interests was stayed, but the reorganization provisions of the old Bankruptcy Act did not provide any express adequate protection of secured parties.²¹ Nevertheless, secured parties frequently asked for relief from these stays on the ground that they would cause undue harm to the secured parties. The requirement of undue harm as cause to lift the stay was created by case law²² out of the old equitable doctrine that preliminary injunctions should not issue unless, first, the plaintiff would probably succeed on the merits, and, second, the defendant would not be unduly harmed.²³

Pursuant to this standard, reorganization courts developed the

18. The sale might or might not be made free and clear of liens. 11 U.S.C. § 363(f) (1982 & Supp. IV 1986). In either case, the automatic stay no longer stops enforcement of a security interest. If the sale is made free of liens, however, the lien on the collateral no longer exists; it is deemed transferred to the cash proceeds received by the trustee in the sale.

19. *In re Johnson*, 63 Bankr. 550, 553 (Bankr. D. Colo. 1986) (Chapter 13).

20. See Chandler Act, ch. 575, § 216(7), 52 Stat. 896 (1938). This Section required the plan:

[to] provide for any class of creditors which is affected by and does not accept the plan by the two-thirds majority in amount required under this chapter, adequate protection for the realization by them of the value of their claims against the property dealt with by the plan.

Id.

21. An exception of a sort existed for rolling stock, airplanes and ships, Bankruptcy Act §§ 77(j), 116(5) & (6), and for mortgages insured under the National Housing Act mortgages. *Id.* §§ 263, 517. These provisions saved such security interests from automatic stays altogether.

In the Bankruptcy Code, ships, planes and rolling stock are immune from the automatic stay only if the trustee, with court approval, agrees to perform all obligations under the security agreement. 11 U.S.C. §§ 1110(a), 1168(a) (1982 & Supp. IV 1986)).

22. See *In re Chicago, Rock Island & Pac. R.R.*, 545 F.2d 1087, 1090 (7th Cir. 1976); *In re Penn Cent. Transp. Co.*, 494 F.2d 270, 276 (3d Cir.), *cert. denied*, 419 U.S. 883 (1974); *Caplan v. Anderson*, 256 F.2d 416, 419 (5th Cir. 1958); *In re Third Ave. Transit Corp.*, 198 F.2d 703, 707 (2d Cir. 1952).

23. See Kennedy, *Stay Under Old Act*, *supra* note 1, at 239-40 (rehabilitation proceedings

custom of conditioning the continuance of the injunction on protection of the secured party's position. When protection of this sort was not provided, and when the bankruptcy proceeding harmed the position of the secured party, courts sometimes insisted that the reorganization plan give the secured party who was harmed a value based on what would have been realized if there had been no bankruptcy.²⁴ When no plan was confirmed, it was not clear what should happen in the ensuing liquidation, but an argument could have been made that depreciation expense constituted an administrative expense, for which secured parties could get a high priority.²⁵

B. Under the Bankruptcy Code

The Bankruptcy Code expressly provides for adequate protection of security interests, so long as the automatic stay in bankruptcy prevents them from being enforced pursuant to state law. This express statutory provision for adequate protection stems from two beliefs held by Congress' legal staff. First, the lawyers for both the House and Senate Judiciary Committees believed that adequate protection was constitutionally required.²⁶ Second, they believed that adequate protection ought to preserve the benefit of the secured parties' bar-

only allowed if court ruled that rehabilitation was likely); see also *id.* at 253 (cases balance benefit to debtor versus harm to creditor).

24. *In re New York, New Haven & Hartford R.R.*, 147 F.2d 40, 48 (2d Cir. 1945), cert. denied, *Commonwealth of Mass. v. New York, New Haven & Hartford R.R.*, 325 U.S. 884 (1945).

25. The Commission on the Bankruptcy Laws of the United States, created by Congress in the 1970's, invented modern adequate protection. It read *Freuhauf Corp. v. Yale Express System, Inc.* (*In re Yale Express System, Inc.*), 384 F.2d 990 (2d Cir. 1967), as requiring or at least authorizing this administrative priority if all other forms of collateral failed during the reorganization proceeding. REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. NO. 137, 93 Cong., 1st Sess., pt. II, at 236-37 (1973). This assumption comes from an elliptical remark in *Yale Express* stating that, if the secured party "has been damaged by the use of its property pending the reorganization, it is entitled to equitable consideration in the reorganization plan." 384 F.2d at 992. See *United Sav. Ass'n. of Tex. v. Timbers of Inwood Forest Assocs.* (*In re Timbers of Inwood Forest Assocs.*), 793 F.2d 1380, 1391 (5th Cir. 1986), *aff'd*, 808 F.2d 363 (1987) (en banc), *aff'd*, 108 S. Ct. 626 (1988) (reading *Yale Express* as authorizing only administrative priority for any failed adequate protection).

The proposal that mere administrative priority in a liquidation serves as adequate protection has now been expressly forbidden in Bankruptcy Code Section 361(3). 11 U.S.C. § 361(3) (1982). Section 361(3) is said to be a purposeful rejection of the holding of *Yale Express*. See Note, *Compensation for Time Value as Part of Adequate Protection During the Automatic Stay in Bankruptcy*, 50 U. CHI. L. REV. 305, 312-13 (1983) [hereinafter Chicago Note].

26. "Perhaps more by dint of repetition than by analysis," comments the leading expert on this question. Rogers, *The Impairment of Secured Creditors' Rights in Reorganization: A Study of the Relationship Between the Fifth Amendment and the Bankruptcy Clause*, 96 HARV. L. REV. 973, 977 (1983).

gain. The first of these reasons is all but completely wrong, and the second is certainly a perplexing argument to use in bankruptcy legislation, where the obliteration of bargains is everywhere observed. We pause briefly to examine these two premises.

1. THE CONSTITUTIONAL STATUS OF ADEQUATE PROTECTION

The argument that the United States Constitution mandates adequate protection must be largely, and perhaps totally, rejected. At a minimum, the constitutional argument confuses the difference between prospective and retrospective legislation.²⁷ There is little doubt that Congress can adversely affect security interests prospectively, even to the point of banning them altogether. When Congress acts prospectively, bankruptcy legislation helps to constitute the very property interest that a secured party might later claim Congress has taken away.²⁸ For example, Congress (prospectively) banned nonpurchase money security interests on certain exempt consumer goods.²⁹ Thereafter, security interests became, by definition, property interests

27. "It seems to be thought that fifth amendment principles . . . impose generally applicable limits on the substantive scope of bankruptcy power of a sort that would apply even to purely prospective bankruptcy legislation." *Id.* at 984. For authorities taking this mistaken position, see *In re Penn Cent. Transp. Co.*, 454 F.2d 9, 12 (2d Cir. 1972); *In re Planned Systems, Inc.*, 78 Bankr. 852, 861 (Bankr. S.D. Ohio 1987); Anderson, *Partially Secured Creditors: Their Rights and Remedies Under Chapter XI of the Bankruptcy Act*, 37 LA. L. REV. 1003, 1005 (1977); Rosenberg, *supra* note 15, at 525; Comment, *The Secured Creditor's Right to Full Liquidation Value in Corporate Reorganization*, 42 U. CHI. L. REV. 510, 514-15 (1975) [hereinafter Chicago Comment].

28. See *Household Finance Corp. v. Carrol (In re Carrol)*, 11 Bankr. 45, 47 (Bankr. E.D.N.Y. 1981). Professor Rogers writes:

What, one may ask, has been "taken" from the secured creditor? At the time he entered into the security arrangement, he knew or should have known that his rights were circumscribed by the federal legislation. If his property rights are defined by reference to existing law, obviously no taking has occurred. Thus, the proposition that the fifth amendment imposes limitations on even purely prospective restrictions of the rights of secured creditors seems to assume that the property rights held by secured creditors are in some sense anterior to positive law. The implications of that concept are staggering.

Rogers, *supra* note 26, at 987. This answer begs a very important question, as Rogers recognizes. If no "takings" issue is ever raised by prospective legislation because that legislation becomes part of the definition of property, then perhaps Congress can repeal the takings clause altogether by passing a law stating that uncompensated forfeitures are part and parcel of all property concepts. *Id.* at 987 n.59. Unless one views this as possible, one is bound to the notion that property is, to some extent, anterior to positive law.

Rogers' own answer to the possibility of repealing the fifth amendment in this way is to state that (a) most takings involve real estate, and (b) they do not make real estate anymore. That is, such a law would obligate Congress to compensate every existing landowner in the country, and therefore we have nothing to worry about.

29. 11 U.S.C. § 522(f)(2) (Supp. III 1985). This provision does not state whether it is retrospective or not, but the Supreme Court assumed that Congress never could have intended to test the constitutionality of retrospective bankruptcy legislation and so chose to interpret

that could not encumber certain consumer goods, at least so far as bankruptcy courts were concerned. This disability cannot (prospectively) be called a "taking." It is simply an inherent flaw in the property interest itself. If Congress therefore can (prospectively) prohibit security interests altogether, it can (prospectively) deny them adequate protection. Surely the power to destroy includes the power to tax.

This much should be self-evident. It is also possible, however, to make a powerful argument that Congress never needed to provide adequate protection even for security interests created before the Bankruptcy Code was enacted. In other words, adequate protection could have been denied retroactively as well as prospectively.

Retroactive denial of adequate protection would have been permissible, because secured parties never had that right prior to 1978. We have seen how, prior to 1978, secured parties were subject to stays of foreclosure and how they sought relief from the stay when they were unduly harmed by it. Although courts were *urged* to give this relief as a matter of discretion, the Supreme Court emphasized several times and even demonstrated that adequate protection was not a legal right that required constitutional protection under the fifth amendment. In *Continental Illinois National Bank & Trust Co. v. Chicago, Rock Island & Pacific Railway*,³⁰ the Supreme Court stated: "A claim that injurious consequences will result to the pledgee or the mortgagee may not, of course, be disregarded by the district court; but it presents a *question addressed not to the power of the court but to its discretion . . .*"³¹ The Court used this discretion to the sorrow of junior secured parties in *Reconstruction Finance Corp. v. Denver & Rio Grande Western Railway Co.*³² In *Reconstruction Finance Corp.*, the Supreme Court permitted the accrual of senior secured interest to squeeze out the junior secured creditors, so that, by the end of the proceeding, the juniors had lost 90% of principal.³³ No fifth amendment impediment stood in the way.³⁴

Similarly, in the *New Haven Inclusion Cases*,³⁵ the Interstate Commerce Commission (ICC) conditioned a merger between Penn

section 522(f) as intended only for prospective application. *United States v. Security Indus. Bank*, 459 U.S. 70, 81-82 (1982).

30. 294 U.S. 648 (1935).

31. *Id.* at 677 (emphasis added); *see also In re Chicago, Rock Island & Pac. R.R.*, 545 F.2d 1087, 1090 (7th Cir. 1976) (denying the constitutional status of adequate protection).

32. 328 U.S. 495 (1946).

33. *Id.* at 533.

34. *See infra* text accompanying notes 238-46.

35. 399 U.S. 392 (1970).

Central and the New York Central Railway Co. on Penn Central's purchase of the encumbered assets of the New York, New Haven & Hartford Railway Co.³⁶ The ICC forced Penn Central to assume control of the unwanted New Haven line, even before a price could be worked out, on the understanding that the assets would be valued later by the ICC, as approved by the reorganization court.³⁷ Although the New Haven line had been in reorganization since 1961, the liquidation value of the assets was set as of 1966.³⁸ In the interim, the value of the collateral had deteriorated to the prejudice of the undersecured creditors.³⁹ In particular, super-priority liens were granted to various suppliers, pursuant to the rules of railroad reorganization.⁴⁰ The secured parties insisted that the 1961 liquidation value be used (or, as the Court put it, that the secured parties be reimbursed for the super-priority liens that eroded their collateral).⁴¹

The Supreme Court affirmed the use of 1966 values, even though this meant that the secured parties received no adequate protection between the years 1961 and 1966.⁴² The secured creditors claimed this was a fifth amendment taking.⁴³ The Supreme Court disagreed, stating:

We do not doubt that the time consumed in the course of the proceedings in the reorganization court has imposed a substantial loss upon the [secured creditors]. But in the circumstances presented by this litigation we see no constitutional bar to that result. The rights of the bondholders are not absolute. . . . [S]ecurity holders "cannot be called upon to sacrifice their property so that a depression-proof railroad system might be created. But they invested their capital in a public utility that does owe an obligation to the public. . . . [B]y their entry into a railroad enterprise, [the secured creditors] assumed the risk that in any depression or any reorganization the interests of the public would be considered as well as theirs."⁴⁴

36. *Id.* at 392.

37. *Id.* at 409.

38. *Id.* at 411-12.

39. *Id.* at 399-407.

40. *Id.* at 491-92.

41. *Id.*

42. *Id.* at 491 ("we see no constitutional bar to that result").

43. *Id.* at 492.

44. *Id.* at 491-92 (citations omitted). This quote *could* be taken as establishing a "public interest" doctrine—i.e., if the security interest encumbers property that has important public implications, the government may erode these liens without having to compensate the losers. See Kennedy, *Bankruptcy and the Constitution*, in *BLESSINGS OF LIBERTY: THE CONSTITUTION AND THE PRACTICE OF LAW* 154-55 (1988). The Supreme Court specifically rejected this suggestion in *Reconstruction Finance Corp. v. Denver & Rio Grande W. R.R.*, 328 U.S. 495, 535 (1945), which permitted the deterioration of junior security interests, while

This case raises doubt as to whether secured parties *ever* had a right to adequate protection. Rather, adequate protection was solely a matter of judicial discretion. As a result, not only could Congress have denied adequate protection *prospectively* in 1978, but Congress could have denied adequate protection *retrospectively* to security interests created before the enactment of the Bankruptcy Code in 1978.⁴⁵ The congressional drafting staff therefore erred in asserting that the Constitution required any form of adequate protection.⁴⁶

specifically disavowing any reliance on a public interest doctrine. The fifth amendment was designed quite specifically to force compensation for property taken in the public interest. It would be shocking if "public interest" would become an excuse for *not* paying compensation.

45. Incidentally, even if putting the expenses of operating the railroad on the secured parties had been considered a fifth amendment taking, it does not follow that this should affect the price that Penn Central was obliged to pay for the assets. Rather, it could have resulted in *government* liability under the Tucker Act. Regional Rail Reorganization Act Cases, 419 U.S. 102, 132-33 (1974); See Countryman, *supra* note 15, at 339 (1976); Chicago Comment, *supra* note 27, at 528-29 (1975); see also Rosenberg, *supra* note 15, at 545 (suggesting that secured parties whose security interests are harmed be given tax credits).

46. The view that, in 1978, Congress could not have enacted retroactive legislation outlawing adequate protection ignores the Supreme Court cases that had already denied secured parties a legal right to adequate protection. In addition, this view against the constitutionality of retroactive legislation also requires the further belief that the bankruptcy clause of the United States Constitution means to distinguish radically between secured and unsecured claims, such that claims in personam can be "taken" without compensation by bankruptcy legislation, but claims in rem may not be. No one doubts that retroactive bankruptcy legislation can impair *unsecured* claims. See *Hanover Nat'l Bank v. Moyses*, 186 U.S. 181, 188 (1902). But some old depression cases have been read to imply that no retrospective impairment can occur for secured claims. See *Louisville Joint Stock Land Bank v. Radford*, 295 U.S. 555, 588 (1935) ("The position of a secured creditor, who has rights in specific property, differs fundamentally from that of an unsecured creditor."). In *Radford*, the Supreme Court struck down legislation that put a moratorium on all mortgages granted before the legislation was passed. *Id.* at 601-02. In other words, the legislation had a strictly retrospective effect. *Id.*

One interpretation of *Radford* that I have not seen made is that the constitutional sin in that case was the purely retrospective effect of the Frazier-Lemke Act. *Id.* at 589. The same Act, made applicable to *future* as well as past mortgages, would be constitutional. This suggestion is based upon the following passage: "Because the Act is retroactive in terms and as here applied purports to take away rights of the mortgagee in specific property, another provision of the Constitution is controlling. . . . The bankruptcy power, like the other great substantive powers of Congress, is subject to the Fifth Amendment." *Id.* at 589 (emphasis added). My suggestion is that when Congress legislates *generally* about security interests in bankruptcy, it is simply defining what a security interest is and is not "taking" property at all. Such definitional work is within the police power of Congress. But what the Frazier-Lemke Act did was not internal or definitional in quality. It was external in the sense that the legislation moved beyond the purview of definition and attacked the rights of certain secured parties, but not all of them, from the outside. Under such circumstances, Congress was guilty of "taking," not defining, property.

Immediately after the Supreme Court issued the *Radford* opinion, Congress redrafted the Frazier-Lemke Act with a view toward answering the concerns of the *Radford* opinion. Although space limitations prohibit a longer critique, let me summarize by saying that the *Radford* opinion was extremely vague and poorly written, and most of the changes in the revised Act were almost all insubstantial and illusory, *except* that the new Frazier-Lemke Act

2. THE BENEFIT OF THE SECURED PARTY'S BARGAIN

The second premise in the legislative history—that secured parties are entitled to the benefit of their bargain—requires some theory that shows why *unsecured* general creditors are not likewise entitled to the benefit of *their* bargain. In bankruptcy, the debtor will have defaulted on many of her bargains. By definition, insolvency implies the defeat of expectations. Therefore, an ethical justification for adequate protection (or for whether security interests should survive in bankruptcy, which is the same question) must extend beyond the assertion that secured parties are entitled to the benefit of their bargain. Such a slogan does not amount to a comprehensive ethical justification for any bankruptcy question.

It is safe to say, then, that the justifications cited by the legislative drafters are unconvincing. But ours is not entirely to reason why. Adequate protection is now a potent reality in bankruptcy law. A

applied to old and new mortgages alike. The Supreme Court upheld the new Act in *Wright v. Vinton Branch of the Mountain Trust Bank of Roanoke*, 300 U.S. 440 (1937). This supports my thesis that bankruptcy legislation that is both retroactive and prospective might always erode security interests; only purely retroactive legislation is an unconstitutional taking of property.

The claim that the fifth amendment overrides congressional bankruptcy power must ground itself on a radical distinction between secured and unsecured debt. See *United States v. Security Indus. Bank*, 459 U.S. 70, 75-78 (1982); see also *Louisville Joint Stock Land Bank v. Radford*, 295 U.S. 555, 588 (1935) (“the position of a secured creditor who has rights in specific property differs fundamentally from that of an unsecured creditor, who has none”); Anderson, *supra* note 27, at 1011-12 (“[A]ll parties to a contract are necessarily aware of the existence of, and subject to, the power of Congress to legislate on the subject of bankruptcies. Therefore, contracting parties are chargeable with the knowledge that their rights and remedies are affected by existing bankruptcy laws and all future bankruptcy legislation.”).

The distinction, however, cannot hold up. The claim by Anderson that people *expect* bankruptcy to destroy contract claims and to preserve secured claims is circular. That is, people expect what the law tells them to expect. Therefore, you cannot assert expectations to justify the content of the law that engendered the expectation. Also, unsecured claims transform themselves into secured claims when they are enforced, i.e., when a general creditor obtains a judgment and a judicial lien in the course of enforcement. Therefore, secured and unsecured claims are the same. Rogers, *supra* note 26, at 988-95. In addition, the rights of a general creditor (under fraudulent conveyance law) are almost identical to the rights of an unperfected secured party under Article 9. Since the latter idea is clearly a property right, then general creditors also have property rights. Note, *Fraudulent Conveyance Law as a Property Right*, 9 CARDOZO L. REV. 843 (1987). Furthermore, contracts are treated as property under Article 9, when contract rights become collateral. Therefore, state law *denies* the distinction between property and contract. Countryman, *Treatment of Secured Claims in Chapter Cases*, 82 COM. L.J. 349, 359-60 (1977). Finally, courts have been willing to grant due process protection to general creditors against whom bankruptcy discharge is asserted. Due process protection of contract rights implies that contracts are “property” for the purposes of the fourteenth amendment. Kennedy, *supra* note 44, at 158-59; Rogers, *supra* note 26, at 989. This implies the falsity of a property-contract distinction for the purposes of the fifth amendment. For these reasons, the claim that the fifth amendment preempts the bankruptcy power—but only with respect to secured claims—is somewhat dubious.

large percentage of all reported bankruptcy court decisions is dedicated to figuring out whether unhappy secured parties are adequately protected.

The avalanche of case law seems to have been just what Congress intended, according to the authors of the Bankruptcy Code's influential legislative history. Rather than define the term, Congress defers to the courts the task of developing an adequate protection doctrine.⁴⁷ Courts, then, are supposed to use their imagination to protect security interests. But before that protective instinct can be consulted, we need to know what entitlements are associated with the idea of "security interest." Until we know that, we cannot imagine a "value" that is to be protected. This leads us directly to the question of whether secured parties are entitled to postpetition interest.

III. POSTPETITION INTEREST

The most confusing issue that arises in the development of a coherent doctrine of adequate protection is whether the secured claim is allowed to grow through the accrual of postpetition interest.⁴⁸ This is a substantive question that helps to define exactly what a security interest *is*. Since every significant adequate protection issue is infused with this controversy, there is no sense in proceeding any further until we thoroughly examine entitlements to postpetition interest.

A. *Under the 1898 Act*

From the earliest days of the 1898 Act, the general rule was that unsecured creditors were not entitled to postpetition interest. The petition halted all interest accrual.⁴⁹ The rule for *secured* creditors was more complex. Those who were still oversecured by the time a

47. See *Bankers Life Ins. Co. of Nebraska v. Alyucan Interstate Corp.* (*In re Alyucan Interstate Corp.*), 12 Bankr. 803, 805 (Bankr. D. Utah 1981) ("Adequate protection is not defined in the Code. This omission was probably deliberate."). One commentator finds in this principle a core meaning of adequate protection. Carey, *Adequate Protection: Lost Opportunity Costs After American Mariner*, *In re Briggs*, and *In re Timbers*, 19 U.C.C. L.J. 317, 320, 333-34 (1987).

48. By postpetition interest, I mean the interest that accrued on claims after the bankruptcy petition is filed but before the plan is confirmed or liquidation is completed. A further note: if interest is allowed to accrue, then usually I have in mind that the trustee would be required to reimburse the secured party with cash, additional collateral, or some form of dollar-for-dollar compensation. I do not have in mind that the accrued interest augment an unsecured deficit claim against the debtor.

49. *Thomas v. Western Car Co.*, 149 U.S. 95, 116-17 (1893). One rationale given for this rule is that the debtor was blameless if the court forbade the debtor from paying interest pending the bankruptcy proceeding. In other words, interest was a kind of penalty and should not accrue. *American Iron & Steel Mfg. Co. v. Seaboard Air Line Ry.*, 233 U.S. 261, 266-68 (1914). Another reason given was to equalize those creditors who extracted ruinous interest

reorganization plan was confirmed were allowed to augment their claims by interest accruing between the time the bankruptcy petition was filed and the confirmation of the plan.⁵⁰ In addition, if the collateral was income producing—for example, dividend-bearing stocks or bonds—the income produced could be applied to the postpetition interest of a secured party.⁵¹ This second rule was not necessarily distinguishable from the first. Income-producing collateral could be viewed simply as a case in which the collateral grows or increases, thereby triggering the rule that *over*-secured parties could claim postpetition interest.

The *stated* rule held that *undersecured* parties could not add postpetition interest to the amount of their claim. A common justification for this disentitlement was that an undersecured creditor resembled a general creditor (not entitled to interest) more than she resembled a secured creditor.⁵² The aesthetics of this analogy were not usually pursued vigorously, but the analogy was nothing if not venerable, going back at least to *Sexton v. Dreyfus*,⁵³ a case in which Oliver Wendell Holmes matched wits with Learned Hand. *Sexton* involved cash proceeds of collateral that the trustee had already liquidated. The undersecured parties wished to have the cash payment applied to postpetition interest that had accrued before the sale; only thereafter would principal be paid down. If the postpetition interest claim were to be paid in cash, then the undersecured parties would have a larger unsecured deficit to claim in the bankruptcy proceeding.⁵⁴

Judge Hand approved this scheme to obtain postpetition interest. His stated reason for doing so was to reconcile a contradiction between two rules that applied to undersecured parties. Hand saw no

with those creditors who were more modest in their demands. *Vanston Bondholders Protective Comm. v. Green*, 329 U.S. 156, 164 (1946).

50. See *Coder v. Arts (In re Coder)*, 152 F. 943, 949-50 (8th Cir. 1907), *aff'd*, 213 U.S. 223 (1909).

51. *Ex parte Penfold*, 4 DeG. & Smale 282 (1851); *Ex parte Ramsbottom*, 2 Mont. & Aryton 79 (1835).

52. "To allow a secured creditor interest where his security was worth less than the value of his debt was thought to be inequitable to unsecured creditors." *Vanston Bondholders Protective Comm. v. Green*, 329 U.S. 156, 164 (1946).

53. 219 U.S. 339 (1911), *rev'g In re Kessler & Co.*, 171 F. 751 (S.D.N.Y. 1909), *aff'd*, 180 F. 979 (2d Cir. 1910).

54. See *id.* at 346. The modern claims to postpetition interest as part of adequate protection will have a different posture. Modern undersecured parties argue that the automatic stay should be lifted unless they receive an entitlement to postpetition interest, in the form of either periodic cash payments or an augmented, fully collateralized claim. Here, the undersecured parties were claiming the right to increase the size of the unsecured deficit, a much less greedy claim than is characteristically made today.

reason why undersecured parties whose collateral produced dividends should get postpetition interest, while undersecured parties whose collateral was fallow should be denied.⁵⁵ In fact, as just suggested, the contradiction Hand found could have been reconciled. Income producing collateral simply increased the size of collateral, turning undersecured parties into oversecured parties. The two rules, then, could have been collapsed into one: Postpetition interest would be allowed only when a secured party was oversecured.

The Supreme Court, led by Justice Holmes, reversed and ruled that the undersecured parties' scheme to get postpetition interest was illegal. Three grounds were cited.⁵⁶ First, Holmes analogized undersecured parties to general creditors, who were specifically denied postpetition interest by the 1898 Act.⁵⁷ By implication, they were less analogous to oversecured parties, who could get postpetition interest. In this analogy, Holmes posed the major ethical issue—equal treatment—that modern proponents of postpetition interest entitlements have yet to solve.⁵⁸ Second, Holmes was unimpressed with the contradiction that Hand had discovered (although not for the reason I have stated). Holmes felt that the bankrupt estate should not profit from income produced by collateral during the bankruptcy proceed-

55. *In re Kessler & Co.*, 171 F. at 754.

56. *Sexton*, 219 U.S. at 346.

57. *Id.* at 344.

58. *Id.* The idea of equal treatment is a subversive one, because the minute you have established a commensurability in one place, you are forever called upon to justify noncommensurability elsewhere. Thus, if general creditors and undersecured parties are the same, why aren't oversecured parties and undersecured parties the same?

One answer is hazarded by the court of appeals in *United Sav. Ass'n. of Tex. v. Timbers of Inwood Forest Assocs.* (*In re Timbers of Inwood Forest Assocs.*), 793 F.2d 1380, 1387, *aff'd*, 808 F.2d 363 (5th Cir. 1987) (en banc), *aff'd*, 108 S. Ct. 626 (1988):

In summary, the interest provisions of the Code and its predecessors, as interpreted by the Supreme Court for almost a century, are premised on the equitable principle that the unencumbered assets of a debtor's estate will not be used to benefit one class of creditors at the expense of another class. Such would be the case if unencumbered assets, otherwise available for the payment of unsecured claims, were used to pay postpetition interest on undersecured debt. Allowing a claim for postpetition interest by an oversecured creditor, on the other hand, is not inconsistent with that equitable principle, because only assets encumbered by the creditor's lien will be used to fund the payment of postpetition accrued interest.

Id. This argument is based entirely on a confusion of terms. The court wants to say that debtor equity is already encumbered, so that if the oversecured creditor's claim for postpetition interest continues to accrue, no unencumbered assets are being diverted to secured parties. But debtor equity is part of the bankruptcy estate, and, until interest actually accrues, we can and probably should say that it is entirely unencumbered. If so, then unencumbered assets are being diverted to oversecured parties in violation of the principle that the court asserts. It may simply be impossible, therefore, to justify both postpetition interest for oversecured parties and no interest for undersecured parties.

ing, when the undersecured party failed to receive interest.⁵⁹ Therefore, it was appropriate for the undersecured party to get interest when the collateral produced income, but not otherwise. Hence, the existing rules were rational and needed no reconciliation. And third, Holmes noted that the reason the trustee retained the collateral rather than abandoning it was to maximize the return. This would adhere to the undersecured parties' advantage, if the trustee were successful. Under the circumstances, it was fair that the undersecured parties absorbed a little risk (by taking no postpetition interest entitlement) in return.⁶⁰

Beyond *Sexton*, almost no cases under the old Bankruptcy Act expressly addressed undersecured parties' entitlements to postpetition interest, perhaps because the question was thought to be settled authoritatively.⁶¹ Yet there existed an indirect way in which courts often *did* grant undersecured parties postpetition interest.

Under the 1898 Act, adequate protection was supplied as a matter of case law. If it was not supplied, then the secured party could claim to be unduly harmed and could move to have the stay lifted. One of the reasons that the secured parties were allowed to have the stay lifted—even in reorganization cases—was that the debtor had no equity cushion⁶² in the collateral.⁶³ If the stay was lifted, the secured

59. *Sexton*, 219 U.S. at 346.

60. *Id.* at 345.

61. What few there are go against the secured party. See *Freuhauf Corp. v. Yale Express System, Inc.* (*In re Yale Express System, Inc.*), 384 F.2d 990, 992 (2d Cir. 1967) (refusing to grant rent to secured parties, pending reorganization plan); *Barth Equipment Co. v. Perlstein*, 128 F.2d 253, 254 (2d Cir. 1942). O'Toole analyzes only one case in which this issue was addressed, and even then the issue is far from explicit. *In re Penn Cent. Transp. Co.*, 358 F. Supp. 154 (E.D. Pa. 1973); see O'Toole, *supra* note 12, at 260-62.

62. For simple cases, "equity cushion" is the positive difference between (1) the relevant secured claim and (2) the value of the collateral. *In re Diplomat Elec. Corp.*, 82 Bankr. 688, 692 (Bankr. S.D.N.Y. 1988). A more precise definition might be the difference between (1) the relevant secured claim, any senior secured claims and chargeable sales expenses, and (2) the value of whatever interest the debtor had in the collateral at the time the relevant security interest attached or perhaps was perfected. See *In re Simmons*, 86 Bankr. 160, 161 (Bankr. S.D. Iowa 1988) (senior priority liens are to be deducted when calculating equity for a secured party); *LaJolla Mortgage Fund v. Rancho El Cajon Assoc.* (*In re LaJolla Mortgage Fund*), 18 Bankr. 283, 287-88 (Bankr. S.D. Cal. 1982) (emphasizing that the equity cushion for senior and junior secured parties might be different). One court reminds us:

There is an obvious need to keep this concept of a "value cushion" separate from the term "equity" of the debtor, which in conjunction with a lack of necessity of the property to an effective reorganization will require granting of relief from the stay under section 362(a) . . . [U]se of the term "equity cushion" is a misnomer and contributes to confusion of the issue of whether a creditor's interest in the debtor's property is adequately protected and the separate issue of whether relief from the stay should be granted because of an absence of need for the property for an effective reorganization.

Because the debtor's lack of an "equity" was equated with a lack of

party was free to foreclose, obtain cash proceeds, or reinvest the proceeds, thereby obtaining a kind of postpetition interest through investment. Conversely, the stay endured if there *was* a cushion. This cushion also guaranteed the accrual of postpetition interest. The effect of this standard was that, as a practical matter, secured parties *did* receive postpetition interest one way or the other. Either the stay was lifted, so that postpetition interest could be obtained by foreclosing immediately and reinvesting the cash proceeds, or the equity cushion existed, so that postpetition interest accrued.

By requiring an equity cushion, courts may not have thought they were insuring the recovery of postpetition interest. It was usually said that the reason for insisting on the equity cushion was not to guarantee the continued accrual of interest (which in fact did take place), but to protect the face amount of the secured party's claim.⁶⁴ An express requirement that the equity cushion always be large enough to cover postpetition interest never existed. Furthermore, no court conditioned the stay on the payment of postpetition interest in cash—only on the existence of equity against which postpetition interest could accrue. But to the extent the courts did not require the cushion, undersecured parties *did* have an entitlement to postpetition interest under the 1898 Act. Consequently, the express formulation of the rule in *Sexton* disagrees with the implicit rule in reorganization

"adequate protection" of the creditor's interest in the subject property, the court's lifting of the stay was reversed in *In re Mellor*, 734 F.2d 1396 (9th Cir. 1984).

The term "equity cushion" is but one of several unfortunate terms which unnecessarily contribute to muddled issues in the courts, but it has had a wide use and probably will linger on.

In re Digby, 47 Bankr. 614, 622 n.21 (Bankr. N.D. Ala. 1985). For an exemplar of confusion, see *In re Lewis*, 83 Bankr. 682, 683 (Bankr. W.D. Mo. 1988). In *Lewis*, the debtor-farmers owed \$330,000 on land worth \$167,000. They had just filed a plan in which they would pay the mortgagee the market value of the land. The mortgagee claimed that the stay had to be lifted for lack of debtor equity. *Id.* at 682. The court found that the debtor had equity: "[A]s a practical matter, it would be somewhat unusual for a Bankruptcy Court to hold that the debtor had no equity in such a situation. It seems clear that Congress intended family farm debtors to be allowed to reorganize on the basis of an equality of assets versus debt." *Id.* at 683. I think what the court meant was that the land was necessary to a reorganization, which also prevents the stay from being lifted. Used in such a context, the idea of equity is unnecessary and confusing.

63. *Silver Gate Sav. & Loan Assoc. v. Carlson (In re Victor Builders, Inc.)*, 418 F.2d 880, 882 (9th Cir. 1969); *In re Riker Delaware Corp.*, 385 F.2d 124, 126 (3d Cir. 1967); *Northwestern Fin. Investors v. O.K. Motels (In re O.K. Motels)*, 1 Collier Bankr. Cas. (MB) 416, 419 (Bankr. M.D. Fla. 1974); see generally Kennedy, *Stay Under Old Act*, *supra* note 1, at 244-50; Webster, *Collateral Control Decisions in Chapter Cases: Clear Rules v. Judicial Discretion*, 51 AM. BANKR. L.J. 197, 229-37 (1977).

64. *Id.* at 209.

cases. To put it another way, the theory and the practice of bankruptcy law were not in accord.

Because the debtor equity requirement was usually characterized as protecting the right to principal, and not the right to interest, not all courts insisted on the presence of a cushion if other protections were adequate.⁶⁵ Some commentators therefore openly urged that the requirement of debtor equity be dropped when *other* adequate protection was supplied and when the collateral was necessary to a successful reorganization.⁶⁶ This was in fact accomplished in the Bankruptcy Code.⁶⁷ Nevertheless, because courts commonly insisted that the debtor have equity in the collateral, secured parties commonly did receive postpetition interest prior to 1979. Furthermore, it is very important to recognize that, in spite of the dicta in *Sexton*, there was no settled rule on postpetition interest for undersecured parties. Usually they received it in one form or another, but sometimes they did not.⁶⁸

65. *Freuhauf Corp. v. Yale Express System, Inc. (In re Yale Express System, Inc.)*, 384 F.2d 990 (2d Cir. 1967); *Lincoln-Alliance Bank & Trust Co. v. Dye*, 108 F.2d 38 (2d Cir. 1939). In some of these cases, the collateral produced income, which itself was part of the collateral, so that the growth of the collateral still covered accruing interest. *Crystal v. Green Point Sav. Bank (In re Franklin Gardens Apartments, Inc.)*, 124 F.2d 451 (2d Cir. 1941).

66. One commentator noted:

Equity is, indeed, a "red herring" Equity . . . is an indication that the security can depreciate in value while the debtor uses it without affecting the secured creditor's interest. It is not a mystical talisman, the presence of which miraculously empowers a court to make decisions it would not make in the absence of equity.

Webster, *supra* note 63, at 231.

67. 11 U.S.C. § 362(d)(2) (1982 & Supp. IV 1986).

68. Another point can be made. Recall that one of the exceptions granted undersecured parties postpetition interest when the collateral produced income. In a reorganization, collateral retained as useful to the continuation of a business helps to create income. Obviously the connection between stock and dividends, for example, seems a great deal closer than a telephone system and income from a service business. But no accountant would have been embarrassed to attribute a portion of firm earnings to various pieces of hardware making up the business. Therefore, it was open to argue that the "income" exception should have allowed postpetition interest for undersecured parties in all reorganizations in which the business continued to earn income. One commentator suggested this argument late in the game, but no court ever adopted it under the Bankruptcy Act. See Anderson, *supra* note 27, at 1022. Nevertheless, this idea was always implicit in the doctrines under the 1898 Act, so that it cannot exactly be said that the 1898 Act had a consistent position on postpetition interest.

More recently, a pair of commentators have opposed such an accounting assumption in a somewhat different context. Baird & Jackson, *Bargaining After the Fall and the Contours of the Absolute Priority Rule*, 55 U. CHI. L. REV. 738, 780-82 (1988). Specifically, Baird and Jackson object to the notion that collateral in a business be given a "going concern" valuation. Their basic point is an appeal to a natural law of causation. They maintain that going concern value is "caused" by managerial expertise and not by pieces of hardware on which management depends. *Id.* at 782. Such a claim is based on a confusion. In their article, Baird and Jackson assume that management has some sort of sine qua non relation with going

B. Under the Bankruptcy Code

The Bankruptcy Code continues the express rule that general creditors get no postpetition interest.⁶⁹ Similarly, the Code continues to allow *oversecured* creditors to get postpetition interest.⁷⁰ The Bankruptcy Code, however, is extremely vague on the rule for *undersecured* parties. The Supreme Court has now decided that undersecured parties are *not* to get postpetition interest, at least as a matter of right.⁷¹

1. THE STATUTES

Section 506(b) of the Bankruptcy Code expressly grants postpetition interest to *oversecured* parties.⁷² This specific grant often is taken to imply that, since the existence of the cushion is a condition of an interest entitlement, *undersecured* creditors may not get interest on their claims.⁷³ Nevertheless, it still remains true that undersecured parties still deserve "adequate protection" of their security interests as

concern value. In other words, "but for" management, going concern value would not exist. *Id.* This may describe some management, but in many organizations, managers are fungible—more so than managers would like to admit.

Furthermore, appeals to natural concepts of causation do not cut any ice whatsoever. Modern legal philosophers tend to view causation as purely a legal, not a factual, question. This is thought to be the major insight of the Coase Theorem. See Kennedy, *Cost-Benefit Analysis of Entitlement Problems: A Critique*, 33 STAN. L. REV. 387 (1981); see also Alchian & Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777, 779 (1972) ("With team production it is difficult, solely by observing total output, to either define or determine each individual's contribution to this output of the cooperating inputs. The output is yielded by a team, by definition, and it is not a *sum* of separate outputs of each of its members"). Therefore, Baird and Jackson presuppose the very proposition—who caused what?—that they set out to justify.

69. See 11 U.S.C. § 502(b)(2) (Supp. IV 1986) (disallowing unaccrued interest). If there is a surplus in the bankruptcy estate then they get the mediocre legal rate. 11 U.S.C. § 726(a)(5) (1982).

70. 11 U.S.C. § 506(b) (Supp. IV 1986).

71. *United Sav. Ass'n of Tex. v. Timbers of Inwood Forest Assocs.* (*In re Timbers of Inwood Forest Assocs.*), 108 S. Ct. 626, 635 (1988).

72. 11 U.S.C. § 506(b) (Supp. IV 1986). Section 506(b) provides:

To the extent that an allowed secured claim is secured by property the value of which, after any recovery under subsection (c) of this section, is greater than the amount of such claim, there shall be allowed to the holder of such claim, interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement under which such claim arose.

Id.

73. An exception exists if the secured party holds boats or planes as collateral. Section 1110(a) provides that the automatic stay does not ground planes or beach vessels, unless the trustee agrees to comply with the security agreement. 11 U.S.C. § 1110(a) (1982 & Supp. IV 1986); see also *id.* § 1166 (pertaining to railroad rolling stock). In addition, new Chapter 12, pertaining to farm reorganizations, provides rental payments to mortgagees as a form of adequate protection. 11 U.S.C. § 1205(b)(3) (Supp. IV 1986). See *infra* text accompanying note 123.

a condition of continuing the automatic stay in bankruptcy.⁷⁴

It has been suggested that adequate protection provides undersecured parties with the interest entitlement that Section 506(b) fails to give. Adequate protection is not defined precisely, but Section 361 suggests three possible definitions:

adequate protection may be provided by—

(1) requiring the trustee to make . . . cash payments . . . to the extent that the stay . . . [or] use, sale, or lease . . . results in a decrease in the value of such entity's interest in such property;

(2) providing . . . an additional or replacement lien to the extent that such stay . . . results in a decrease in the value of such entity's interest in such property; or

(3) granting such other relief . . . as will result in the realization by such entity of the indubitable equivalent of such entity's interest in such property.⁷⁵

In spite of the negative implication in Section 506(b),⁷⁶ each of these provisions plausibly suggests that postpetition interest payments could be an element of adequate protection. If true, adequate protection provides undersecured creditors with an entitlement to postpetition interest that Section 506(b) fails to give them.⁷⁷

Take the first suggestion for example: periodic cash payments to the extent the automatic stay decreases "*the value of such entity's interest*" in the collateral.⁷⁸ If state law defines the parameters of the "entity's interest," then surely the secured party has a right to repossess, sell, and obtain cash from the proceeds of the enforcement sale. The "value" of this interest—to a third party assignee who might buy out the undersecured creditor's position—is detrimentally affected if an automatic stay prevents those rights from being enforced, rendering distant the prospect of a cash recovery. The value of that interest would be restored by "periodic cash payments." What else could those payments be but interest on the secured portion of an undersecured creditor's claim?⁷⁹

74. 11 U.S.C. § 362(d)(1) (Supp. IV 1986).

75. 11 U.S.C. § 361 (1982 & Supp. IV 1986).

76. 11 U.S.C. § 506(b) (Supp. IV 1986) ("To the extent that . . .").

77. General Motors Acceptance Corp. v. Briggs Transp. Co. (*In re Briggs Transp. Co.*), 780 F.2d 1339, 1347 (8th Cir. 1985).

78. 11 U.S.C. § 361(1) (Supp. IV 1986) (emphasis added).

79. *E.g.*, *In re Deeter*, 53 Bankr. 623 (Bankr. N.D. Ind. 1985); Molbert, *Adequate Protection for the Undersecured Creditor in a Chapter 11 Reorganization: Compensation for the Delay in Enforcing Foreclosure Rights*, 60 N.D. L. REV. 515, 520 (1984). The leading case in favor of postpetition interest proclaims this the "plain meaning" of § 361. *Crocker Nat'l Bank v. American Mariner Indus., Inc.* (*In re American Mariner Indus., Inc.*), 734 F.2d 426, 430 (9th Cir. 1984).

There is a counter-reading, however. The attributes of the entity's interest might be constituted, not only by state law, but also by the provisions of the Bankruptcy Code. In other words, a security interest is defined as a lien that is not foreclosable, so long as the automatic stay is in place.⁸⁰ If susceptibility to the automatic stay is part of the definition of a security interest, adequate protection does not require protection against the economic effects of the inability to foreclose. Stated differently, Section 361(1) protects the secured party from declines in the value of the *collateral*, but not from the decline in value of the secured claim itself.⁸¹ Or, to state the theory in yet a third way, the automatic stay in bankruptcy may be viewed as having a *procedural*, not a substantive, effect on security interests.⁸² Under any version of this counter-reading, the secured party is required to absorb the cost of delay that bankruptcy entails. As a result, the "value of such entity's interest" implies no entitlement to postpetition interest at all.⁸³ Notice that under such a counter-reading, the secured party is not protected *from the stay*. Rather, she is only protected from declines in the market for the items of collateral.⁸⁴ Yet

80. This reading was adopted by the lower court in *Timbers of Inwood Forest*: "Furthermore, the 'bargain' which the creditor enters into incorporates the applicable requirements of federal bankruptcy law. . . . Two aspects of the law, of course, are the automatic stay . . . and the interest provisions of § 502(b)(2) and § 506(b). The stay and the interest provisions themselves substantially alter the bargain of the parties." 793 F.2d 1380, 1414 (5th Cir. 1986) (citation omitted), *aff'd*, 808 F.2d 363 (1987) (en banc), *aff'd*, 108 S. Ct. 626 (1988).

81. "Clearly [Section 361(1) does not] authorize[] periodic payments to a creditor whose collateral is not decreasing in value." *Id.* at 1388. Here we see the custom of courts, confronted with an ambiguous and confusing statute, trying to bolster their dubious arguments with such pejoratives as "clear," "obvious" and "plain meaning."

82. *Continental Ill. Nat. Bank & Trust Co. v. Chicago, R.I. & P. Ry.*, 294 U.S. 648, 681 (1935). This kind of formulation attempts to make it seem as though the rights of the secured party are completely unaffected, but the strategy is based on a syllogistic mistake. Those making such an argument claim that (a) procedural matters do not harm substantive rights, (b) the automatic stay in bankruptcy is merely a procedural matter, therefore (c) the automatic stay must do no harm to the rights of a secured party. See *In re Empire Steel Co.*, 228 F. Supp. 316, 319 (D. Utah 1964) (right of a secured party "depends not only upon assurance of eventual payment but the right to payment or enforcement in point of time").

83. For a case making the counterreading, see *In re Pine Lake Village Apartment Co.*, 19 Bankr. 819, 825-26 (Bankr. S.D.N.Y. 1982). It is usually assumed that, in Section 361(1), Congress intended to codify the holding of *In re Bermec Corp.*, 445 F.2d 367 (2d Cir. 1971), and that the cash payments to the secured party were strictly related to depreciation of the collateral, not to postpetition interest. Gordanier, *The Indubitable Equivalent of Reclamation: Adequate Protection for Secured Creditors under the Bankruptcy Code*, 54 AM. BANKR. L.J. 299, 312-13 (1980).

84. *Hoyt, Inc. v. Born (In re Born)*, 10 Bankr. 43, 48 (Bankr. S.D. Tex. 1981) ("Under the concept of adequate protection the secured creditor's interest in the property cannot be damaged because of the automatic stay."). But see *United States v. Smithfield Estates, Inc. (In re Smithfield Estates, Inc.)*, 48 Bankr. 910 (Bankr. D.R.I. 1985). In refusing to lift the stay, or

Section 361 strongly implies that the secured party is to have protection *from the stay*.

The second suggestion in Section 361 for adequate protection also implies postpetition interest for the undersecured creditor. Instead of periodic payments, Section 361(2) proposes extra collateral to the extent the automatic stay decreases "*the value of such entity's interest*" in the collateral.⁸⁵ As before, the amount a third party would pay an undersecured creditor to take over her position is detrimentally affected by an automatic stay that defers receipt of cash payment. To this extent, the secured party might be given additional collateral. "This extent" is nothing more than interest on the secured portion of the undersecured creditor's claim. The secured party gets an increased lien instead of periodic cash payments.⁸⁶ Stated differently, interest accrues and is added to the undersecured creditor's secured claim, for which the trustee must supply additional collateral.

This view of adequate protection presupposes that the value of the undersecured creditor's claim is assessed from the viewpoint that no automatic stay is or will be in effect (that the value protected is based on the prepetition attributes of a security interest). If, on the other hand, both state law *and* the automatic stay provision of the Bankruptcy Code describe the attributes of the security interest, then adequate protection implies no entitlement to postpetition interest.

Finally, Section 361(3) suggests that the undersecured creditor

grant postpetition interest the *Smithfield Estates* court, in a case in which no equity cushion existed, stated:

An undersecured creditor's position is not worse immediately after the filing than it was just prior thereto, and the provisions for adequate protection may only protect the secured creditor from any impairment in the value of its interest that is *attributable to the stay*. The concept of adequate protection was not designed or intended to place an undersecured or minimally secured creditor in a better post-filing position than it was before the stay.

Id. at 914-15 (emphasis in original). This view is not comprehensible. How can it be said that lifting the stay puts a secured party in a better position than she was before the bankruptcy?

85. 11 U.S.C. § 361(2) (1982) (emphasis added).

86. The United States Court of Appeals for the Fifth Circuit, in *Timbers of Inwood Forest*, thought that adequate protection inevitably meant payment *in cash*, which would defeat many reorganization proceedings before the plan was formulated. 793 F.2d 1380, 1409 (5th Cir. 1986), *aff'd*, 808 F.2d 363 (1987) (en banc), *aff'd*, 108 S. Ct. 626 (1988). But clearly *deferred* interest payments are authorized by section 361(2), where helpful. The ability to defer actual payments of accruing interest was emphasized by the Eighth and Ninth Circuits. *Norwest Bank Worthington v. Ahlers (In re Ahlers)*, 794 F.2d 388, 397 (8th Cir. 1986) (interest need not be paid until harvest time), *rev'd and remanded on other grounds*, 108 S. Ct. 963 (1988), *vacated and remanded*, 844 F.2d 587 (8th Cir. 1988); *Crocker Nat'l Bank v. American Mariner Indus., Inc. (In re American Mariner Indus. Inc.)*, 734 F.2d 426, 433 (9th Cir. 1984).

be given an "indubitable equivalent" to her state-law rights.⁸⁷ This mellifluous phrase has been plagiarized from *In re Murel Holding Corp.*,⁸⁸ a famous old opinion by Learned Hand. In *Murel*, Judge Hand held that, in order for a reorganization plan to be confirmed, the secured parties had to be completely compensated:

And . . . payment ten years hence is not generally the equivalent of payment now. Interest is indeed the common measure of the difference, but a creditor who fears the safety of his principal will scarcely be content with that; he wishes to get his money or at least the property. We see no reason to suppose that the statute was intended to deprive him of that . . . unless by a substitute of *the most indubitable equivalence*.⁸⁹

The above quote demonstrates that the phrase "indubitable equivalence," as originally used by Hand, is directly connected to the idea of postpetition interest.⁹⁰

Yet even here, one can argue that there is no "plain meaning" of indubitable equivalence, for we need to know what is equivalent to what. For example, if the security interest is defined solely by state law, then the undersecured party does not bear this cost, if one assumes that the secured party would have repossessed the collateral and obtained cash proceeds expeditiously.⁹¹ On the other hand, if the security interest is defined as "state law plus the automatic stay," so that the undersecured party assumes the cost of bankruptcy delay, then the secured party gets the indubitable equivalent of her security interest without obtaining postpetition interest.

Postpetition interest for undersecured creditors is not the only idea conveyed by the concept of adequate protection, but it is noteworthy that the three statutory suggestions can arguably be connected with an entitlement to postpetition interest. Each idea, however,

87. 11 U.S.C. § 361(3) (1982).

88. Metropolitan Life Ins. Co. v. Murel Holding Corp. (*In re Murel Holding Corp.*), 75 F.2d 941 (2d Cir. 1935). Section 361(3)'s phrase "indubitable equivalent," 11 U.S.C. § 361(3) (1982), was a last minute replacement for the word "value," contained in H.R. REP. NO. 595, 95th Cong., 1st Sess. 340 (1977), reprinted in 1978 U. S. CODE CONG. & AD. NEWS 5963, 6296. The word "value" in Section 361(3) would have implicated a postpetition interest entitlement in the same manner as it did in Sections 361(1) and (2). Compare 11 U.S.C. § 361(3) (1982) with 11 U.S.C. § 361(1) (Supp. IV 1986); 11 U.S.C. § 361(2) (1982).

89. *In re Murel Holding Corp.*, 75 F.2d at 942 (citations omitted and emphasis added).

90. United Sav. Ass'n of Tex. v. Timbers of Inwood Forest Assocs. (*In re Timbers of Inwood Forest Assocs.*), 808 F.2d 363, 377-78 (5th Cir. 1987) (dissenting opinion), *aff'd*, 108 S. Ct. 626 (1988); see Nimmer, *Secured Creditors and the Automatic Stay: Variable Bargain Models of Fairness*, 68 MINN. L. REV. 1, 11 (1983).

91. This is essentially the objection to this argument posed in United Sav. Ass'n of Tex. v. Timbers of Inwood Forest Assocs., (*In re Timbers of Inwood Forest Assocs.*), 793 F.2d 1380, 1388-89 (5th Cir. 1986), *aff'd*, 808 F.2d 363 (1987) (en banc), *aff'd*, 108 S. Ct. 626 (1988).

depends on the view that the thing valued is the undersecured creditor's claim against the collateral, as a would-be assignee of the undersecured creditor's position might value it, if bankruptcy's automatic stay were not in the picture. But if the would-be assignee takes the view that the automatic stay is a reality, then the assignee will discount the value of the secured claim by the amount of time necessary to collect that claim. Note that terms like "value" or "indubitable equivalent" cannot tell us what the undersecured creditor's legal entitlements are because "value" and "equivalence" depend upon a preexisting legal entitlement. Yet it is this very legal entitlement that is in question.⁹²

To summarize, in determining the meaning of adequate protection, we have to hypothesize a "value." Value of a legal entitlement depends upon what rules constitute the entitlement. Do we hypothesize a value based on the absence of an automatic stay or a value based on the reality of an automatic stay? Nothing in the Bankruptcy Code tells us this. Happily, the Supreme Court has spoken.

2. *Timbers of Inwood Forest*

The Supreme Court has ruled out the possibility that adequate protection routinely implies postpetition interest. Writing for a unanimous court in *United Savings Ass'n of Texas v. Timbers of Inwood Forest Assocs.*⁹³ Justice Scalia admitted that Section 361 can be read to favor postpetition interest for undersecured parties,⁹⁴ but he stated

92. An interesting but failed attempt to show that Congress intended to award postpetition interest as part of adequate protection appears in Chicago Note, *supra* note 25, at 312-13. The author notes that Congress rejected the holding of *In re Yale Express System*, 384 F.2d 990 (2d Cir. 1967), and refused to allow administrative priority, in lieu of collateral, to serve as a means of adequate protection. See Chicago Note, *supra* at 313. From this, the author infers that Congress did not want secured parties to bear the risk that the collateral might dissipate in a failed reorganization. *Id.* Furthermore, refusing to grant postpetition interest likewise makes secured parties bear the risk of a failed organization. *Id.* at 314 n.42. Therefore, Congress must have intended to award secured parties postpetition interest.

This argument, though seemingly clever, overlooks the fact that *Yale Express* put an admitted entitlement of a secured party at risk. The question we are asking, however, is whether postpetition interest should be an entitlement. If not, then nothing is at risk. Hence, one is not required to draw from this a view of congressional intent. The author raises similar types of arguments about congressional intent, but each time, the author cites a provision of the Bankruptcy Code that protects the value of an admitted entitlement of a secured party. *Id.* at 318-19. It is not possible to draw from such instances any learning about whether postpetition interest should be an entitlement.

93. 108 S. Ct. 626 (1988).

94. Scalia concedes this grudgingly: "The term 'interest in property' certainly summons up such concepts as . . . 'security interest' more readily than it does the notion of 'right to immediate foreclosure.'" *Id.* at 630. Scalia is about to separate the concept of "security interest" and "right of foreclosure," a dubious dichotomy indeed.

that Section 361 must be read in a way that makes sense of the rest of Bankruptcy Code (as if that were possible!).⁹⁵ Scalia has five different interpretive arguments for the view that adequate protection does not require an undersecured creditor to receive postpetition interest. None of them is a drop dead argument, and some of them are demonstrably wrong. Let's review them one at a time.

a. Deriving the Meaning of Adequate Protection
From Section 506(a)

First, in searching for the meaning of Section 361, Justice Scalia notes that the key words are "such entity's interest."⁹⁶ These words also appear in Section 506(a).⁹⁷ Scalia reasoned that if the meaning of Section 506(a) is understood, then the problem of Section 361's meaning will also be solved.⁹⁸

Section 506(a) requires a bankruptcy court to divide an undersecured claim into two claims—one perfectly secured and one perfectly unsecured. It provides:

An allowed claim of a creditor secured by a lien on property in which the estate has an interest . . . is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property . . . and is an unsecured claim to the extent that the value of such creditor's interest . . . is less than the amount of such allowed claim.⁹⁹

In noting that the words from Section 361 also appear in Section 506(a),¹⁰⁰ Scalia asserts that "the creditor's 'interest in property' obviously means his security interest without taking account of his right to immediate possession of the collateral on default."¹⁰¹ Anytime a judge says that a meaning is obvious, you can be sure that just the opposite is true! Meanings that are obvious do not have to be described as such, for the very reason that they are obvious. Although the meaning is *far* from obvious, Scalia reads the creditor's "interest in property" as meaning no more than the dollar amount the creditor could expect to receive from the proceeds of collateral after an enforcement sale.¹⁰² These words therefore exclude the possibility of postpetition interest.

95. *Id.* at 630.

96. 11 U.S.C. § 361(1) (Supp. IV 1986).

97. 11 U.S.C. § 506(a) (1982).

98. *Timbers of Inwood Forest*, 108 S. Ct. at 630.

99. 11 U.S.C. § 506(a) (1982).

100. 11 U.S.C. § 361 (1982 & Supp. IV 1986).

101. *Timbers of Inwood Forest*, 108 S. Ct. at 630.

102. *Id.*

The claim that the word "interest"—as in "security interest"—contains this meaning may or may not be valid. Even if true, the exact words in Section 506(a)—and Section 361—are "the *value* of such creditor's interest."¹⁰³ In other words, the creditor's interest may be the dollar payment after a foreclosure sale, but the *value* of that interest depends heavily on *when* the creditor might expect to receive the dollar payment. If the funds can be received relatively quickly (as in an unopposed Article 9 enforcement sale), the value of the creditor's security interest might be one thing. But if the funds can be had only after a Chapter 11 plan is confirmed, the value might well be lower. We are therefore back to figuring out exactly what it is that the Bankruptcy Code "adequately protects"—a security interest defined by state law or a security interest defined by state law *plus* bankruptcy's automatic stay.

Writing about the meaning of the words as they appear in Section 506(a), Scalia tries to show that, if he is wrong, absurd results would follow! In this regard he is half-right! While the consequences he predicts are absurd, they do not follow:

the "value of such creditor's interest" would increase, and the proportions of the claim that are secured and unsecured would alter, as the stay continues—since the value of the entitlement to use the collateral from the date of bankruptcy would rise with the passage of time. No one suggests this was intended.¹⁰⁴

This argument is deeply confused. It may be observed that, over time, the face amount of the secured claim will increase if interest is allowed to accrue, but face amount is economically meaningless. *Value* is what counts in financial markets, and Section 361 calls for protection of *value*. If face amount is allowed to increase by the accrual of postpetition interest, the *value* of the secured claim (as of today) may stay the same, if the right interest rate is chosen. It will *not* necessarily increase, as Scalia suggests. The change in the *face* amount of a claim is inevitable if the *value* of the claim is to be protected. In arguing that postpetition interest entitlements change the value of an undersecured creditor's claim, Scalia confounds the concept of value and face amount and therefore has not developed a strong argument for his view that undersecured creditors have no postpetition entitlement to interest.¹⁰⁵

103. 11 U.S.C. § 506(a) (1982) (emphasis added); 11 U.S.C. § 361 (1982 & Supp. IV 1986) (emphasis added).

104. *Timbers of Inwood Forest*, 108 S. Ct. at 630.

105. Scalia also objects that, if postpetition interest is awarded, "the proportions of the claim that are secured and unsecured would alter, as the stay continues." *Timbers of Inwood Forest*, 108 S. Ct. at 630. If the face amount of the secured claim increases and the face value

b. Adequate Protection and Section 506(b)

Justice Scalia's second argument is based on the observation that Section 506(b)¹⁰⁶ conditions postpetition interest on the presence of an equity cushion.¹⁰⁷ Scalia infers from this entitlement that undersecured creditors have no entitlement to postpetition interest.¹⁰⁸

In response to the argument that adequate protection supplies undersecured creditors the entitlement that Section 506(b) denies them, Scalia remarks:

If the Code had meant to give the undersecured creditor, who is thus denied interest on his *claim*, interest on the value of his *collateral*, surely [Section 506(b)] is where the disposition would have been set forth, and not obscured within the "adequate protection" provision of § 362(d)(1). Instead of the intricate phraseology set forth above, § 506(b) would simply have said that the secured creditor is entitled to interest "on his allowed claim, or on the value of the property securing his allowed claim, whichever is lesser." Petitioner's interpretation of § 362(d)(1) must be regarded as contradicting the carefully drawn disposition of § 506(b).¹⁰⁹

This passage establishes a kind of reverse "Ockham's Razor" argument: If Congress intended postpetition interest for undersecured creditors, then it could have developed a less complicated statutory structure than it did.¹¹⁰ The complexity of the Code under the postpetition interest view therefore strongly suggests that this view is not the intent of Congress.¹¹¹

of the unsecured deficit remains the same, this is true. But so what? It is hard to see why a fixed proportional division between secured and unsecured claims is important. If it is, it could be achieved by paying the undersecured parties periodic cash. A concern about secured/unsecured ratios therefore does not compel a view concerning entitlements to postpetition interest.

106. 11 U.S.C. § 506(b) (Supp. IV 1986).

107. *Timbers of Inwood Forest*, 108 S. Ct. at 631.

108. *Id.*

109. *Id.* (emphasis in original). In this quote, Scalia is trying to make a very tricky distinction. He wants to suggest that adequate protection involves interest on the collateral, whereas Section 506(b) involves interest on the claim. This distinction is superficially plausible. Suppose *A* (who is senior) and *B* (who is junior) each have \$100 claims against \$150 worth of collateral. *A* is entitled to interest on the "claim" of \$100. *B* is entitled to interest on \$50 which seems to be interest on collateral. This distinction ignores Section 506(a) of the Bankruptcy Code, which makes clear that *B* has two claims—one that is fully secured for \$50, and one that is fully unsecured for \$50. Therefore, *B*, as well as *A*, would be getting postpetition interest on her claim.

110. The theory of Ockham's Razor states: If two theories explain reality, and one theory is much simpler than the other, choose the simpler theory. Scalia argues that if a text produces a complicated or a simple reality, choose the simple reality.

111. A variation on this argument is presented in Fortgang & Mayer, *Valuation in Bankruptcy*, 32 UCLA L. REV. 1061, 1082 (1985). Fortgang and Mayer worry that the accrued interest is not part of the secured claim itself and therefore *must* be paid out later as if

As Judge Jones in her dissent in the United States Court of Appeals for the Fifth Circuit pointed out, this argument can be turned against Scalia.¹¹² The Fifth Circuit took the position that, in Section 361, "value of an entity's interest in the debtor's property" means "value of the collateral."¹¹³ Jones observed, "If Congress had wanted to limit adequate protection to a decline in the value of the collateral, it could have done so, but did not."¹¹⁴ Each of these opposing arguments assumes a certain natural state of affairs that Congress had the burden of counteracting. But neither argument proves the basis on which the presumed background state of affairs was natural.

For example, the *stated* rule under the Bankruptcy Act was clear—no postpetition interest for undersecured parties. Nothing in the legislative history of the Bankruptcy Code strongly suggests an intent to change the rule.¹¹⁵ From this perspective, adequate protection ought to mean *no* interest for undersecured parties. But it will be recalled that the theory and the practice of the Bankruptcy Act diverged. We have seen that to the extent courts insisted on debtor equity as a condition of continuing the automatic stay, undersecured

it were an administrative expense. Upon confirmation of the plan, administrative expenses in Chapter 11 must be paid immediately in cash. Secured claims can be paid in debt instruments not presently mature (although their value must be *equal* to present cash). As a result *oversecured* creditors in a Chapter 11 plan can be forced to take time instruments, whereas *undersecured* parties get cash straight out (for the amount of the interest).

None of this necessarily follows at all. We can treat postpetition interest as part of the secured claim. As such, it may be added to the allowed secured claim of the undersecured party. In any case, if time instruments are *really* equal to present cash, none of this matters. In a *perfect* market, creditors are indifferent between cash now or debt instruments bearing the market rate of interest. (Of course, we know that, in fact, cash is much better. You don't need to pay a broker to dispose of it, for starters. And time instruments are valued according to the court's judgment, which may in fact be wrong in a prejudicial way.)

112. United Sav. Ass'n of Tex. v. Timbers of Inwood Forest Assocs. (*In re* Timbers of Inwood Forest Assocs.), 808 F.2d 363, 375 (5th Cir. 1987) (dissenting opinion), *aff'd*, 108 S. Ct. 626 (1988).

113. *Id.* at 376.

114. *Id.*

115. See General Elec. Mortgage Corp. v. South Village Inc. (*In re* South Village, Inc.), 25 Bankr. 987, 992-96 (Bankr. D. Utah 1982). Judge Mabey's scholarly opinion against postpetition interest for undersecured parties stresses the fact that advocates for secured parties complained about the absence of a postpetition entitlement for undersecured parties, but Congress chose to do nothing in response. *Id.* at 994 n.8. This seems to assume that Congress *did* do nothing about postpetition interest, the very question Judge Mabey had been asked to decide. Cf. *Timbers of Inwood Forest Assocs.*, 793 F.2d at 1395-96. The Court stated:

Not one of the many witnesses for secured creditors even mentioned the award of postpetition interest payments or sought compensation for the delay required by the stay. Viewed in this context, it seems unlikely that Congress intended the adequate protection provisions to require periodic payment of postpetition interest to an undersecured creditor.

Id.

parties did receive a kind of postpetition interest entitlement.¹¹⁶ We therefore are forced to choose between what judges *said* and what judges *did*. Thus the background conditions against which the current Bankruptcy Code can be read are controversial. No one interpretation can be passed off as natural.¹¹⁷

c. Postpetition Interest and Rent

In his third argument, Scalia worries about whether postpetition interest entitlements for undersecured parties would invade the turf of Bankruptcy Code Section 552,¹¹⁸ which both disencumbers postpeti-

116. See *supra* text accompanying notes 61-68.

117. Another kind of argument against postpetition interest made from Section 506(b) occurred in the original court of appeals decision in *United Sav. Ass'n of Tex. v. Timbers of Inwood Forest Assocs.* (*In re Timbers of Inwood Forest Assocs.*), 793 F.2d 1380, 1407-08 (5th Cir. 1986), *aff'd*, 808 F.2d 363 (1987) (en banc), *aff'd*, 108 S. Ct. 626 (1988). According to Judge King (née Randall), (1) oversecured parties may not get postpetition interest until a reorganization proceeding is over, because it is impossible to know what administrative expense is chargeable to the collateral until then. This, of course, is a very dubious proposition. Bankruptcy proceedings routinely rely upon estimates of value, and such administrative expenses must of necessity be estimated anyway, as part of a good valuation. *In re Boring*, 91 Bankr. 791, 795 (Bankr. S.D. Ohio 1988) (citing but rejecting some contrary authority).

In any case, King goes on to argue that (2) undersecured parties would necessarily have a *present* right to cash payments, if it were true that adequate protection required postpetition interest for undersecured parties. There is no justification for this view either; section 361(2) can be read as direct authority for deferring the payment of accruing interest. (King thought that Section 361(2) could logically apply only to protecting the value of collateral, not the value of the secured party's claim. She thought postpetition interest could *only* be justified by section 361(3), the "indubitable equivalent" subsection. She saw that the phrase came from *In re Murel Holding Corp.*, 75 F.2d 941 (2d Cir. 1935), which provided for actual cash payments and, unjustifiably, assumed that "indubitable equivalent" must mean cash payments only, not deferred payments.). *But see In re Wright, Egan & Assoc.*, 60 Bankr. 806, 807 (Bankr. E.D. Pa. 1986) (failure to pay interest in cash was cause to lift automatic stay); *In re Graves*, 59 Bankr. 928 (Bankr. E.D. Pa. 1986) (same); *In re Augustus Court Assocs.*, 46 Bankr. 619, 620 (Bankr. E.D. Pa. 1985) (failure to meet contractually scheduled payments a per se reason to lift the automatic stay). A later opinion from the Eastern District of Pennsylvania interprets these precedents as cases in which no equity was present. As such, they simply become opinions in which undersecured creditors are entitled to postpetition interest. See *In re Morysville Body Works, Inc.*, 86 Bankr. 51, 57 (Bankr. E.D. Pa. 1988).

To return to Judge King's views, King deduces from the above two wrongheaded premises that (3) undersecured parties must *not* get postpetition interest because to do so would be to treat undersecured parties *better* than oversecured parties. Obviously, this conclusion is delegitimated by the errors in the premises. Also, King did not see that *refusing* to give undersecured parties postpetition interest means that totally unsecured parties get better treatment than *undersecured* parties—in cases in which there is a surplus in the bankrupt estate. This is because Section 726(a)(5) gives postpetition interest to *unsecured* creditors in case the estate has a surplus, whereas undersecured parties do *not* get postpetition interest. See *supra* text accompanying note 69. This is an argument that Scalia will acknowledge but dismiss as an unavoidable contradiction. The point is that *no* view on postpetition interest can render the Bankruptcy Code completely consistent.

118. Section 552 provides:

tion property from prepetition after-acquired property clauses in security agreements and saves the secured party's right to proceeds and rent. The right to rent is preserved, however, only if the secured party had the right to it under state law.¹¹⁹ Scalia fears that postpetition interest as part of adequate protection amounts to the right to rent even in cases in which state law did not permit the secured party to have rent.¹²⁰

At the appropriate levels of generality, all things are the same or all things are different. Thus Scalia is not totally wrong when he asserts that rent and interest are the same thing. Rent is to property what interest is to money—both are charges for use. A secured party's right to rent and a secured party's right to postpetition interest do seem similar in that both are the right to income streams after bankruptcy. Although they are the same in this respect, they are also different.¹²¹ For one thing, interest is something the debtor owes to

(a) Except as provided in subsection (b) of this section, property acquired by the estate by the debtor after the commencement of the case is not subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case.

(b) Except as provided in section 363, 506(c), 522, 544, 545, 547, and 548 of this title, if the debtor and an entity entered into a security agreement before the commencement of the case and if the security interest created by such security agreement extends to property of the debtor acquired before the commencement of the case and to proceeds, product, offspring, rents, or profits of such property, then such security interest extends to such proceeds, product, offspring, rents, or profits acquired by the estate after the commencement of the case to the extent provided by such security agreement and by applicable nonbankruptcy law, except to any extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise.

11 U.S.C. § 552 (Supp. IV 1986).

119. Scalia writes:

Section 552(b) . . . makes possession of a perfected security interest in postpetition rents or profits from collateral a condition of having them applied to satisfying the claim of the secured creditor ahead of the claims of unsecured creditors. Under petitioner's interpretation, however, the undersecured creditor who lacks such a perfected security interest in effect achieves the same result by demanding the "use value" of his collateral under § 362. It is true that § 506(b) gives the oversecured creditor, despite lack of compliance with the conditions of § 552, a similar priority over unsecured creditors; but that does not compromise the principle of § 552, since the interest payments come only out of the "cushion" in which the oversecured creditor *does have* a perfected security interest.

Timbers of Inwood Forest, 108 S. Ct. at 631-32 (emphasis in original).

120. *Id.*

121. See *In re Turner*, 82 Bankr. 465, 469 (Bankr. W.D. Tenn. 1988) (denying the connection between rent and interest and stating that rent must compensate for any declining market values); *In re Offerman Farms, Inc.*, 67 Bankr. 279, 283 (Bankr. N.D. Iowa 1986) (awarding third party rent accruing after bankruptcy while denying a right to postpetition interest).

the creditor. Rent is conceived in Section 552 as something a lessee of the debtor owes to the debtor but which is assigned to the creditor.¹²² Furthermore, postpetition interest increases the size of the secured claim, and postpetition rent increases the size of the collateral. They are mirror images of each other. In addition, they are not necessarily related. The right to interest rarely equals the right to rent, which a debtor has against a third party. In fact, economically, one expects that interest is *less* than rent; otherwise, the landlord-borrower is better off defaulting. Thus, although it is possible to say that "interest is rent," it is also possible to say the opposite. For this reason, Scalia's argument has no logical bite to it.¹²³

d. The Indifference of Undersecured Parties

Scalia's fourth argument must be given a poorer grade than his other arguments have received. Scalia bases his argument on the fact that, if adequate protection requires postpetition interest sufficient to preserve the prepetition value of the underwater security interest, then an undersecured creditor becomes indifferent to the automatic stay in bankruptcy.¹²⁴ Now one would have thought that the purpose of adequate protection would be to do just that! But Scalia fears that, *if* the

122. One can easily argue for a rental award from the debtor to the creditor in such circumstances when the debtor herself uses the collateral in lieu of a third party. *In re Glinz*, 69 Bankr. 916, 921-22 (Bankr. D.N.D. 1987) (disallowing postpetition interest but allowing rent payments by the debtor to the secured party). That is not the kind of rent Section 552 seems to be talking about, however. See 11 U.S.C. § 552 (1982 & Supp. IV 1986).

123. One hint about the rent-interest relationship that Scalia ignored was a new rehabilitative chapter for farmers that Congress passed in 1986. This new chapter specifically provides "reasonable rent[all]" payments to mortgagees as a form of adequate protection. 11 U.S.C. § 1205(b)(3) (Supp. IV 1986). According to legislative statements pertaining to Chapter 12, rental payments were expected to be less than opportunity cost payments. H.R. REP. NO. 958, 99th Cong., 2d Sess., 49-50 (1986); see *United Sav. Ass'n of Tex. v. Timbers of Inwood Forest Assocs.* (*In re Timbers of Inwood Forest Assocs.*), 808 F.2d 363, 368 (5th Cir. 1985) (en banc), *aff'd*, 108 S. Ct. 626 (1988).

In *Timbers of Inwood Forest*, the majority opinion of the Fifth Circuit disagreed over the inferences to be drawn from the fact that Congress has provided a potential rent entitlement as part of adequate protection in farm cases. 808 F.2d at 369. According to the majority, the failure of Congress to give interest in the new farm rehabilitation chapter showed that Congress disdained postpetition interest generally. *Id.* In other words, the majority thought rent (which *was* awarded) to be *different* from interest. *Id.* The dissent suggested that Section 1205 endorses compensation for opportunity costs, even in farm cases. *Id.* at 379. In other words, the idea of rent can be viewed as tantamount to postpetition interest. *Id.* Hence, we have judges disagreeing over whether rent and interest are "the same" or "different."

124. *Timbers of Inwood Forest*, 108 S. Ct. at 632. This assumption shows that Scalia has read too much law-and-economics. Just because a judge has made an award of interest with the idea that a creditor will be rendered indifferent does not mean that the creditor *is* indifferent. That depends on whether the judge is right on the money—not too high and not too low—in estimating a market interest rate. Such an occurrence happens in mathematical models but not usually in real life.

secured parties' protection was truly adequate, it would "make[] nonsense"¹²⁵ out of Section 362(d)(2)¹²⁶ of the Bankruptcy Code. And in order to achieve "sense" for 362(d)(2), it is necessary for adequate protection to be inadequate (itself no mean bit of nonsense).

Section 362(d) provides two reasons why the automatic stay might be dissolved. First, the stay might be dissolved for lack of adequate protection.¹²⁷ Second, if adequate protection has been awarded, Section 362(d)(2) allows further grounds for relief if there is no collateral cushion and no need for the property in a reorganization.

Justice Scalia argues that if an undersecured creditor is indifferent to the automatic stay once she receives the postpetition-interest version of adequate protection, then the undersecured creditor has no incentive to use Section 362(d)(2) for relief.¹²⁸ In other words, if adequate protection is *too good*, Section 362(d)(2) is deprived of its necessity. Since every statutory clause must have a purpose, the view that adequate protection includes postpetition interest must be wrong, according to Scalia.¹²⁹

Unfortunately for this argument, one *can* think of a utility to Section 362(d)(2) if undersecured parties get postpetition interest. A decision by a bankruptcy court on adequate protection does not prove the undersecured creditor *feels* adequately protected. The undersecured creditor may feel that the bankruptcy court has awarded an insufficient amount of postpetition interest, or that the undersecured creditor could do better under state-law systems of enforcement. In such a case, the undersecured creditor can move for relief under Section 362(d)(2). Thus, if undersecured parties are entitled to postpetition interest, they still have an incentive to utilize Section 362(d)(2).

e. The Implications of Standards for Confirming a Chapter 11

A fifth argument used by Justice Scalia is a positive flop. The petitioner had argued that the concept of adequate protection implied a right to postpetition interest because a Chapter 11 provision also required that the undersecured creditor receive "present" value of the security interest.¹³⁰ In other words, the petitioner argued that, if Chapter 11 required dissenting secured parties to receive the present value of their claims, then so did the adequate protection requirement.

125. *Id.*

126. 11 U.S.C. § 362(d)(2) (1982 & Supp. IV 1986).

127. 11 U.S.C. § 362(d)(1) (Supp. IV 1986).

128. *Timbers of Inwood Forest*, 108 S. Ct. at 632.

129. *Id.* This argument also persuaded Judge Mabey. *Bankers Life Ins. Co. v. Alyucan Interstate Corp.* (*In re Alyucan Interstate Corp.*), 12 Bankr. 803, 811 (Bankr. D. Utah 1981).

130. *Timbers of Inwood Forest*, 108 S. Ct. at 633.

Scalia defeats this argument by noting that Chapter 11 requires the dissenting secured party to get present value of her claim "*as of the effective date of the plan*."¹³¹ This implies that the cost of delay pending confirmation of the plan rests on the undersecured creditor.

This argument proves way too much. Not only does it prove that the undersecured creditor gets no interest, but it also proves that the undersecured creditor gets no adequate protection at all. For instance, between the time the bankruptcy petition is filed and the Chapter 11 plan is confirmed, the collateral might deteriorate from use in an ongoing business. Under Scalia's argument, this depreciation cost would also be borne by the undersecured creditor. Yet such a meaning clearly contradicts the requirement for adequate protection and therefore must be rejected. Adequate protection trumps the inference Scalia drew from Section 1129(b)(2)(A).¹³² This conclusion throws us back to the issue of what adequate protection means in and of itself.

Using a similar argument, Scalia also tries to defeat the suggestion that the phrase "indubitable equivalence" is connected to postpetition interest.¹³³ He notes (correctly) that Learned Hand required that the secured party be paid present value as of the time a Chapter 11 plan was confirmed, not the time the bankruptcy petition had been filed. The phrase "indubitable equivalent" therefore can say nothing about postpetition interest *before* the plan is confirmed.¹³⁴

This attempt suffers from precisely the same overbreadth I have just described. If "indubitable equivalence" never requires anything more than value of the secured claim at the time a plan is confirmed, then "indubitable equivalence" rules out any sort of adequate protection before that time: "indubitable equivalence" as a means of adequate protection means *no* adequate protection is required at all!¹³⁵

131. *Id.* (emphasis in original).

132. 11 U.S.C. § 1129(b)(2)(A) (1982 & Supp. IV 1986); see *Timbers of Inwood Forest*, 108 S. Ct. at 633.

133. *Id.* at 633-34.

134. *Id.*; see Note, *Adequate Protection and the Automatic Stay Under the Bankruptcy Code: Easing Restraints on Debtor Reorganization*, 131 U. PA. L. REV. 423, 435-36 (1982).

135. The opposite argument was made by Judge Jones, dissenting in the Fifth Circuit. She claimed that, since "indubitable equivalent" implies "present value" in Section 1129(b)(2)(A)(iii), it must also imply present value in Section 361(3). *Timbers of Inwood Forest*, 808 F.2d at 380; see Chicago Note, *supra* note 25, at 321; see also MBank Dallas N.A. v. O'Connor (*In re O'Connor*), 808 F.2d 1393, 1398 (10th Cir. 1987). The Tenth Circuit stated:

[P]rior to confirmation of a plan of reorganization, the test of that protection is not by the same measurements applied to the treatment of a secured creditor in a proposed plan. In order to encourage the Debtors' efforts in the formative period

3. THE TRUSTEE'S STATUS AS HYPOTHETICAL LIEN CREDITOR

Because none of the arguments hazarded by Justice Scalia is very persuasive, I would like to contribute one of my own. One possible hint of meaning might be gleaned from a source overlooked at all levels of the *Timbers of Inwood Forest* case: the status of a trustee as a hypothetical lien creditor under state law. The theory goes as follows: A bankruptcy trustee is considered to have the powers of a hypothetical lien creditor on the day of bankruptcy.¹³⁶ This means that, on the day a bankruptcy petition is filed, the debtor transfers property to the trustee as if the trustee possessed an enormous judicial lien on whatever equity the debtor had in the secured party's collateral.

This hypothetical lien creditor status is a kind of "what if" exercise based on the idea that bankruptcy can be viewed as a collective creditors' remedy that displaces individual remedies. Subjunctive "counterfactual" speculation always plays an enormous role in the debate over adequate protection and postpetition interest entitlements. Usually, the argument for giving undersecured parties postpetition interest rests on the supposition that, but for bankruptcy, the secured party would have repossessed the collateral, foreclosed on it, and earned interest.¹³⁷ Instead of imagining that there had been no bankruptcy, as is usually done, the hypothetical lien creditor idea asks us to imagine that, but for the bankruptcy, a judgment creditor under state law has induced a sheriff to levy on the collateral. This collateral cannot be sold, however, because there is no debtor equity. Now the sheriff cannot determine whether there is or is not debtor equity until she holds an auction and fails to get a bid. Until then, the absence of

prior to the proposal of a reorganization, the court must be flexible in applying the adequate protection standard.

Id. An elaborate argument based on confirming Chapter 11 plans was asserted by Judge King (née Randall) in the original Fifth Circuit opinion. See *Timbers of Inwood Forest*, 793 F.2d at 1409-10. In this argument, King supposes again (erroneously) that adequate protection for undersecured parties inevitably implies immediate cash payments to them; no deferred interest payments could be used. *Id.* Therefore, King thought important distributional decisions had to be made, not according to the careful and detailed provisions of Chapter 11, but according to the rushed, emergency provisions of Section 362(d) involving the lifting of the stay. *Id.* This, King thought, would violate the intent of Congress in developing a painstaking information-gathering procedure in Chapter 11 for actually distributing the bankrupt estate. *Id.* Since King was wrong in her assertion that adequate protection must imply immediate cash payment instead of adequately protected deferred cash payments, this argument can be dismissed as invalid.

136. 11 U.S.C. § 544(a) (Supp. IV 1986).

137. Baird & Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. CHI. L. REV. 97, 105, 115 (1984); Note, *The Cost of Realization by a Secured Creditor in Bankruptcy*, 28 VAND. L. REV. 1091, 1106 (1975).

debtor equity is a mere *prediction*. Pending the attempted sale, the sheriff is obliged to retain the collateral. Once it is clear that there can be no sale because there is no debtor equity, the sheriff then returns the collateral to the secured party.¹³⁸ If this were the counterfactual history, it ought to be clear that the undersecured party could not collect interest for the delay from either the sheriff or the judgment creditor. Similarly, in bankruptcy, when a trustee "levies" for the benefit of all the general creditors, undersecured parties should not be able to get postpetition interest from the trustee or the general creditors. Under this view, the trustee's hypothetical status as lien creditor cuts against the idea that undersecured parties should get postpetition interest.

4. SUMMARY

As we have seen, the Bankruptcy Code fails to yield a clear answer as to whether adequate protection requires undersecured parties to receive postpetition interest. Justice Scalia has purported to find a clear meaning against postpetition interest, but his arguments derived from the text of the Bankruptcy Code are weak at best. One cannot say that he has successfully read the Code in the "holistic"¹³⁹ manner he claimed. But more to the point is whether a holistic reading of the Bankruptcy Code is even possible. If a complete coherent vision cannot be adduced from the Bankruptcy Code,¹⁴⁰ does it make sense to achieve a purely local reconciliation of a few provisions chosen at random? If not, then perhaps this enterprise can be abandoned in favor of some ethical or public policy considerations, to the extent they can be located.

Speculation on the ethics of postpetition interest will not necessarily be wasted. In *Timbers of Inwood Forest*, an undersecured party requested and failed to receive postpetition interest on its secured claim.¹⁴¹ This does not inevitably mean that undersecured parties

138. Ordinarily, junior judicial lien creditors cannot foreclose or affect senior security interests. See Carlson, *Death and Subordination Under the Uniform Commercial Code*, 5 CARDOZO L. REV. 547, 567 (1984).

139. *Timbers of Inwood Forest*, 108 S. Ct. at 630.

140. Justice Scalia candidly admits this is impossible. *Id.* at 634. He acknowledges that his reading of the Bankruptcy Code means that, in case the bankruptcy proceeding produces a surplus, the unsecured creditors receive postpetition interest while the secured portion of the undersecured claim does not. *Id.* "It would be disingenuous to deny that this is an apparent anomaly . . .," writes Justice Scalia, "but it will occur so rarely that it is more likely the product of inadvertance than are the blatant inconsistencies petitioner's interpretation would produce." *Id.* Scalia therefore puts himself in the position of claiming that he can tell which inconsistency must be endured as "inadvertent" and which inconsistency must be obliterated by a local reconciliation, even though total reconciliation is impossible.

141. *Id.* at 626.

may *never* receive postpetition interest as part of adequate protection. Some courts prior to *Timbers of Inwood Forest* have ruled that, while an undersecured party has no absolute right to postpetition interest as part of adequate protection, it nevertheless is within the discretion of bankruptcy courts to give it.¹⁴² Nothing in *Timbers of Inwood Forest* seems to preclude a doctrine of discretionary awards of postpetition interest.¹⁴³ In addition, a venerable Supreme Court decision from long ago generally described interest entitlements as a matter of equity for courts.¹⁴⁴ Thus, if reasons for postpetition interest can be developed, perhaps it is still possible for judicial discretion to fill in the gap left by positive congressional intent.

The next two Sections examine the ethical status of postpetition interest entitlements for undersecured parties. The first of these Sections discusses economic accounts of postpetition interest, and the second examines the noneconomic justifications.

IV. THE ECONOMIC EFFECTS OF POSTPETITION INTEREST

One explanatory instinct that law professors indulge in is that law *serves a purpose*. That is, for any given law there is a purpose that can be deduced from it. It is healthy to be skeptical of such instrumental accounts of law. Law is not always the tool that satisfies the wants and desires of a prelegal self. Sometimes, it helps to constitute

142. *General Motors Acceptance Corp. v. Briggs Transp. Co.* (*In re Briggs Transp. Co.*), 780 F.2d 748 (8th Cir. 1985); see also *United Sav. Ass'n of Tex. v. Timbers of Inwood Forest Assocs.* (*In re Timbers of Inwood Forest Assocs.*), 808 F.2d 363, 374 (5th Cir. 1987) (Clark, J., concurring) (en banc), *aff'd*, 108 S. Ct. 626 (1988) (Cash payments for lost opportunity costs are not always prohibited.).

143. For a post-*Timbers* case upholding postpetition interest entitlements, see *In re Milleson*, 83 Bankr. 696 (Bankr. D. Neb. 1988). In *Milleson*, the court lifted the automatic stay because the bankruptcy proceeding threatened to eat away enough of the equity cushion to deprive the secured party of postpetition interest. *Id.* at 700-01. See also *In re Rivers*, 89 Bankr. 1007 (Bankr. N.D. Ga. 1988) (refusing to apply *Timbers of Inwood Forest* retroactively to a case in which interim postpetition interest had been awarded); *In re Sherwood Square Assoc.*, 87 Bankr. 388 (Bankr. N.D. Ga. 1988) (same).

144. *Vanston Bondholders Protective Comm. v. Green*, 329 U.S. 156, 165 (1946) ("It is manifest that the touchstone of each decision on allowance of interest in bankruptcy, receivership and reorganization has been a balance of equities between creditor and creditor or between creditors and the debtor."). For what it is worth, Section 552(b) states that a secured party is entitled to postpetition proceeds, offspring, rents, and so forth "to the extent provided by such security agreement and by applicable non-bankruptcy law, *except to any extent that the court . . . based on the equities of the case, orders otherwise.*" 11 U.S.C. § 552(b) (Supp. IV 1986) (emphasis added). If a court has equitable power to manipulate the postpetition growth of the collateral, it is not a far stretch to suppose that the court may also manipulate the postpetition growth of the secured claim as well. One author, however, draws the opposite inference: because Congress was competent to give express equitable powers here, it must have intended *no* equitable powers with regard to postpetition interest. See O'Toole, *supra* note 12, at 269.

our wants and desires. The effects law has on society are always extremely complicated and counterintuitive. Having said this, however, it cannot be denied that legal rules sometimes do affect human behavior. When they do, law-and-economics becomes a possibility.

There are two types of law-and-economics: one that is dubious and another that is dubious in the extreme. The merely dubious version of law-and-economics simply tries to predict how people will react to a given law. The ethical meaning of that action is not assigned. This prediction of human behavior is a kind of sociology of law, except that, instead of real humans with historical passions, this brand of law-and-economics assumes all people are self-serving profit maximizers. The enterprise is dubious because, although profit maximizing is a genuine human desire from time to time, often it is mixed with other sentiments. Therefore, prediction of what selfish people will do is not necessarily valid for cases in which people are not totally selfish.

If this kind of economics is simply bad sociology, it is nevertheless better than the extremely dubious version of law-and-economics, which goes further and not only tries to describe human behavior, but also tries to tell us whether that behavior is good or bad according to a utilitarian standard. This is welfare economics. A welfare economist can assign positive and negative values to all human behavior caused by law and can then tell you whether the law increases or decreases human happiness. Laws that create more pleasure than pain are called "efficient." Often net aggregate happiness is expressed in fictional units called utils. This is a very egalitarian practice if all humans are assumed to have an equal entitlement to utils. Sometimes net aggregate happiness is expressed in terms of wealth. The norm of wealth maximization is very inegalitarian because it assumes that people are entitled to whatever happiness they can buy on the basis of how much money they have (with no questions asked about how they got their money).

This Section of the Article examines whether postpetition interest for undersecured parties might have some instrumental effect on human behavior and whether that effect (if it exists) is efficient. Postpetition interest for undersecured creditors might affect human happiness in one of three ways. First, if we institute a postpetition interest entitlement for undersecured parties, the added entitlement might induce secured lenders to lower the price of secured loans. Second, the entitlement might affect the behavior of bankruptcy trustees. And third, the incentive might cause "forum shopping," a phenomenon assumed to be evil. In this Section, I examine these three pos-

sibilities and critique a prominent pseudo-law-and-economics position taken by Professor Douglas Baird and Dean Thomas Jackson.

A. *Lower Interest Rates*

The first suggestion is that postpetition interest entitlements will lower the cost of secured debt.¹⁴⁵ This lower cost could appear in two different forms. Secured parties could either offer lower interest rates, or they could demand less collateral. Either form is the equivalent of a price reduction.¹⁴⁶ This reaction—lower prices—is not automatic, even if creditors are always rational (which they are not). Economic theory itself can explain why creditors might be indifferent to legal change. If default and the possibility of extended bankruptcy proceedings are viewed as such low probabilities that the cost of thinking about them exceeds the benefit of doing so, then it would follow that a postpetition interest entitlement would have no effect on the price of secured credit. In other words, this issue may be too trivial for real businesspersons to pay attention to at the time a price for a loan is set.¹⁴⁷

This is especially true in the case of postpetition interest entitlements, since the amount of judicial delay is not necessarily expected to be great, compared to collection delays that would otherwise occur after a default. According to the United States Court of Appeals for the Fifth Circuit:

In the case of most Chapter 11 debtors . . . a plan of reorganization can be effectuated, if at all, within a matter of months, not years. An occasional Chapter 11 debtor, for example, one with a complex debt structure or multifarious business problems, may take more time. However, the existence of such a debtor is the exception, not

145. See Schorer, *supra* note 14, at 68.

146. If a secured party takes less collateral and keeps the interest rate the same, the debtor is still benefited because some collateral still remains available to give to a future creditor who might otherwise be unsecured. That future creditor will then lower *her* interest charge, even if the original secured party does not. See Carlson & Shupack, *Judicial Lien Priorities Under Article 9 of the Uniform Commercial Code*, 5 CARDOZO L. REV. 287, 308 n.89 (1984).

147. Law professors flatter themselves by assuming that what concerns *them* concerns ordinary people, but this is not *necessarily* the case. Robert Gordon calls this assumption functionalism and points out that the assumption just happens to accord to lawyers a very important place in our culture. Gordon, *Critical Legal Histories*, 36 STAN. L. REV. 57, 78-79 (1984). When scholars do empirical studies, they frequently find that secured lenders do not react at all to unfavorable changes in the law. *E.g.*, Shuchman, *Data on the Durrett Controversy*, 9 CARDOZO L. REV. 605, 607 (1987) (failing to find an effect in loan pricing from a well-known ruling that low bids at foreclosure sales could be fraudulent conveyances). In response, law-and-economics practitioners have an infinite opportunity to show that these studies were marred by countervailing effects on loan prices that prevent the effect of their theories from being realized. Therefore, the assertion that people react to changes in the law ends up being a nonfalsifiable proposition.

the rule.¹⁴⁸

The expected brevity of a bankruptcy proceeding must be compared to the time it would take secured parties to foreclose under state law. In some cases, this period can be very long.¹⁴⁹ Thus, even if postpetition interest is awarded from the time foreclosure would have occurred (in order to replicate what the secured party would have received if there had been no bankruptcy), many bankruptcy proceedings will have ceased by then. In such cases, undersecured parties will get no postpetition interest at all. Such an expectation minimizes the effect of postpetition interest entitlements on the price of a loan.

In any loan, the chances of default are sure to be low and within the narrow scope of this unlikely event, a bankruptcy rule on postpetition interest could be relatively unimportant (when viewed at the time the loan is being negotiated). Whether the price of credit will fall is therefore an empirical question the answer to which should not be easily assumed.¹⁵⁰ But, even if the price of secured credit falls as a result of an extra bankruptcy entitlement, it does not follow that the decline in prices is efficient in the welfare sense. Welfare efficiency is a utilitarian standard that judges human events (including law) on the basis of whether it increases happiness (or sometimes wealth) in the world. Although both the secured party and the debtor would be happy enough at the lower price of secured credit, third parties might feel differently. The postpetition interest entitlement denies general creditors funds they previously would have had. If the general creditors react to the postpetition interest entitlement by raising the price of their loans, then the debtor will be better off only contingently—only if the decline in the price of secured credit exceeds the hike in the

148. *United Sav. Ass'n of Tex. v. Timbers of Inwood Forest Assocs. (In re Timbers of Inwood Forest Assocs.)*, 808 F.2d 363, 372 (5th Cir. 1987) (en banc), *aff'd*, 108 S. Ct. 626 (1988).

149. See *Greives v. Bank of W. Ind. (In re Greives)*, 81 Bankr. 912, 964-65 (Bankr. N.D. Ind. 1987) (two months as to farm machinery and livestock); *In re Glinz*, 69 Bankr. 916, 919-20 (Bankr. D.N.D. 1987) (same); *In re Asbridge*, 66 Bankr. 894, 900-01 (Bankr. D.N.D. 1986) (fifteen months on North Dakota ranch); *In re Bessey*, 65 Bankr. 638, 644 (Bankr. S.D. Cal. 1986) (7.5 months on California home requiring repair); Waas, *Letting the Lender Have It: Satisfaction of Secured Claims by Abandoning a Portion of the Collateral*, 62 AM. BANKR. L.J. 97, 101 (1988) (emphasizing delay in foreclosing on agricultural real estate).

150. This is not to say that it is unimportant to the parties at the time of bankruptcy. But in this version of the economic argument, we are trying to figure out the effect of a bankruptcy rule on the price of credit, which is given long before a bankruptcy proceeding is imminent.

Analogously, those of us who play the lottery and buy a dollar ticket are not, before the drawing, profoundly affected by the chance of a \$1 million prize. But the prize matters to us a lot if we hold the winning ticket. Similarly, a bankruptcy rule that enriches a particular creditor may mean little to creditors in general at the time creditors price their loans.

price of unsecured credit.¹⁵¹ Thus, in order to have a position on whether postpetition interest entitlements are efficient, one must also have a position on what effect secured credit has on the *net* cost of credit.¹⁵²

Even if the net interest burden of the debtor were to be decreased by a postpetition interest rule (an empirical fact that must not be assumed), there is yet another impediment to declaring postpetition interest entitlements efficient. This impediment relates to what economists call the "second best" phenomenon. The "second best" doctrine tells us that what appears inefficient in a "perfect market" might be efficient in a market with imperfections because countervailing inefficiencies cancel each other out and produce an allocation of resources closer to the perfect market model.

To illustrate, let us define a "firm" as the aggregate value of the creditors' claims and the debtor's equity. Those people without legal claims against the debtor are therefore excluded from the firm. It is unambiguously efficient for the debtor to maximize her position only if, (1) by doing so, she also maximizes firm value—the aggregate value of the debtor's equity and the creditors' claims, and (2) the firm does not cause harm to any person who is not a member of the firm. Debtor-maximizing activity might still be efficient if one of these two conditions is not met, but only ambiguously so. In other words, the efficiency of debtor-maximizing activity will have to be proven empirically, or at least be consistent with our intuitions about the facts, because efficiency will depend on weighing the costs against the benefits.

The two conditions for a priori efficiency are very hard to achieve. A debtor might maximize its own position but not that of the firm. Or a debtor might maximize firm value but still create more

151. As is true for secured parties, one must always question whether general creditors care enough about marginal bankruptcy rules to be affected by them. If they do not, then a shift in the rule on postpetition entitlements simply transfers wealth from one person to another, an event that does not necessarily have any efficiency significance.

152. The lead article asserting the efficiency of postpetition interest entitlements waffles about. Professor Douglas Baird and Dean Thomas Jackson write:

Our argument . . . does not rest on an assumption that secured credit, as it currently exists under state law, is worth having. Even though the institution of secured credit in its present form may not be easy to justify, we need rest on nothing more than the fact that it exists.

Baird & Jackson, *Corporate Reorganizations*, *supra* note 137, at 110-11. But, later Baird and Jackson state that secured credit is probably efficient. *Id.* at 112 n.52 ("It is entirely possible, and indeed very likely, that those who insist on secured credit, and those, including shareholders, who do not, do so for a reason, and that this reason advances the interests of all investors, creditors and shareholders alike"). Thus, these authors assert simultaneously that secured credit is "not . . . easy to justify" and is "very likely" efficient. *Id.* at 110-11, 112 n.52.

harm to nonfirm members than net benefit to firm members. For example, a corporation might undertake a risky strategy that lowers the overall value of the firm but raises the price of the common shares. Such a strategy maximizes the debtor's position (the position of shareholders), but fails to maximize firm value. In such a case, even if there are no externalities, the strategy is inefficient. Creditors absorb the full downside risk, but are cut off from the full benefits of the upside risks; shareholders could lose their investments, but have unlimited upside potential. Together, the value of common shares increases, but the value of the firm decreases even more.

Alternatively, maximizing debtor value and firm value could be inefficient. For example, a debtor might move a factory to a country with lower wage rates. This move might increase the value of the corporation's stocks and bonds and might even increase the value of all legal claims against the firm, but it harms dismissed workers who suffer displacement costs and local suppliers who can't find replacement business. Neither of these harms is currently redressable with a legal claim. These harms are "externalities."¹⁵³ The move just described might be firm-maximizing, but in the welfare sense, it might be inefficient. For welfare efficiency, the benefits to the firm (and to others) must be weighed against the harm to nonfirm members, such as workers and suppliers.

Now suppose a debtor proposes an investment that is profitable only so long as tort victims and pollution victims have no legal claims or are unable to bring legal claims against the firm. Nevertheless, the probability is high that such tort victims will suffer harm without "joining the firm." It would be efficient for this firm never to come into existence because it creates more harm in the world than benefits. Unsecured creditors might balk at lending because the risks of insolvency (from prospective tort claims that may or may not be asserted) are so great that the expected income from the firm cannot cover the debt service. Secured creditors, however, are immune from tort claims by virtue of their security interests. If the firm can now meet debt service because secured creditors charge less, then an inefficient firm is brought into existence. In this instance, the security interest is inefficient.

Applying these thoughts to postpetition interest entitlements,

153. If you think *foreigners* have utilities that should be counted, one should take into account the benefits and harms obtained because the factory will be opening up in *their* neighborhood.

there might be, at the margin,¹⁵⁴ a few inefficient firms that will not go forward if the price of secured debt is high due to the unavailability of postpetition interest. These same firms *would* go forward if the price of secured debt falls (thanks to the change in the postpetition interest rule). In such a case, the change in the rule might be inefficient, if the harm created by inefficient firms exceeds the benefit created by the efficiencies of lower credit costs. The balance of costs and benefits cannot be known deductively—only inductively. This illustrates the “second best” effect. In a perfect market, a postpetition interest rule may seem efficient, but because of externalities, the rule may be inefficient in the real world.

In the end, whether highly leveraged firms in the aggregate do or do not create externalities when they maximize firm value is a difficult empirical fact that cannot be assumed one way or the other. For this reason (the problem of the “second best”), it is not very fruitful to speculate on the efficiency of postpetition interest entitlements in bankruptcy from the perspective of its effect on the cost of lending.¹⁵⁵

B. *The Effect of Postpetition Interest on Trustees*

It is sometimes suggested that refusing undersecured creditors postpetition interest skews the choice between liquidation and reorganization. The claim is that, if undersecured parties do not get postpetition interest, then DIPs will be offered rent-free collateral, or interest-free loans. These subsidies will then induce a DIP to keep a business alive when the business is worth more in liquidated piecemeal form. As a result, this incentive leads to inefficiency.¹⁵⁶ This

154. When economists use the phrase “at the margin,” what they mean is that most of the time the incentives created by law don’t make a dime’s worth of difference.

155. Second-best arguments are everywhere, all the time. For this reason, welfare economists prefer to ignore them. They ignore them, however, at the expense of the validity of their enterprise. Indeed, because of the blizzard of counterincentives that always exists, I offer the following maxim: The better law-and-economics becomes, the less it can say. The more irresponsible and unscientific it becomes, the bolder and more impressive are its conclusions.

156. See Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors’ Bargain*, 91 YALE L.J. 857, 875 (1982) (fearing “distorted evaluation of the relative merits of reorganization versus piecemeal liquidation”). This argument also seems to be the import of Baird & Jackson, *Corporate Reorganizations*, *supra* note 137, at 121-25. In favoring a rule under which undersecured creditors get full postpetition interest entitlements, they write: “A rule that forces general creditors and shareholders to give secured creditors the full value of their claims (including compensation for the time value of money) puts the cost of a decision to reorganize the firm entirely on the junior [claims]” *Id.* at 125.

Later in the Article, however, these authors worry at length about who would fardles bear in light of the law’s delay. That postpetition interest affects the amount of judicial delay a bankruptcy trustee prefers is a much better claim, but Baird and Jackson do not explicitly connect the effect of a postpetition interest rule to the trustee’s incentive to delay.

In contrast, Judge Jones, dissenting in *United Sav. Ass’n of Tex. v. Timbers of Inwood*

theory is quite wrong, however, and those who believe it have fallen for the "sunk cost" fallacy. In theory, postpetition interest entitlements can have no effect on this choice between liquidation and continuing the business.

The decision whether to liquidate or continue is governed by rules pertaining to confirmation of a Chapter 11 plan. If the plan is successfully confirmed, the business is continued. If the plan is not confirmed, or it appears that confirmation is impossible, the firm is liquidated. At the time of the decision to confirm a plan or liquidate, postpetition interest actually paid to undersecured parties beforehand cannot affect the decision.

Two requirements for the Chapter 11 plan make clear why this is true. First, secured parties must get the present value of their claims.¹⁵⁷ Present value implies that, if the secured parties receive debt claims in lieu of cash or the collateral, the debt claims must carry sufficient interest to guarantee an equivalence between their rights in the collateral and the actual debt instruments they receive. Second, under the Bankruptcy Code, a DIP can propose a reorganization plan only if the plan produces for every dissenting creditor no less than a prospective liquidation.¹⁵⁸ This means that there comes a point in the course of a reorganization proceeding when a DIP must choose between a *future* liquidation and a *future* reorganization. With respect to this decision, a rule on postpetition interest *prior* to the termination of the proceeding has no effect. In other words, even if enormous transfers of wealth from secured to unsecured creditors have already taken place, these transfers cannot affect the purely prospective choice between liquidation and reorganization. No future thefts can occur under the theory of Chapter 11 plans because all creditors must get cash or the equivalent of cash—that is, interest-bearing debt. A purely prospective decision concerning whether to liquidate or to reorganize is therefore immune from any influence of postpetition interest entitlements.

Instead, the incentive created is for DIPs to maximize the length of time before they have to choose. It is during this period that thefts of value from undersecured creditors occur. The longer the delay, the more value a DIP can steal from undersecured parties. Any incentive

Forest Assocs. (*In re* Timbers of Inwood Forest Assocs.), 808 F.2d 363, 375 (5th Cir. 1987) (dissenting opinion), *aff'd*, 108 S. Ct. 626 (1988), clearly sees that judicial delay *pending* the decision to liquidate or to reorganize is the harmful effect produced by refusing to give undersecured parties postpetition interest. She never bothers with the effect of a postpetition interest rule on the decision between liquidation and reorganization, and properly so.

157. 11 U.S.C. §§ 1129(a)(7), (b)(2) (1982 & Supp. IV 1986).

158. 11 U.S.C. § 1129(a)(7) (1982 & Supp. IV 1986).

therefore is not felt when a DIP formulates the plan. The incentive is felt at or near the date of bankruptcy, when the DIP must decide to delay the court proceeding or to terminate the court proceeding early. It is irrelevant to this incentive whether the eventual termination is in the form of reorganization or liquidation.

The chance to obtain rent-free use of collateral that otherwise would be repossessed by secured parties might be desirable to DIP management, but (putting aside the question of externalities) it is inefficient if and only if a firm that should be liquidated immediately produces positive income that is less than the opportunity costs of the secured and unsecured creditors combined. For example, suppose the following: (1) General creditors, if given their bankruptcy dividends in an immediate liquidation, could earn an income stream presently worth \$10, and undersecured parties could earn an income stream worth \$10. (2) During the period of bankruptcy delay, the DIP produces income worth \$19. If undersecured creditors are paid \$10, continuation is worth only \$9 to the general creditors. Given these numbers, there should be an immediate liquidation and no strategic delay. Now, suppose that (3) undersecured parties cannot obtain postpetition interest until the bankruptcy proceeding is over, so that the present value of the undersecured party's legal rights falls to \$8. This means that the DIP can divert an income flow from these undersecured parties worth \$2. In this situation, the general creditors prefer bankruptcy delay to immediate liquidation because their bankruptcy dividends, given the delay, are now worth \$11, one dollar more than the \$10 they could have earned in an immediate liquidation. Only under such conditions does judicial delay fail to increase the value of the firm. The key variable is that the difference between the general creditors' positions in and out of bankruptcy delay is less than the value that can be seized from undersecured parties by refusing to pay them interest,¹⁵⁹ or:

$$\left[\begin{array}{l} \text{What general cred-} \\ \text{itors could earn if} \\ \text{liquidation is} \\ \text{immediate and all} \\ \text{dividends are paid} \\ \text{out early (\$10)} \end{array} \right] - \left[\begin{array}{l} \text{Going concern} \\ \text{value available to} \\ \text{general creditors} \\ \text{(if undersecured} \\ \text{creditors get post-} \\ \text{petition interest)} \\ \text{(\$9)} \end{array} \right] < \left[\begin{array}{l} \text{Value stolen from} \\ \text{undersecured cred-} \\ \text{itors (\$2)} \end{array} \right]$$

But even here, the inefficiency of refusing to give undersecured

159. A mathematical version of this formulation is presented in the Appendix to this Article.

parties postpetition interest presupposes a DIP management that perfectly maximizes the position of unsecured creditors and produces no externalities. If the DIP acts optimally in this situation, then a case might be made for the inefficiency of the current rules—at the margin. Unfortunately, we are unwise to assume that DIP management always behaves this way. Recent economic literature emphasizes “agency costs”—the cost of self-serving fiduciaries who do not behave in the optimal fashion.¹⁶⁰ In the case of judicial delay, DIP managers, whose duty really calls for liquidation, might nevertheless keep a firm alive solely to earn salaries, fees, and perquisites for themselves. In such a case, management would keep a firm going under judicial protection, even when the general creditors are worse off. If this incentive is operative, a rule that prevents wealth transfers from undersecured parties might not have any effect on DIP behavior.¹⁶¹ In other words, the chance to steal from the general creditors is all the incentive a self-serving DIP needs to maximize judicial delay. Consequently, if the rule is changed, some DIPs might not cut down on the preferred amount of judicial delay.

The failure of bankruptcy trustees to act in the interest of general creditors is addressed through various means of judicial supervision. Since this supervision exists anyway, it could be cost effective for courts to supervise judicial delay in order to protect the position of undersecured parties. As judicial diligence increases and delay declines, the harmful effects of inefficient going concerns will be minimized.¹⁶²

160. For a discussion of this literature in a debtor-creditor context, see Bratton, *Corporate Debt Relationships: Legal Theory in a Time of Restructuring*, 1989 DUKE L.J. (forthcoming).

161. Judge Jones, in her dissent to the Fifth Circuit opinion, believes that a postpetition interest entitlement for undersecured parties would protect general creditors from self-serving DIP management because, as a result, the DIP will be forced to close down earlier. *Timbers of Inwood Forest*, 808 F.2d at 383 (dissenting opinion). This argument doesn't work. If DIP management files for Chapter 11 because it wishes to churn high priority fees, a postpetition interest obligation will force the managers to share the kitty with secured creditors, and this sharing will hasten the demise of the firm. But it doesn't help the unsecured creditors any, unless the unsecured creditors actually get part of the kitty. Postpetition interest entitlements for undersecured parties do not help unsecured creditors in gaining access to this wealth.

Still, one might argue that, at the margin, a requirement of postpetition interest gives self-interested managers less to steal, and hence makes the choice of remaining with the DIP less attractive in comparison to moving on to their next best employment opportunity. This argument is attractive, but, as a strictly *economic* argument, it is dubious. It is similar to the one rightwing politicians and Malthusian economists sometimes assert about welfare to the poor—if we cut off welfare, the recipients will go out and get a job and become productive. The argument depends on the assumption that the next best opportunity is indeed socially productive, which may very well not be the case.

162. See *id.* at 371-72; *General Elec. Mortgage Corp. v. South Village, Inc.*, (*In re South Village, Inc.*), 25 Bankr. 987, 1000-02 (Bankr. D. Utah 1982).

In any case, we must not assume that the bankruptcy trustee is the only one affected by rules on postpetition interest. The secured parties themselves are affected. One writer creatively argues that refusing to give postpetition interest is a good incentive to convince the undersecured party to agree to a low-cost consensual workout. If the undersecured party is indifferent to bankruptcy, the other claimants have less leverage to get the undersecured party to agree to a low-cost, prepetition loan workout.¹⁶³ Another writer suggests that unhappy undersecured parties are useful in judicial supervision—they have an incentive to bring to the court's attention the undue delay of DIP management.¹⁶⁴ And a third writer points out that a no-interest rule simplifies the issues between debtors and creditors and holds down litigation costs.¹⁶⁵ These good incentives surely should count in any efficiency analysis of postpetition interest entitlements.

C. *Forum Shopping*

It has been alleged that failure to give undersecured parties postpetition interest would, in the words of Judge Jones of the Fifth Circuit, "create a rush of forum-shopping by debtors into the already beleaguered bankruptcy courts"¹⁶⁶ Dissenting from a ruling that denied an absolute entitlement to postpetition interest, Jones thought that the consequences of forum shopping would be "profound."¹⁶⁷ By "forum shopping," I assume that Jones is making an economic argument—that incentives to use bankruptcy courts would be inefficient.

An objection to the forum shopping theory is that, if bankruptcy is an efficient forum, then incentives to use it should be counted as a good thing. It is only if bankruptcy is ambiguous that incentives cause concern. Furthermore, the very ambiguity of bankruptcy might cause counterincentives that are just as healthy. We have seen that, if secured parties are harmed by bankruptcy, they have an incentive to agree to informal loan workouts that might be more efficient than a

163. See Note, *supra* note 134, at 433.

164. See Rosenberg, *supra* note 15, at 545. The lower court in *Timbers of Inwood Forest* was particularly enamored of this point. *United Sav. Ass'n of Tex. v. Timbers of Inwood Forest Assocs. (In re Timbers of Inwood Forest Assocs.)*, 793 F.2d 1380, 1407 (5th Cir. 1986), *aff'd*, 808 F.2d 363 (1987) (en banc), *aff'd*, 108 S. Ct. 626 (1988).

165. See Schorer, *supra* note 14, at 66. It should be pointed out that reducing litigation costs is not per se efficient. Litigation costs are usually transfers of wealth from one party to another. Wealth transfers have no obvious effect on total aggregate wealth. Some further demonstration is needed to show that enriching lawyers and accountants is inefficient.

166. *United Sav. Ass'n of Tex. v. Timbers of Inwood Forest Assocs. (In re Timbers of Inwood Forest Assocs.)*, 808 F.2d 363, 375 (5th Cir. 1987) (dissenting opinion), *aff'd*, 108 S. Ct. 626 (1988).

167. *Id.*

bankruptcy proceeding. The case for the inefficiency of incentives therefore must be based on transaction costs. In other words, we must ask whether the costs for bargaining out of an inefficient bankruptcy are greater than the alternative costs of going through with the bankruptcy, when secured parties are indifferent to the fact of, and length of, a bankruptcy proceeding. So posed, the question of efficiency becomes intensely empirical. Being empirical, we dare not say anything *a priori* about the efficiency of a given postpetition interest rule.

Thus, in asserting that bankruptcy courts would be deluged with new business as a result of the majority's ruling, Judge Jones emphasizes the costs of these proceedings but says nothing about the benefits. In particular, if bankruptcy is considered an efficient forum in which to wind down insolvent estates, an incentive to forum shop seems commendable. Thus, forum shopping is treated by Jones as if it were an inherent evil, but *nothing is* an inherent evil to the law-and-economics movement. *Everything* is judged by its instrumentality to human preference. Forum shopping is an inherent evil to federalists who fear that federal courts will displace the sovereignty of local courts, but such concerns seem far removed from the context of bankruptcy, where there seems little interest in preserving state court alternatives to bankruptcy proceedings.

D. *Pseudo-Law-and-Economics*

Representing the law-and-economics movement, after a fashion, are Dean Thomas Jackson and Professor Douglas Baird, who have made postpetition interest a cause célèbre.¹⁶⁸ Yet they are curiously opaque about the normative basis upon which they argue. The goal of the normative law-and-economics tradition is ordinarily to find the *efficient* solution to any given legal question. In the welfare economics sense, efficiency means the greatest good for the greatest number of people, usually as measured by wealth. Close attention to the work of Baird and Jackson shows no such basis for their policy recommendations.

Recall that wealth maximizing behavior of a firm is unambiguously efficient in the welfare sense only if the firm imposes no net external costs on others. Few firms are so inoffensive or inconsequen-

168. Jackson files amicus briefs on this question. See *Timbers of Inwood Forest Assocs.*, 808 F.2d at 380 (dissenting opinion); Brief for Amicus Curiae, Thomas H. Jackson, pro se (Oct. Term 1987) (Dock no. 86-1602); *Timbers of Inwood Forest Assocs.*, 108 S. Ct. 626 (1988); *Crocker Nat'l Bank v. American Mariner Indus., Inc. (In re American Mariner Indus., Inc.)*, 734 F.2d 426, 435 n.10 (9th Cir. 1984).

tial as to export no costs whatsoever. Therefore, anyone who talks about optimal firm behavior is not talking efficiency, unless she also means to deny that American business never exports costs to the public—a foolish claim indeed. Jackson, and later Baird and Jackson together, talk only about optimal firm behavior, even while hinting that the global efficiency of such behavior is too difficult to assess. But if optimal firm behavior is not necessarily efficient, what values are served by maximizing the position of firms? Are firms “better” than the entities who are harmed by firm maximization? It would appear so,¹⁶⁹ but Baird and Jackson give us no clue as to why this should be.

Jackson first broached these issues in his much cited article, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*.¹⁷⁰ In this article, Jackson argues that bankruptcy rules should be assessed according to whether abstract creditors, with attributes chosen by Jackson, would unanimously agree to them.¹⁷¹ For example, Jackson establishes that general creditors would agree to be equal in bankruptcy, in order to maximize the estate and reduce legal costs.¹⁷² Furthermore, Jackson shows that, *if* the existence of secured credit as a medium of investment can help to maximize firm value, then creditors would agree to allow bankruptcy to honor security interests. This claim that everyone would gladly consent in advance is tantamount to a claim that the value of the firm is maximized under the consented-to rules.¹⁷³ Applied to postpetition interest, this “creditor's bargain” implies that secured parties would veto a bankruptcy proceeding that denies them postpetition interest; therefore, they should receive it.

Now *if* security interests help to maximize firm value, then awarding postpetition interest to undersecured parties might maxi-

169. I think that Baird and Jackson *do* believe that members of the firm are *better* in some way than nonmembers of the firm who nevertheless bear the cost of firm behavior, although they do not say why. They define the firm very clearly as the aggregate of claimants against the firm, whether secured or unsecured creditors, or shareholders. Those without legal rights against the firm do not count. See Baird & Jackson, *Corporate Reorganizations*, *supra* note 137, at 103 (“bankruptcy law is, and should be, concerned with the interests of those (from bondholders to unpaid workers to tort victims to shareholders) who, outside of bankruptcy, have property rights . . .”).

170. See Jackson, *supra* note 156.

171. *Id.* at 907.

172. *Id.* at 865. This consent is based on the fact that Jackson assigns to hypothetical creditors the condition of complete equality *inter se*. He then shows that equals will agree to perpetuate equality—a truism. As it turns out, since the creditors are profit-maximizing abstractions, his equally powerful creditors can be shown to agree on *inequality*, if they are asked to, so long as every creditor is better off in bankruptcy than out of it. Carlson, *Philosophy in Bankruptcy*, 85 MICH. L. REV. 1341, 1345-56 (1987) [hereinafter Carlson, *Philosophy in Bankruptcy*].

173. *Id.* at 1356-57.

mize firm value in marginal cases, assuming all sorts of other undisclosed assumptions.¹⁷⁴ On the other hand, if security interests do not necessarily maximize firm value, but allow the debtor to maximize its *own* position instead, then *refusing* to grant postpetition interest to undersecured parties tends to maximize firm value in marginal cases. Jackson fails to mention this. In fact, Jackson fudges the question of whether secured transactions increase firm value.¹⁷⁵ But in doing so, he disables himself from having anything useful to say about maximizing firm welfare, let alone total societal welfare. If Jackson could assert that security interests help maximize firm welfare, then at least, with a postpetition interest entitlement, we would have reached firm optimizing behavior. Unhappily, we have not received even this much from Jackson's work, let alone a plausible claim of welfare efficiency.

In a later work, Jackson, with the assistance of Douglas Baird, seems to renounce the very possibility of general welfare maximization as a goal courts can follow.¹⁷⁶ This is done for the refreshingly candid reason that it is too hard for courts to decide the fate of a firm on the basis of welfare efficiency.¹⁷⁷ Instead, Baird and Jackson make an essentialist argument:¹⁷⁸ the purpose of bankruptcy is to maximize firm value (even when doing so is inefficient). This allows them to claim (with some plausibility) that the challenging and difficult prob-

174. Such as, the bankruptcy rule in question is sufficiently important to lenders that they will consider it when pricing their loans.

175. In an earlier article, Jackson claimed that security interests were efficient because general creditors were better monitors of debtor behavior than secured creditors. Therefore, a debtor's total interest expense could be reduced by assigning collateral to the poor monitors, while the good monitors could extend unsecured credit. See Jackson & Kronman, *Secured Financing and Priorities Among Creditors*, 88 YALE L.J. 1143, 1158-61 (1979).

This thesis was attacked by a fellow member of the law-and-economics movement. Schwartz, *Security Interests and Bankruptcy Priorities: A Review of Current Theories*, 10 J. LEGAL STUD. 1, 9-14 (1981). Perhaps as a result of this attack Jackson chose to beg the question concerning whether security interests are efficient. In fact it is a key assumption in trying to identify firm-optimal legal entitlements.

176. See Baird & Jackson, *Corporate Reorganizations*, *supra* note 137, at 102.

177. They write:

Fashioning remedies for all the harm a failing business may bring is difficult and beyond the competence of a bankruptcy court. . . . Keeping a firm in one town from closing may have the indirect effect of keeping a new one in a different town from opening Instead of weighing these effects equally, a bankruptcy judge is likely to focus on the demonstrable harms of those who are before him.

Id.

178. By "essentialist" argument, I mean an argument that rests upon the assertion of the "true nature" of a socially contingent phenomenon. Such arguments, though disguised as appeals to truth, are really intensely political appeals to temporary historical conditions. An essentialist argument, especially when unacknowledged as such, is the surest sign of analytical weakness.

lem of externalities are "not bankruptcy problems."¹⁷⁹

For this reason, Baird and Jackson are not at all in the welfare efficiency tradition of law-and-economics. Instead, we see Baird and Jackson renouncing utilitarianism in favor of a system of posited Aristotelian essences.¹⁸⁰ In other words, Baird and Jackson attempt what can only be called a *medieval* argument. The problem with essentialist argument is that it is difficult to prove that the essence is a fact in the world. A positivist might accept an essence if it were "posited" by the legislature, and if this is what Baird and Jackson mean, their methodology might be persuasive at the level of legal formalism. But where in the legislative history does it say that the purpose of bankruptcy is to maximize "firm value," as they define it? It is quite possible to read statements to the effect that the purpose of bankruptcy is to maximize the position of general creditors and to rehabilitate debtors,¹⁸¹ but general creditors and debtors are only part of the firm. *This* essence suggests that bankruptcy trustees *should* steal from secured creditors. To make their essentialism credible, Baird and

179. Baird & Jackson, *Corporate Reorganizations*, *supra* note 137, at 102. Baird and Jackson are not always consistent in their view that externalities are not bankruptcy problems. Not only should bankruptcy maximize the aggregate claims of each person in the firm, but the legal costs of these parties, which are not always claims against the firms, should be minimized as well. Recall that externalities of nonfirm members—harms that cannot be visited upon the debtor through a lawsuit—are to be ignored because they are "not bankruptcy problems." But externalities appended to those who have other, separate claims against the firm *are* to be considered. They *are* bankruptcy problems. But on what basis can one distinguish the external harms of firms members from the external harms of nonfirm members? The idea is that only legally compensable claims should be maximized, and yet attorneys' fees are not ordinarily legally compensable.

One of the things Baird and Jackson particularly emphasize is that bankruptcy courts should slam the factory gates shut whenever firm value is enhanced. *Id.* at 102-03. But if we can consider the nonlegal (external) harms of firm members—that is, if we can work to minimize attorneys' fees for creditors—why can't we work to minimize the external harms of workers who lose their jobs? They too are likely to be members of the firm because of wage or pension claims and therefore ought to be eligible to append their nonlegal harms to the legal claims.

180. They write:

Our view derives from two related observations: first, that bankruptcy law is, and should be, concerned with the interests of those (from bondholders to unpaid workers to tort victims to shareholders) who, outside of bankruptcy, have property rights in the assets of the firm . . . and second, that in analyzing the interests of these parties with property rights, our baseline should be applicable nonbankruptcy law.

Id. at 103. Recall that the definition of "firm value" is the aggregate value of all property rights under state law.

181. *In re Bermec Corp.*, 445 F.2d 367, 369 (2d Cir. 1971) ("the Congressional mandate [is] to encourage attempts at corporate reorganization when there is a reasonable possibility of success").

Jackson must exclude the alternative essences that might claim allegiance. This they never do.

Even assuming their *ex cathedra* essentialist program is correct, the strong position of Baird and Jackson in favor of postpetition interest still suffers from the internal contradiction that plagued Jackson's solo work. Although postpetition interest would enhance the value of a secured claim, they continue to beg the question of whether secured credit enhances firm value.¹⁸² Security interests might do the opposite—they might allow debtors to grab wealth from general creditors at the *expense* of total firm value. If this is true, then anything that discourages secured credit maximizes firm value. Hence, under their essentialist metaprinciple, they cannot tell us whether postpetition interest for undersecured parties maximizes firm value, until they resolve their feelings about the efficiency of security interests on firm value.

It is possible to derive a tricky and subtle maneuver in the work of Baird and Jackson that obviates the need to take a position on the efficiency, or even firm maximizing quality, of secured credit. The response is not expressly set forth, and it may represent my misreading of their article. But here it is: Maximizing firm value is not bankruptcy's most important metanorm. Even more important is the principle that bankruptcy rules must never affect the world of state law (even when firm value could be maximized by doing so). Bankruptcy rules should be innocuous, impotent, harmless, and ineffectual. Stated differently, bankruptcy rules should not maximize firm value prior to the bankruptcy decision. It is more important that bankruptcy be neutral. Meanwhile, given that a neutral bankruptcy law exists, a metanorm of the second rank now insists that the postpetition firm's value be maximized. In other words, the role of bankruptcy is to maximize the value of the wreckage (although it may not prevent the wreckage in the first place).

Now, in light of this scrambled priority of essences, Baird and Jackson can claim that bankruptcy should have no effect on the everyday affairs of firm creation and investment policy. Instead, it must have its effect on firms that have already failed. Under this restricted view of firm maximization, it is irrelevant whether security interests are nonmaximizing out of bankruptcy. So characterized, firm-maximization, as subordinated to bankruptcy neutrality, equates with the

182. "Our argument, then, does not rest on an assumption that secured credit, as it currently exists under state law, is worth having." Baird & Jackson, *Corporate Reorganizations*, *supra* note 137, at 110-11.

concern about forum shopping,¹⁸³ an idea critiqued earlier. Note that in asserting their transcendent essences, and subordinating firm maximization to them, Baird and Jackson are doubly removed from a welfare economics argument. Under welfare maximization, the essences (bankruptcy neutrality, and firm maximization) could not be sustained unless *they* were welfare maximizing. For this reason, to avoid confusion, it is better to term the views of Baird and Jackson as "pseudo-law-and-economics"—a methodology that uses the jargon but not the norms or the insights of welfare economics.

Even under this system in which bankruptcy neutrality is the transcendent norm, it is far from clear that Baird and Jackson will have maximized firm value by urging the adoption of a *single* rule that appears to be neutral in the abstract. If the postpetition interest rule were the *only* nonneutral bankruptcy rule that existed, then once we neutralized that rule, the creditors would choose bankruptcy over the alternatives only when the value of the insolvent firm would be maximized. The condition for such a world is as follows:

$$\frac{C_s}{E_s} = \frac{C_b}{E_b}$$

In this formula, C_s is the creditor's expected return under state (or nonbankruptcy) liquidation systems. C_b is the creditor's expected return from a bankruptcy proceeding, while E_s and E_b , respectively, are the value of the entire estate in a state-law proceeding and in a bankruptcy-law proceeding. For a truly neutral bankruptcy regime to exist, the above formula would have to hold for each and every creditor.

Not only is this condition impossible, but Baird and Jackson themselves do not favor it. They write:

[B]ankruptcy law necessarily overrides the remedies of individual investors outside of bankruptcy, for those "grab" rules undermine the very advantages sought in a collective proceeding.¹⁸⁴

Here, Baird and Jackson claim that treating general creditors equally and taking away their judicial liens is required to maximize the aggregate value of the firm. These rules that cut general creditors down to size produce the same "incentives" that were denounced earlier when they cut against secured parties. For example, those general creditors

183. "A rule change unrelated to the goals of bankruptcy creates incentives for particular holders of rights in assets to resort to bankruptcy in order to gain, for themselves, the advantages of that rule change, even though a bankruptcy proceeding was not in the collective interest of the investor group." *Id.* at 104.

184. *Id.* at 100-01.

who have received voidable preferences have an incentive to shun bankruptcy, while those creditors who have not received their share of voidable preferences have a nonneutral incentive to force the firm into bankruptcy. Why don't *these* incentives lead to bad bankruptcies, as did the ones that hurt secured parties?

The answer has to be that voidable preference law and the like create nonneutral incentives for some general creditors to pursue nonmaximizing bankruptcies. Given the nonneutrality of *this* rule, the essences postulated by Baird and Jackson might dictate precisely the *opposite* policy that they assert. That is, a nonneutral rule that denies undersecured parties postpetition interest could be seen as a good second-best strategy that moves bankruptcy law closer to the stipulated goal of neutrality. In other words, general creditors who lose their payments or their judicial liens because they are voidable preferences are partially compensated by the chance to steal some wealth from undersecured parties. Meanwhile, the general creditors who never had preferences have a double incentive to seek bankruptcy (even when not firm-maximizing), but they also have nonneutral disincentives. In particular, general creditors do not receive postpetition interest during the delay before reorganization or liquidation. An increased bankruptcy estate, due to a rule against postpetition interest for secured creditors, helps to compensate against this nonneutral dis-entitlement. Furthermore, general creditors are at the mercy of bankruptcy trustees, their lawyers, and accountants who are likely to take value that general creditors might otherwise get. These counter-vailing disincentives—each completely nonneutral in the abstract—conceivably help to balance out the nonneutrality of a postpetition interest rule for undersecured parties, although, as always, these are empirical questions. Hence, asserting neutrality in a specific case might be the equivalent of asserting nonneutrality generally, and asserting nonneutral bankruptcy rules specifically might further the goal of bankruptcy neutrality (assuming that this is a worthwhile goal).

At the risk of turning this into a massacre, there is yet another serious contradiction in the work of Baird and Jackson on postpetition interest. They claim strongly that, even if security interests are bad or unfair, bankruptcy should do nothing about it. Otherwise, the above incentives for bankruptcy are created. The new contradiction I wish to illustrate is that, at the same time Baird and Jackson want secured parties to get postpetition interest—in order to save the value of their rights at state law—they also insist on equal treatment for general creditors. General creditors are most unlikely to be equal

under state law. They will differ in their power over the debtor and the quickness with which they can obtain a judgment or other form of payment. Why aren't general creditors entitled to their rights under state law? Why should secured parties be protected, but not general creditors? This contradiction is one Baird and Jackson share with some of the other normative theories on postpetition interest—an inability to distinguish between general creditors (who get no postpetition interest) and undersecured parties (who do allegedly deserve it). The inability to justify unequal treatment of secured and unsecured creditors is the one problem that no writer has yet solved when dealing with the ethics of postpetition interest entitlements.

V. NONECONOMIC ARGUMENTS FOR GIVING UNDERSECURED CREDITORS POSTPETITION INTEREST

We have just seen that the economic argument for postpetition interest is inconclusive. Assuming that postpetition interest is still possible as a matter of judicial discretion, what kind of noneconomic principles might be brought to bear? Two different views have been located in the literature, and a line of cases already exists with regard to discretion. Each, however, is flawed in one way or another.

The first of the academic views is founded upon the notion of reciprocity—that is, since undersecured creditors are being deprived of an entitlement, reciprocity demands that they be compensated. A second view suggests that postpetition interest should be awarded in cases in which the value of the collateral varies greatly (such as inventory financing cases), but should not be awarded in cases in which the collateral has a relatively stable value over time (such as equipment cases). The crux of this claim seems to be that secured parties who take risks by lending on floating collateral should be compensated for having done so. In this Section, each of the academic views will be considered. In addition, this Section will examine the norms presented by courts in the discretionary interest cases.

A. *Postpetition Interest as a Matter of Reciprocity*

An early pitch that undersecured creditors should receive a postpetition interest entitlement was made by Patrick Murphy, a lawyer active in drafting some proposed replacements for the Bankruptcy Act of 1898. He justified the idea as follows:

This . . . idea may seem shocking at first because it has been long recognized in bankruptcy that a secured creditor is entitled to the payment of interest only in the event that it holds surplus security Nevertheless . . . [i]f the stay of the marginally

secured creditor is properly viewed as an involuntary loan of property to the debtor, there seems little reason not to afford the secured creditor some protection against the ravages of inflation and the fact that his own creditors have not given him an interest moratorium.¹⁸⁵

So portrayed, the postpetition interest entitlement is a trade-off. The debtor gets to use property characterized as belonging to the undersecured creditor and therefore should be made to pay for it. Unfortunately, general creditors, who get no postpetition interest, can make the same argument. The debtor gets to use the money lent (or at least not collected) by general creditors, and therefore the debtor should pay interest for the use of that money.¹⁸⁶ Like the argument for adequate protection presented in the legislative history,¹⁸⁷ this argument about postpetition interest fails to distinguish undersecured creditors from general creditors.¹⁸⁸ Complete reciprocity in bankruptcy is out of the question and must yield to concerns about equal treatment.

B. Risk Compensation

One of the more ambitious attempts at a theory of adequate protection comes from Professor Raymond Nimmer,¹⁸⁹ who discovered that, in cases decided as of 1983, courts were more likely to award postpetition interest as part of adequate protection when the collateral was floating collateral, such as accounts or inventory, but not in cases involving equipment.¹⁹⁰ Based on this observation, Nimmer has filled in a normative justification based on creditor expectations with regard to risk undertaken. Interest is appropriate for inventory and accounts because the risk of collateral depreciation is greater than for equipment.¹⁹¹ Meanwhile, interest is not appropriate for equipment

185. Murphy, *Use of Collateral in Business Rehabilitations: A Suggested Redrafting of Section 7-203 of the Bankruptcy Reform Act*, 63 CALIF. L. REV. 1483, 1506 (1975); see also *United Sav. Ass'n of Tex. v. Timbers of Inwood Forest Assocs. (In re Timbers of Inwood Forest Assocs.)*, 808 F.2d 363, 381 (5th Cir. 1987) (dissenting opinion), *aff'd*, 108 S. Ct. 626 (1988) ("An undersecured creditor . . . [who] has property at risk . . . is 'doing business' with the debtor by virtue of a forced loan of his collateral.").

186. Anderson, *Adequate Protection of Opportunity Cost after In re Briggs*, 19 CREIGHTON L. REV. 765, 778 (1986).

187. See *supra* text accompanying note 47.

188. It can be said that, in the absence of bankruptcy, the secured creditor has a property claim, deprivation of which demands compensation via interest, while the unsecured creditor does not have a property claim until she obtains a judicial lien on the debtor's property. This is true by definition. Nevertheless, *both* have acquiesced in the debtor's possession of personal property, and both would have a similar claim to interest compensation.

189. See Nimmer, *supra* note 90.

190. *Id.* at 20-22, 25-35.

191. Nimmer writes:

[F]loating collateral cases routinely involve substantial reconstruction of the

because it tends to have a more stable and predictable value over time and hence less risk.¹⁹²

This concept of additional risk for accounts and inventory lending seems to be based on the idea that, with floating collateral, the borrower is often invited to liquidate the collateral in the ordinary course of business.¹⁹³ The risk is that since the borrower is allowed to handle cash, he might divert it from the secured party. In addition, inventory or accounts probably depreciate faster, generally speaking, than equipment.

The problem with Nimmer's thesis is that the greater the risk of the undersecured creditor, the more likely the undersecured creditor will be rewarded with interest entitlements. Yet the more risky the collateral, the more the undersecured creditor resembles general creditors, who also take big risks. If general creditors are denied interest because they have "trusted" the debtor by not reserving liens, then in the interest of equal treatment, perhaps inventory lenders should be denied postpetition interest as well. They "trust" the debtor with cash proceeds of the collateral and therefore face an absence of collateral, just like general creditors.

An additional problem with this thesis is that a prebankruptcy risk taken by inventory and accounts lenders is used to justify a postpetition entitlement. Yet in the postpetition period, the risk is substantially transformed and perhaps eliminated. In other words, prior to bankruptcy, inventory lenders might take a greater risk than equipment lenders, but after bankruptcy, their fundamental right to the value of the collateral is preserved and is entitled to be protected. After bankruptcy, the collateral is extremely nonrisky. Why should these inventory lenders have this risk removed *and* get postpetition interest as well?

An adequate theory for a postpetition interest award needs to show why undersecured creditors deserve postpetition interest, while general creditors do not. Professor Nimmer argues that because undersecured creditors claiming inventory face bigger risks than undersecured creditors claiming equipment, the former deserve the postpetition interest entitlement. But if high risk is the key factor, why don't general creditors get interest entitlements also?

original bargain [between debtor and creditor], due in large part to a general tendency on the part of courts to compensate for the extra risk encountered by the creditor. Compensation commonly includes payment of interest on the enforced investment and maintenance of at least some cash flow to the creditor.

Id. at 29.

192. *Id.* at 20.

193. *Id.* at 30.

C. Normative Principles in the Case Law

Prior to the Supreme Court's opinion in *Timbers of Inwood Forest*,¹⁹⁴ several cases held that, as a matter of discretion, courts could award postpetition interest to undersecured parties. The leading case on discretionary awards of postpetition interest is *In re Briggs Transportation Co.*,¹⁹⁵ named by one writer as the case that "most closely meets Congress's intent that courts use flexibility in determining adequate protection."¹⁹⁶ For a discretionary doctrine to succeed the courts must tell us when and why undersecured parties are entitled to postpetition interest.

Briggs sacrifices guidance in favor of praise for the virtues of flexibility, but it does provide one criterion: that creditor expectations must be weighed against debtor expectations for a successful reorganization.¹⁹⁷ An undersecured party *should* get postpetition interest when it is highly probable that no Chapter 11 plan will be approved. But she should *not* get postpetition interest when it is highly probable that a Chapter 11 plan *will* be approved.¹⁹⁸ This standard has the virtue of prohibiting a marginal DIP from speculating at the expense of undersecured parties.¹⁹⁹ This can be viewed as an extension of the principle found in Section 362(d)(2)(B)—that the trustee must not retain collateral unless useful to a reorganization.²⁰⁰ Section 362(d)(2)(B) has no effect if the debtor also has equity in the collateral.²⁰¹ The *Briggs* principle therefore allows the court to consider the viability of the firm, even when debtor equity exists to oust Section

194. *United Sav. Ass'n of Tex. v. Timbers of Inwood Forest Assocs. (In re Timbers of Inwood Forest Assocs.)*, 108 S. Ct. 626 (1988).

195. *General Motors Acceptance Corp. v. Briggs Transp. Co. (In re Briggs Transp. Co.)*, 780 F.2d 1339 (8th Cir. 1985); *see also* *Norwest Bank Worthington v. Ahlers (In re Ahlers)*, 794 F.2d 388 (8th Cir. 1986), *rev'd and remanded on other grounds*, 108 S. Ct. 963 (1988), *vacated and remanded*, 844 F.2d 587 (8th Cir. 1988).

196. Carey, *supra* note 47, at 320.

197. This formulation once again tries, in a circular fashion, to deduce the law from creditor expectations when creditors in fact expect the protection the law gives them. Yet the existence or prelegal expectations is impossible to show or prove. *See In re All-Ways Servs., Inc.*, 73 Bankr. 556, 575 (Bankr. E.D. Wis. 1987) (emphasizing that creditors must show they relied on their contractual right to receive interest compensation).

198. *Id.* at 1349.

199. Carey, *supra* note 47, at 339. This would be so even if actual *payment* of the interest is deferred until the plan is confirmed. *Briggs*, 780 F.2d at 1348 (approving the idea of deferring interest payments). A DIP must still have the funds to make sure that all dissenting creditors receive as much in the plan as they would have received in a hypothetical liquidation. 11 U.S.C. § 1129(a)(7) (1982 & Supp. IV 1986). To the extent undersecured parties have extra entitlements, this goal will be harder to achieve, no matter when the payments to the undersecured parties are actually made.

200. 11 U.S.C. § 362(d)(2)(B) (1982 & Supp. IV 1986).

201. *Id.*

362(d)(2)(B) from jurisdiction.²⁰²

Besides *Briggs*, several other cases deserve mention.²⁰³ Some cases asserted that the pressure on banks carrying unproductive loans was a reason to lift the stay, though not to award periodic interest,²⁰⁴ but these cases also balanced debtor interests against creditor interests in determining whether to lift the stay.²⁰⁵ Similarly, in *In re Colrud*,²⁰⁶ an undersecured party was himself close to liquidation. He asked for a postpetition interest award on the grounds that it was necessary to stave off his own financial ruin. The bankruptcy court granted it based on this grounds, suggesting that the postpetition interest entitlement belongs to poor creditors but not to rich ones.²⁰⁷

To conclude, if it is true that a court has discretion to award postpetition interest as part of adequate protection, the ethical grounds for doing so has not been developed very well. This failure plagues the entire issue both in the courts and in the academic commentary. Perhaps a reason can be proffered for this. Postpetition interest *vel non* amounts to a property entitlement or disentitlement, and an ethical theory must be able to tell us who deserves to be enriched and who deserves to be impoverished. Perhaps a deeply con-

202. Of course, Justice Scalia would say this counts as an argument *against Briggs*. It will be remembered that he based one of his main arguments for no postpetition interest entitlements for undersecured parties on preserving the *necessity* of Section 362(d)(2). *United Sav. Ass'n of Tex. v. Timbers of Inwood Forest Assocs. (In re Timbers of Inwood Forest Assocs.)*, 108 S. Ct. 626, 627 (1988). The *Briggs* court may have erred in making adequate protection too adequate!

203. One court was skeptical as to whether any grounds for discretionary interest payments could be developed: "This court does not believe that lost opportunity cost is always required for adequate protection. Indeed, the payment . . . should rarely be required, if ever. The court sees no special circumstances in this case that call for the payment . . ." *Parker v. Concorde Ltd. Partnership (In re Concorde Ltd. Partnership)*, 67 Bankr. 717, 723-24 (Bankr. E.D. Tenn. 1986). In this case, however, the junior mortgagee had some equity cushion, but apparently wanted *cash* payments, not accrual over time. *Id.* at 724-25.

204. *See In re C.F. Simonin's Sons, Inc.*, 28 Bankr. 707, 713 (Bankr. E.D.N.C. 1983); *Commonwealth of Pa. School Employees' Retirement Fund v. Heath (In re Heath)*, 9 Bankr. 665, 668-69 (Bankr. E.D. Pa. 1981).

205. *City Nat'l. Bank v. San Clemente Estates (In re San Clemente Estates)*, 5 Bankr. 605, 611 (Bankr. S.D. Cal. 1980) (stay not lifted because debtor sincere); *cf. Fidelity Bond and Mortgage Co. v. Britton (In re Britton)*, 9 Bankr. 245, 248 (Bankr. E.D. Pa. 1981) (stay lifted because debtor insincere).

206. 45 Bankr. 169 (Bankr. D. Alaska 1984).

207. *Id.* at 179-81; *see also In re McDaniel*, 89 Bankr. 861, 877-78 (Bankr. E.D. Wash. 1988) (since creditors required "income" from real estate mortgage, monthly payments were granted, but no guidance given as to whether payments are on principal or interest); *Yaffe, M.D. v. Andrews (In re Andrews)*, 17 Bankr. 515, 518-19 (Bankr. C.D. Cal. 1982) (relief from automatic stay granted in case in which debtor acted in bad faith and failed to pay, almost causing creditor financial ruin). *Contra Neier v. Clark Oil & Refining Corp. (In re Apex Oil Co.)*, 85 Bankr. 538, 541 (Bankr. E.D. Mo. 1988) (erroneously claiming no cases exist to support such a proposition).

textual case-by-case analysis can reveal the answer to this question, but such questions of who gets what cannot very easily be disposed of at a high level of abstraction. As a result, nothing much can be said in general about when a secured party should receive postpetition interest by way of adequate protection.

VI. OVERSECURED PARTIES AND POSTPETITION INTEREST

Up to this point, we have been examining the issue of whether *undersecured* parties may obtain postpetition interest under the guise of adequate protection, a question which the Supreme Court has answered in the negative. It should not be assumed, however, that *Timbers of Inwood Forest* has no application to *oversecured* parties.²⁰⁸ On the contrary, Section 506(b) provides:

To the extent that an allowed secured claim is secured by property the value of which . . . is greater than the amount of such claim [i.e., a collateral cushion exists], there shall be allowed to the holder of such claim, interest on such claim²⁰⁹

The postpetition interest entitlements described in Section 506(b) are susceptible to two different readings. Under the first reading, if a collateral cushion exists, then the secured party receives full interest on her claim. In other words, the cushion is simply a necessary condition precedent to postpetition interest but is not a limit on the amount of interest that can be collected. Under the second reading, if a collateral cushion exists, then the secured party gets full interest on her claim, but the cushion itself limits the amount of interest that the secured party can receive. To illustrate, suppose collateral is worth \$1,100, and a secured party is entitled to 10% on a claim of \$1,000. Under the first reading, the oversecured party can get 10% in perpetuity because the condition precedent of an equity cushion at the beginning of the bankruptcy has been met. Under the second reading, the oversecured party can get one year's worth of interest. If the bankruptcy proceeding lasts into the second year, then no further interest can be paid.

208. Courts routinely use equity cushions as the device of adequate protection without considering the effect of such use on the postpetition interest entitlement of the oversecured party. *E.g.*, *Sun Valley Ranches, Inc. v. Equitable Life Assurance Soc'y (In re Sun Valley Ranches, Inc.)*, 823 F.2d 1373, 1376 (9th Cir. 1987).

209. 11 U.S.C. § 506(b) (Supp. IV 1986). The omitted words make clear that the collateral cushion should be calculated only after the trustee has deducted from the collateral fund any "necessary costs and expenses of preserving, or disposing of, such property to the extent of any benefit to the holder of such claim." 11 U.S.C. § 506(c) (1982). Other omitted words also give secured parties the "fees, costs, or charges provided for under the agreement," to the extent of the collateral cushion. 11 U.S.C. § 506(b) (Supp. IV 1986).

In *Timbers of Inwood Forest*, the Supreme Court endorsed this second reading,²¹⁰ which means that, if a bankruptcy proceeding lasts long enough, then all oversecured parties will eventually become undersecured parties.²¹¹ With this reading of Section 506(b) in effect, *Timbers of Inwood Forest* will govern the interest entitlements of undersecured and oversecured parties alike. The contradictions between oversecured and undersecured parties will be avoided only when the equity cushion is so large that no bankruptcy proceeding could possibly take long enough for postpetition interest to erode the cushion.

Although the Supreme Court has endorsed the second view of Section 506(b)—wherein the equity cushion is the limit of postpetition interest entitlements, lower courts have in fact taken both views of Section 506(b)—the “conditional” view and the “limitation” view. In other words, sometimes secured parties receive unlimited bankruptcy interest, so long as there is *some* equity cushion when the bankruptcy proceeding started, and sometimes the cushion serves as the limit of interest dollars an oversecured party can receive. The fact that courts have split on this issue is not usually recognized because courts have reached these results obliquely through technical manipulations of the adequate protection doctrine.

Neither reading of Section 506(b) is free from unpleasant side effects. If the equity cushion is viewed to be the condition but not the limit of postpetition interest for the oversecured party, then secured parties with a one dollar equity cushion get full postpetition interest, while creditors with a one dollar deficiency get *no* postpetition interest. This state of affairs appears highly arbitrary. On the other hand, if the equity cushion is viewed as the limit of how much interest an oversecured party can get, then terrible confusion is created by the fact that the equity cushion simultaneously becomes both the measure of the secured party's entitlement and the device by which adequate protection is assured.

What follows is an account of all the logical permutations of the conflict between adequate protection and postpetition interest entitlements for oversecured parties. We start with the simplest case.

210. *United Sav. Ass'n of Tex. v. Timbers of Inwood Forest Assocs.* (*In re Timbers of Inwood Forest Assocs.*), 108 S. Ct. 626, 631 (1988) (“[T]his provision permits postpetition interest to be paid only out of the ‘security cushion’ . . .”).

211. Or, to be more precise, at least they would be on the borderline between being oversecured and undersecured and no longer entitled to postpetition interest.

A. Extremely Large Equity Cushions

Every oversecured creditor is potentially an undersecured creditor if (a) the equity cushion is a limit on the postpetition interest entitlement, and (b) the bankruptcy proceeding lasts long enough. But sometimes an equity cushion is so large that no oversecured creditor is likely to become undersecured through the accrual of interest. If so, the ambiguity of Section 506(b)—whether debtor equity is a condition or a limitation—may be avoided altogether.²¹²

The following schematic drawing illustrates this and subsequent situations. In Figure 1, the left ordinate represents face amounts of

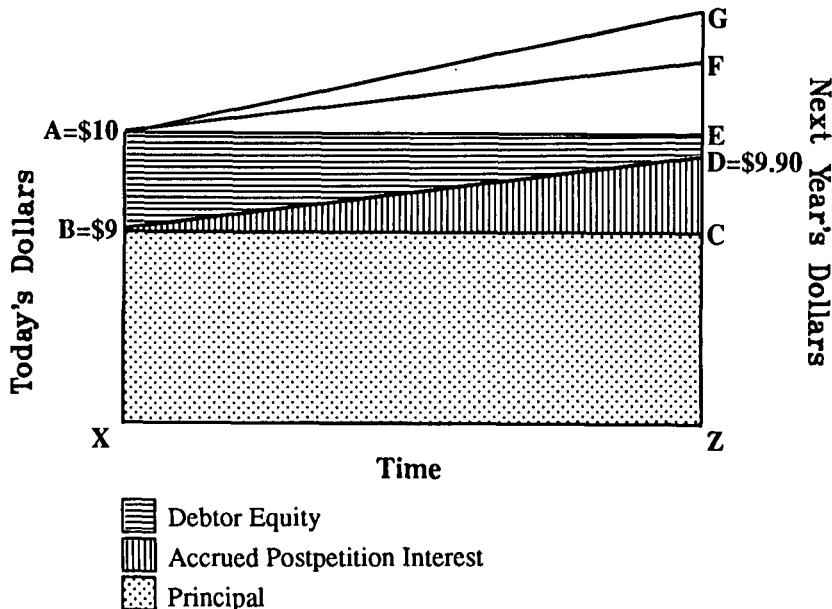


FIGURE 1

dollars today. The right ordinate represents the face amount of dollars at the time the bankruptcy proceeding is expected to be concluded. The abscissa represents time.

For ease of illustration, we assume that one year is the time the bankruptcy proceeding is expected to take. At the time of bank-

212. For some cases with equity cushions large enough to avoid the meaning of section 506(b), see *In re Grant Broadcasting of Philadelphia, Inc.*, 71 Bankr. 376, 386 (Bankr. E.D. Pa.), *aff'd*, 75 Bankr. 819 (E.D. Pa. 1987); *In re Dunes Casino Hotel*, 69 Bankr. 784, 795 (Bankr. D.N.J. 1986) (equating size of cushion with prospective accrual of interest); *Parker v. Concorde Ltd. Partnership (In re Concorde Ltd. Partnership)*, 67 Bankr. 717, 724-25 (Bankr. E.D. Tenn. 1986); *Peninsula Sav. & Loan Assoc. v. R & H Investment Co. (In re R & H Investment Co.)*, 46 Bankr. 114, 116 (Bankr. D. Conn. 1985).

ruptcy, the value of the collateral is expected to be \$10. One year from bankruptcy, the value of the collateral is expected to remain at \$10. The oversecured party has a claim of \$9 and is entitled to 10% interest, so that, in a year, the secured party will have a claim of \$9.90. We assume for the moment that the oversecured party is not paid cash. Instead, interest is allowed to accrue against the debtor's shrinking equity. Compound interest is not allowed in bankruptcy,²¹³ so the secured party can get only a straight 10% on the principal.

In such a case, a court need not choose between the two interpretations of Section 506(b) because the collateral travels from point *A* to point *E*—a horizontal line at \$10— while the amount of the secured claim goes from *B* to *D*. On the right ordinate, *CZ* represents the principal amount of the secured party's claim, while *CD* represents postpetition interest. Together, *DZ* represents the oversecured party's allowable claim at the time the reorganization plan takes effect.

It can be seen that postpetition interest depletes the bankrupt estate. Retaining the collateral is rational only if the estate can earn more than the expense of retention. Line segment *EG* represents the expense of retention. *EF* represents the amount of interest paid to the oversecured party. *FG* represents the amount the estate could have earned if it had liquidated the collateral immediately, paid \$9 to the secured party, and invested the equity cushion according to its best alternative opportunity. For retention to make sense, the estate will have to earn revenues in excess of *EG*.

B. *Same: Interest Paid Periodically*

Section 506(b) hints that a trustee might refuse to pay the oversecured party postpetition interest in cash, and instead allow the interest to accrue, so that the size of the secured claim grows.²¹⁴ In Figure 1, this is shown by line *BD*. If instead the court insists that the trustee must pay interest from time to time in lieu of accrual, then the amount of interest the oversecured party receives increases (and the expense of retention also increases). This is because, in bankruptcy, compounded interest cannot be awarded. If interest is actually paid out, however, the secured party can reinvest the payments and earn compound interest. A court order requiring periodic payment of interest prior to confirmation of the plan therefore has the effect shown in Figure 2. The return to the oversecured party shifts upwards from *BD* to *BD'*. Accordingly, the cost of retention shifts from *AG* to *AG'*, where *DD' = FF'*. Notice that the oversecured party obtains

213. *Vanston Bondholders Protective Comm. v. Green*, 329 U.S. 156 (1946).

214. 11 U.S.C. § 506(b) (Supp. IV 1986).

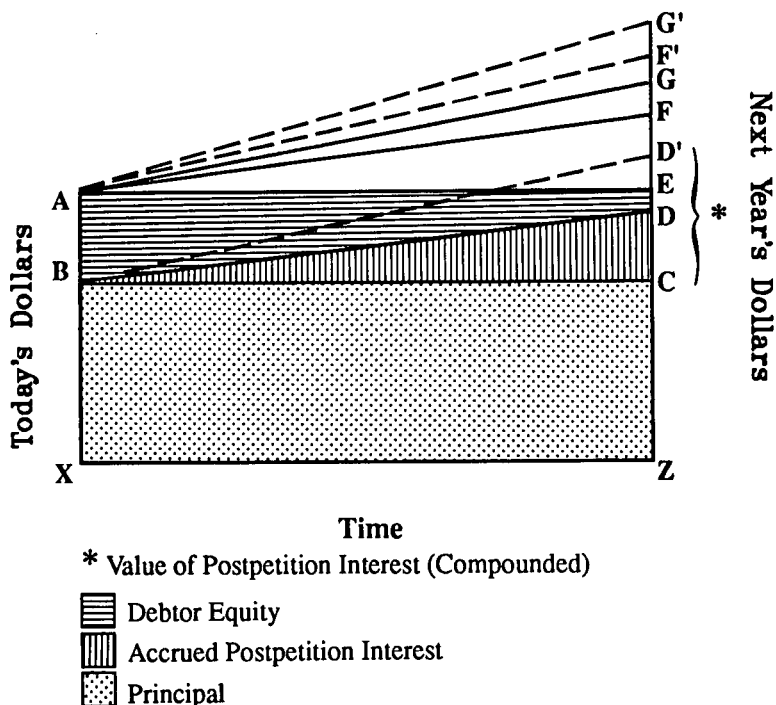


FIGURE 2

postpetition interest entitlements that are higher than the equity cushion. In other words, $CD' > CE$. This is unobjectionable. The total dollars paid out (unadjusted for time value) is represented by CD . This amount does not exceed the equity cushion, so that a court is not required to choose between the two interpretations of Section 506(b). Nevertheless, the periodic payment of interest is more expensive for the bankruptcy estate than the accrual of interest because periodic payouts deprive the bankrupt estate of an investment opportunity.

C. *Depreciating Collateral and Periodic Payout of Interest*

Figure 3 already introduces a paradox. In this case, the collateral depreciates in value from \$10 to \$9.10. The oversecured party is entitled to 10% interest. This is paid out periodically, so that the oversecured party earns compound interest, represented by BD' . If interest is accrued instead of paid out, the secured party would have gotten BD , for a total interest entitlement that is less than the *initial* equity cushion of the debtor ($DC < AB$).²¹⁵

215. Cases following this approach include *Tokai Bank of Cal. v. Old Town Historic Bldg. Ltd. Partnership* (*In re Old Town Historic Bldg. Ltd. Partnership*), 79 Bankr. 8, 11 (Bankr. C.D. Cal. 1987) (with no depreciation proven, interest payments to thinly secured creditor

of *Inwood Forest* might rule out alternative (b)(ii).²¹⁸ Thus, any post-*Timbers* court following the plan in Figure 3 takes a position on the meaning of Section 506(b): The cushion is the condition, but not the limit, of the postpetition interest entitlement.

In Figure 3, the secured party is oversecured between time *X* and *Y*. She is undersecured between times *Y* and *Z*. For courts wishing to establish the equity cushion as the limit of interest for the oversecured party, periodic interest can be paid until point *Y*, but not after then.

The effect of such a ruling is shown in Figure 4. After point *Y*, a court will have to terminate periodic interest payments to the secured party who is now undersecured. Line *BD'''* therefore flattens out to represent the termination of the interest payments. Because interest was paid prior to time *Y*, the secured party will continue to get some benefit from compounding. Therefore, after time *Y*, *BD''* is positively sloped.

The collateral is depreciating, so that after point *Y*, the secured party is entitled to have the automatic stay lifted. To prevent this, the trustee can award additional collateral to the secured party, starting at point *Y*. This extra collateral is represented by *E'D'''*. The total scheme's effect on income is beneficial to the debtor. The needed income to justify retention of the collateral levels out from *G'* to *G''*.

Figure 4 assumes that, after point *Y*, adequate protection is supplied through additional collateral. Many courts approve adequate protection in the form of cash payments equal to depreciation (*E'D'''*). In Figure 4, this ruling shifts *BD''* further upwards because it is possible for the secured party to invest cash actually paid out and obtain a form of compound interest.

To summarize, Figure 4 illustrates the problems caused when the equity cushion is simultaneously the mode of adequate protection and the limit of the oversecured party's postpetition interest entitlement. In order to solve the paradox, one must take the view that the equity cushion is not the limit of the undersecured party's postpetition interest entitlement, or that interest entitlements run out at point *Y*. Alternatively, one could also decide that the secured party has the right to

therefore requested, as a remedy, a superpriority under Bankruptcy Code section 507(b). The court allowed the secured party to add what appears to be full postpetition interest to the superpriority claim, even though that interest must have far exceeded the tiny equity cushion that existed at the start of the bankruptcy proceeding. But the court indicated that it would have allowed undersecured creditors to do the same for the interest on the secured portion of their claims. *Id.* at 979 n.5.

218. It will be recalled that *Timbers of Inwood Forest* may simply rule out an automatic right to postpetition interest for undersecured parties. 108 S. Ct. at 635. If discretionary postpetition interest is still permitted, that alternative (b)(ii) is *not* ruled out.

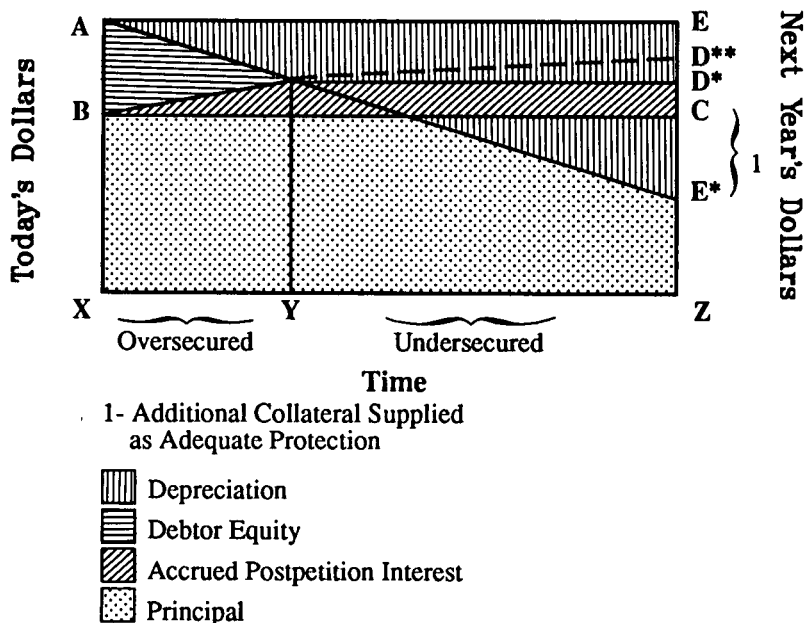


FIGURE 5

also received E^*D^* in periodic cash payments. This cash can be reinvested by the secured party, so that the total value of her bankruptcy entitlements is $D^{**}Z$.

E. Plans that Preserve the Existence of Equity

One kind of adequate protection scheme for oversecured parties is represented by Figure 6. In this scheme, the court orders cash payments to compensate for depreciation (EE^*). For *undersecured* parties, this adequate protection is uncontroversial.²²¹ But when the secured party has an equity cushion, depreciation payments preserve for the secured party the same amount of equity cushion that existed at the start of the bankruptcy proceeding ($AB = C^*E^*$). Meanwhile, interest on the declining principal is paid in cash as well (C^*D^*). Because the secured party can reinvest the cash actually received, the package of entitlements is worth $D'Z$ to her. This plan is designed to

interest in this fund, but instead it ruled that the *unsecured* deficit of the creditor should be reduced, not the secured claim, on the theory that the debtor should not profit from postpetition fires. *Id.* Clearly, payments as a means of adequate protection ought to reduce only the *secured* claim. Payments on the unsecured claim are preferential.

221. "The Code itself, the legislative history, and the numerous cases interpreting the same are fairly harmonious in requiring adequate protection payments by the debtor for the decrease in the value of the collateral arising out of the use thereof by the debtor." *Greives v. Bank of Western Ind.* (In re Greives), 81 Bankr. 912, 961 (Bankr. N.D. Ind. 1987).

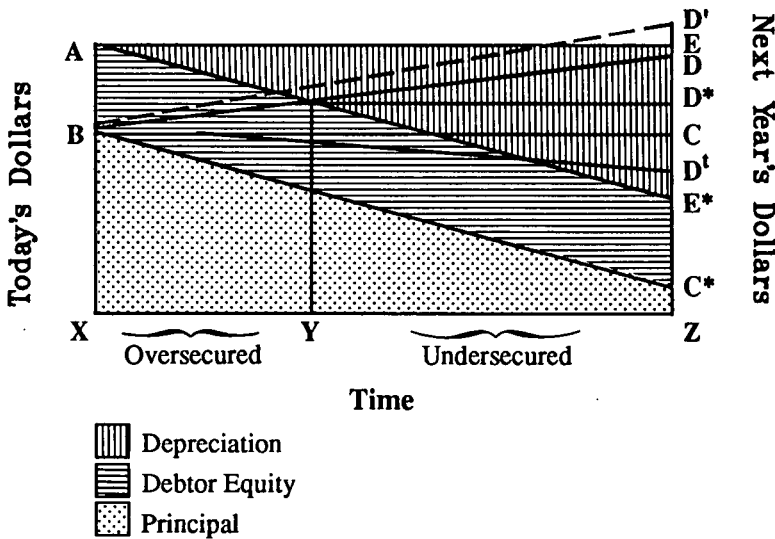


FIGURE 6

guarantee that the value of the secured claim at the start of the bankruptcy (BX) is preserved at the end of the bankruptcy ($D'Z$).²²²

If Section 506(b) is interpreted according to the "limitation" view, this plan violates the rule in *Timbers of Inwood Forest*. After point Y , it provides an undersecured party with postpetition interest. In order to comply, a bankruptcy court will have to find a way to flatten out BD' after point Y .²²³

222. On the assumption that undersecured parties are entitled to postpetition interest as part of adequate protection, two decisions have noted that oversecured creditors eventually become undersecured, if the bankruptcy proceeding lasts long enough. *Albion Prod. Credit Assoc. v. Langley* (*In re Langley*), 30 Bankr. 595, 603 (Bankr. N.D. Ind. 1983); *In re Schaller*, 27 Bankr. 959, 962 (W.D. Wis. 1983). These opinions therefore require adequate protection of any equity cushion of an oversecured party, no matter how large the cushion. This also seems to be the import of *In re Hagendorfer*, 42 Bankr. 13 (Bankr. S.D. Ala. 1984):

The value of the secured party's lien, or interest, can be determined by comparing the amount of the debt, principal, and accrued interest, any costs and expenses incurred in protecting that interest as allowed by the instrument, and the *increase or decline* in value of the property held as security. If the value of the lien has decreased following the filing of the petition in bankruptcy, the secured creditor is entitled to protection, *even if there is sufficient equity to pay the indebtedness in full on foreclosure or liquidation*.

Id. at 16 (emphasis added). The italicized words hint that the point is to protect a specific equity cushion over time. Elsewhere in the *Hagendorfer* opinion, the judge emphasizes that the existence of the equity cushion cannot be adequate protection itself. I take this to mean that the court thinks that the equity cushion is the *end* and not the *means* of adequate protection.

223. Some courts have required a constant, noneroding debtor equity over time, but they did so on the assumption that, after the equity cushion eroded, the now undersecured party could have postpetition interest as a matter of adequate protection. *In re Liona Corp.*, N.V., 68

One possible solution would be to provide for payments on interest up to point *Y* (*CD**) and payments on depreciation (*CC**) after point *Y*. Before point *Y*, interest is paid out periodically, but after point *Y*, *BD** levels out. In other words, the court will revert to Figure 5.

F. *Lifting the Stay*

Another scheme that might award postpetition interest to soon-to-be undersecured parties is for the court simply to lift the automatic stay, so that the secured party can obtain the collateral outside of bankruptcy. This ruling would allow the secured party to get postpetition interest because the secured party can foreclose, obtain cash proceeds, and reinvest them. When the stay is lifted *specifically* to guarantee postpetition interest to a secured party, the court implicitly includes the right to postpetition interest in its view of adequate protection.²²⁴ Therefore, lifting the stay for this reason might violate the principles of *Timbers of Inwood Forest*.²²⁵

G. *The Secured Party's Right to the Debtor's Equity*

It has been suggested that the use of the debtor's equity both as the measure of a secured party's entitlement to postpetition interest and as the means of adequate protection poses a contradiction. One way a court can reconcile a limited-liability concept of Section 506(b)

Bankr. 761, 767-68 & n.8 (Bankr. E.D. Pa. 1987); *In re Park West Hotel Corp.*, 64 Bankr. 1013, 1022-23 (Bankr. D. Mass. 1986); see *Heritage Sav. & Loan Ass'n v. Rogers Dev. Corp.* (*In re Rogers Dev. Corp.*), 2 Bankr. 679, 685 (Bankr. E.D. Va. 1980) (court thought the increasing value of collateral would protect the ongoing right to postpetition interest).

These cases are no longer tenable after *Timbers of Inwood Forest*, unless Section 506(b) is read in the "conditional," not the "limitation," manner. In other words, if oversecured parties can receive interest indefinitely, so long as there is one dollar of equity at the start of the bankruptcy proceeding, these cases do not violate the rule of *Timbers of Inwood Forest*. It must be recalled, however, that, in dictum, the Supreme Court has read Section 506(b) in the "limitation" fashion. 108 S. Ct. at 631-32.

224. *E.g.*, *First Agricultural Bank v. Jug End in the Berkshires, Inc.* (*In re Jug End in the Berkshires*), 46 Bankr. 892, 899-900 (Bankr. D. Mass. 1985) (equity inadequate to cover anticipated interest accrual); *In re Woodbranch Energy Plaza One, Ltd.*, 44 Bankr. 733, 737 (Bankr. S.D. Texas 1984) (where equity was thin, accruing interest and declining trend in real estate market justified lifting the stay); *GECC Fin. Corp. v. Bandy* (*In re Bandy*), 39 Bankr. 673, 675 (Bankr. D. Haw. 1982); *Ukrainian Sav. & Loan Ass'n v. Trident Corp.* (*In re Trident Corp.*), 19 Bankr. 956, 958 (Bankr. E.D. Pa. 1982); *Lincoln Bank v. High Sky, Inc.* (*In re High Sky, Inc.*), 15 Bankr. 332, 338 (Bankr. M.D. Pa. 1981) (stay lifted because interest was accruing, the collateral was not appreciating in value, and no other protection offered); *In re H & F Inv. Co.*, 9 Bankr. 548 (Bankr. N.D. Ohio 1981) (same); *In re Stuart Motel, Inc.*, 8 Bankr. 50 (Bankr. S.D. Fla. 1980) (same); *Vlahos v. Pitts* (*In re Pitts*), 2 Bankr. 476, 479 (Bankr. C.D. Cal. 1979) (threatening to lift stay if interest accrual destroys equity cushion).

225. 108 S. Ct. at 633.

and the use of cushions to protect against depreciation is to estimate the length of the bankruptcy proceeding, calculate postpetition interest for oversecured creditors, and then treat the secured claim as if it were for that augmented amount. If the collateral depreciates below this projected amount, then the court can either lift the stay or require some supplementary protection.²²⁶ In so doing, it would not actually be awarding unaccrued interest to the oversecured parties. Rather the court would simply be protecting the oversecured parties' rights under Section 506(b), in order to utilize the equity cushion for postpetition interest as it *eventually* accrues. Meanwhile, the equity cushion that actually existed at the time dictated by valuation constitutes the limit of postpetition interest an undersecured party can get.

A middle view—less favorable to secured parties—is that collateral for anticipated postpetition interest need not be set aside for secured parties. The debtor's equity is property of the estate, and as such, may be used at any time for the benefit of the estate, even if the use interferes with the future accrual of interest.²²⁷ But the trustee must never invade the collateral needed to support *accrued* postpetition interest. In Figure 4, for example, the trustee must let postpetition accrue until point Y, the time at which use of the collateral finally interferes with the secured party's right to collateral. Thereafter, the

226. One case that used this technique was *Hamilton Bank v. Diaconx Corp.* (*In re Diaconx Corp.*), 69 Bankr. 333, 339 (Bankr. E.D. Pa. 1987). However, it was not interest that was anticipated, but attorneys' fees and collection expenses to which the secured party was entitled under Section 506(b) of the Bankruptcy Code. Nevertheless, the principle can be used analogously for postpetition interest as well.

227. Such a set of beliefs authorizes the DIP to expropriate the surplus without regard to the secured party's right to save the collateral for future unaccrued postpetition interest. This right of expropriation also means that the DIP can take proceeds without providing the (over)secured party with adequate protection. See *In re Triplett*, 87 Bankr. 25, 27 (Bankr. W.D. Tex. 1988) (where equity cushion existed, secured party had no right to complain that the DIP was using cash collateral).

Chapter 11 also authorizes the seizure of the debtor's equity away from the secured party, because the Chapter 11 plan need only provide secured parties with the "indubitable equivalent" of their state law rights. 11 U.S.C. 1129(b)(2)(A)(ii) (1988). That is, the power to expropriate the surplus under the adequate protection doctrine and under the plan appears to be the same. But new Chapter 12 breaks this correlation. Under a Chapter 12 plan, where a secured party dissents, either the collateral must be abandoned to the secured party, or the secured party *must* retain "the lien securing such claim . . ." *Id.* § 1225(1)(5). At least one court has commented:

Read literally, Section 1225(a)(5)(B)(i), which requires that a secured creditor retain its lien, would preclude reorganization when an oversecured creditor has a lien in all property of the estate since the collateral could not be sold and the debtor could not use its equity in the property to finance its reorganization.

In re Underwood, 87 Bankr. 594, 597 (Bankr. D. Neb. 1988). Finding such a lack of flexibility absurd and necessary, the court simply read the adequate protection standards into section 1225(a)(5), thereby reestablishing the parallelism between Chapter 11, Chapter 12 and preplan adequate protection doctrines with regard to exploitation of the debtor surplus.

trustee must protect the secured party for at least the amount of $D'''Z$. It will be noted that the first idea protected the secured party for BD , where $D > D'''$.

A third view is the least favorable to secured parties. Pending a sale of collateral or confirmation of a Chapter 11 plan, an oversecured party is *not* entitled to adequate protection for postpetition interest—only prepetition interest and principal are to be protected. The secured party therefore could be deprived of postpetition interest that has already accrued against an existing equity cushion, so long as the oversecured party's principal was not invaded.²²⁸ Meanwhile, if, at the time of sale or confirmation, the collateral's value exceeded the amount of the claim at the time of the bankruptcy petition, then the oversecured party could obtain an award of postpetition interest. The consequence of this view is that, even if it means a loss of already accrued postpetition interest, an oversecured party has no right to complain about a shrinking equity cushion. Under this view, oversecured parties are not entitled to adequate protection for their fully allowed secured claims.

This view—no right to adequate protection for *any* kind of postpetition interest entitlement—is arguably an accurate portrayal of the prevailing attitude under the 1898 Act. The old Act simply did not provide a right to adequate protection. Instead, the secured party simply hoped that the value of the collateral did not deteriorate over time.²²⁹ This absence of right was tempered by the practice of lifting the stay in bankruptcy if the secured party claimed the stay to be prejudicial. Such a request, however, was within the discretion of the court to deny. If the court lifted the stay, then the secured party could obtain a form of postpetition interest by obtaining and reinvesting cash proceeds from a nonbankruptcy sale of the collateral.²³⁰ Therefore, this interpretation of the secured party's right to anticipate the existence of the debtor's equity at the end of a bankruptcy proceeding is only half-supported by the history of the old Act.

Whether the trustee can interfere with the secured party's future enjoyment of the debtor's equity is especially important if the trustee

228. This view is forcefully presented in O'Toole, *supra* note 12, at 267, 270-72, 274. It has been followed in *McCombs Properties VI, Ltd. v. First Tex. Sav. Ass'n. (In re McCombs Properties VI, Ltd.)*, 88 Bankr. 261 (Bankr. C.D. Cal. 1988); *In re National Computer Comm. Corp.*, 85 Bankr. 6 (Bankr. D. Conn. 1988).

229. See *supra* text accompanying notes 15-25.

230. This view was taken for granted as true by Judge King in *United Sav. Ass'n of Tex. v. Timbers of Inwood Forest Assocs. (In re Timbers of Inwood Forest Assocs.)*, 793 F.2d 1380, 1407-08 (5th Cir. 1986), *aff'd*, 808 F.2d 363 (5th Cir. 1987) (en banc), *aff'd*, 108 S. Ct. 626 (1988).

wants to obtain new credit and wants to use the debtor's equity as collateral. In other words, the trustee would like to give a second or even a first security interest on the collateral to obtain the new loan.²³¹ How much of this debtor equity belongs to the prior secured party, and how much of it belongs to the bankrupt's estate? On the first view, the secured party is entitled to *DZ* (of Figure 4) at the end of the bankruptcy. In such a case, only *DE* can be used to secure the new loan, no matter when the new loan is obtained. Under the second view, the trustee cannot invade the collateral needed to secure accrued interest claims. Thus, at time *X*, *AB* is available to secure new loans. This amount shrinks until it disappears at time *Y*, when no debtor equity remains for this purpose. Finally, under the third view, the entire *AB* is available to the estate, no matter when the new loan is obtained, in which case, by getting a new loan, the trustee can eliminate an oversecured party's entire right to postpetition interest.

These contradictory views require us to determine whether secured parties have the right to preserve the debtor's equity in collateral for anticipated interest accrual (and, for that matter, anticipated legal expenses that the secured party can charge against the collateral).²³²

At state law, the matter is very uncertain. Under Article 9 of the UCC, one court has held that judicial lien creditors could not levy property that senior secured parties needed to cover future unaccrued interest and future collection expenses.²³³ If this authority is adopted (through the idea that a bankruptcy trustee is a hypothetical judicial lien creditor), then the debtor's equity belongs to the secured party, and a trustee may do nothing to interfere with any debtor equity existing at the beginning of a bankruptcy proceeding that a secured party might need to secure claims for future interest. The idea that Article 9 preserves collateral for unaccrued interest, however, is quite questionable if one pays close attention to the text of Article 9. The opposite seems to be the better view—that the attachment of a judicial lien stops all further interest from accruing.²³⁴

And yet, if debtor equity is totally unavailable to secured parties

231. 11 U.S.C. § 364(c)(2) (1982) (authorizing superpriority for new credit if old secured parties are adequately protected from senior lien).

232. This latter feature is also supplied to oversecured parties under Section 506(b). 11 U.S.C. § 506(b) (Supp. IV 1986). Although the right of oversecured parties to postpetition attorneys' fees is beyond the scope of this Article, much of what is said about postpetition interest will also apply to postpetition collection expenses.

233. *Dick Warner Cargo Handling Corp. v. Aetna Business Credit, Inc.*, 746 F.2d 126 (2d Cir. 1984).

234. See Schroeder & Carlson, *Future Nonadvance Obligations Under Article 9 of the UCC: Legitimate Priority or Unwarranted Squeeze-Out?*, 102 BANKING L.J. 412, 434 (1985).

to cover the expected future accrual of interest, then one might ask why Congress bothered to write in Section 506(b) that oversecured parties could have postpetition interest, given that the bankruptcy trustee can immediately deprive the secured party of the opportunity to receive future bankruptcy interest, simply by issuing a superpriority lien for the existing debtor equity.²³⁵ The best available answer follows the second, middle view: Congress intended to let the bankruptcy trustee use available debtor equity immediately for the benefit of the estate, but the trustee must not invade any equity needed to secure any postpetition interest that has already accrued.

H. *Multiple Security Interests*

These rules for postpetition interest—whether the equity cushion does or does not constitute the limit on the interest an oversecured party can get—should not be confused with the right of a junior secured party to be protected against the accrual of senior interest. Up to now, it has been assumed that a single security interest encumbered a piece of collateral. Suppose, however, that there are multiple security interests encumbering the collateral. The senior secured party remains senior with regard to postpetition interest.²³⁶ Therefore, if the collateral cushion is insufficient to sustain the accruing postpetition interest claims of both parties, then the senior creditor displaces the junior, and the junior becomes undersecured. Similarly, if there is no equity cushion at all (from the perspective of both secured parties), then the part of collateral that belongs to the junior secured party is in fact the equity cushion for the senior secured party.²³⁷ In other words, as interest accrues on the senior claim, the junior party is displaced.

The leading pre-Code case on this conflict is *Reconstruction Finance Corp. v. Denver & Rio Grande Western Railway Co.*²³⁸ In *Reconstruction Finance Corp.*, assets existed at the time of the bankruptcy filing in 1935 to pay off the senior secured parties and the junior secured parties in full.²³⁹ The railroad, under judicial protection, made a great deal of money profiteering off World War II. None of this money was used to pay interest to the senior creditors.²⁴⁰

235. 11 U.S.C. § 506(b) (Supp. IV 1986).

236. Under Article 9, the first party to perfect or file a financing statement has a seniority that clearly extends to interest. UCC § 9-312(5)(a).

237. *Pistole v. Mellor* (*In re Mellor*), 734 F.2d 1396, 1400-02 (9th Cir. 1984).

238. 328 U.S. 495 (1946).

239. *Denver & R.G.W.R.R. v. Insurance Group Comm.* (*In re Denver & R.G.W.R.R.*), 150 F.2d 28, 38 (10th Cir. 1945).

240. *Id.* at 35.

Instead, it was used to undo the damage caused by deferred maintenance. This investment apparently did increase the value of the collateral, but the increase did not come close to matching the amount of senior postpetition interest that had accrued.²⁴¹ As a result, accruing senior interest squeezed out the junior secured parties from the collateral. In 1943, the plan gave the junior secured parties only 10% of principal.²⁴²

This 90% loss of principal is not the whole story. The railroad proposed a nearly all-equity plan. It paid off some of the senior debt, but mostly gave other senior creditors enough stock in the railroad to equal the value of principal and postpetition interest. The junior secured parties received stock in amounts that equalled about 10% of principal. The railroad had more than enough cash in the bank to meet working capital needs. Therefore, money that could have been given to the juniors to compensate them for lost principal instead was split with the fully compensated seniors.²⁴³

In railroad reorganizations at the time, creditors voted on the plan, but the court could approve a plan over the unreasonable dissent of creditors. The junior secured parties, not surprisingly, voted against the plan. In addition to the stock they had received, they wanted the railroad to hand over cash beyond what was needed as working capital. They also thought that, to the extent senior secured parties were paid, the disencumbered collateral should work to increase the collateral claimed by the juniors.

The Supreme Court ruled that it was very unreasonable of the juniors to object.²⁴⁴ The extra cash and unencumbered collateral were part of the firm assets that justified the allocation of common shares in the railroad. To give that cash or collateral to the juniors would have preferred one class of shareholders over another and would have affected adversely the value of the stock by which the seniors received full compensation.²⁴⁵ No sympathy was given for the fact that the junior secured parties suffered a 90% erosion of their position during the pendency of the reorganization proceeding. Under the Bank-

241. *Id.* at 38.

242. 328 U.S. at 514-15.

243. The United States Court of Appeals for the Tenth Circuit thought this was unfair. *Denver*, 150 F.2d at 35. The Supreme Court, however, correctly pointed out that the entitlement to excess war profits was an element of the value of the common shares. 328 U.S. at 518-19. If the railroad had to pay out that cash to junior secured parties, then the stock would have to be valued downward. A downward valuation would have shifted more stock to the seniors and away from the juniors. Therefore, whatever the juniors received in cash they would lose in common shares.

244. *Id.* at 519-20.

245. *Id.* at 518-19.

ruptcy Act, the junior secured parties were not entitled to protection against squeeze-outs caused by senior secured claims accruing interest after the bankruptcy petition, but before the plan was affirmed.²⁴⁶

In modern times, this precedent has been forgotten. Recent cases have protected junior secured parties from accruing senior interest in three ways. First, they have prevented the senior claim from growing by ordering periodic payments of cash to the senior secured party.²⁴⁷ Assuming no depreciation, these payments freeze the status quo. Second, they have allowed the DIP to give the undersecured party extra collateral to secure the amount of the squeeze-out.²⁴⁸ Third, and more remarkably, courts have ordered payments to the *junior* secured party to compensate for the squeeze-out that occurs when senior interest starts to accrue.²⁴⁹ It seems odd that the amount of postpetition interest due and owing the *senior* creditors was actually paid to the junior creditors. Such a solution makes sense, but if all else is equal, it seems the privilege of receiving cash (in lieu of noncash adequate protection) ought to be offered to the senior secured parties first, before it is offered to the juniors. Such an award is valuable because it provides an opportunity for reinvestment by the recipient.

It should be noted that these cases do not necessarily award undersecured parties postpetition interest in the manner disapproved of by the Supreme Court in *Timbers of Inwood Forest*. There, the Court held that adequate protection was to protect against erosion of the collateral, not against erosion of the value of the security interest

246. One commentator reads this confusing case as saying just the opposite. Chicago Comment, *supra* note 27. But this reading is based on a failure to grasp what is at stake. The student author writes:

Junior bondholders were seeking to reject a plan because investments undertaken out of current earnings during the trusteeship failed to add to the total valuation of the railroad, while interest on senior claims continued to run, so that the amount of compensation for their claims and their participation in the reorganized enterprise were thereby reduced. But they did not contend that the liquidation value of their liens was impaired So *Denver* itself reaffirmed the secured creditor's right to the full value of his lien and limited the role of the public interest to justifying investments and maintenance expenditures not impairing lien value.

Id. at 523-24 (footnote omitted). The author fails to see that continuing accrual of senior interest is *exactly* what impairs the liquidation value of the junior lien. Hence, *Denver* stands *against* the secured creditor's right to the full value of the lien (as it existed at the time of the bankruptcy petition).

247. *In re McKillips*, 81 Bankr. 454, 459 (Bankr. N.D. Ill. 1987); *Parker v. Concorde Ltd. Partnership* (*In re Concorde Ltd. Partnership*), 67 Bankr. 717, 724 (Bankr. E.D. Tenn. 1986).

248. *Bramham v. Nevada First Thrift* (*In re Bramham*), 38 Bankr. 459, 467 (Bankr. D. Nev. 1984).

249. *Topeka Bank & Trust v. American Properties, Inc.* (*In re American Properties, Inc.*), 8 Bankr. 68, 71 (Bankr. D. Kan. 1980).

due to the delayed collection of proceeds.²⁵⁰ From the viewpoint of the junior secured party, senior interest clearly erodes the collateral.

VII. CONCLUSION: IS A RULE AGAINST POSTPETITION INTEREST EVEN POSSIBLE?

The purpose of this article was to show that postpetition interest entitlements and adequate protection do not exist in an instrumental relationship. In other words, one cannot argue for a view of postpetition interest because it is necessary for adequate protection, nor can one argue for a view of adequate protection because it is necessary for postpetition interest. Instead, postpetition interest entitlements must rise and fall for ethical reasons separate from the adequate protection doctrine. Once we have a consistent, deontological (noninstrumental) position on postpetition interest, then and only then will it be possible to develop a consistent adequate protection doctrine.

Yet, until the Supreme Court spoke with its usual authority on the subject of postpetition interest, neither positive law nor ethical theory demonstrated that the weight of argument rested on either side of the question. To make matters worse, no single position on postpetition interest can render the law consistent or coherent. Any argument based on equality simply produces inequalities elsewhere.

There is a further problem. It may be the case that a rule against postpetition interest for undersecured parties is unattainable, given a strategy suggested by Professor Lynn LoPucki. Under this strategy, postpetition interest can always be attained if secured parties subdivide the loan *by agreement* into a fully secured and a partly secured portion.²⁵¹ The fully secured portion would have a sizable equity cushion built into it, so that if the debtor files for bankruptcy, at least that portion will obtain interest.²⁵²

To illustrate, suppose the collateral is worth \$80, a secured party's claim is worth \$90, and the relevant interest rate is 10%. If the rules provide postpetition interest for oversecured parties, but not for undersecured parties, then such a secured party gets no interest. Suppose that, in the security agreement, the single loan is subdivided into two loans—one for \$70 and one for \$20. The \$70 portion is oversecured, so that, under Section 506(b), the secured party can obtain

250. 108 S. Ct. at 635.

251. See L. LoPUCKI, STRATEGIES FOR CREDITORS IN BANKRUPTCY PROCEEDINGS viii (Supp. 1988).

252. This is under the view that Section 506(b) sets the equity cushion as the limit of the interest a secured party can collect. Also, note that 10% interest on \$70 does not fully compensate the secured party, who bargained for 10% on \$90. But it is better than nothing.

interest for over one year after bankruptcy. By dividing the loan into two parts, the secured party obtains the right to postpetition interest.²⁵³

Courts could counter with a rule that pierces the veil and proclaims the two loans to be in reality one. But this may not defeat resourceful creditors. Loans could be made "genuinely separate" from one another by adding attributes to each loan that make them seem more and more different. For example, each loan could be made by a different corporate subsidiary, or lenders could sell participations in such a way that they amount to partial assignments of the claim.

In short, it may be the case that a rule against postpetition interest for undersecured parties must be ineffective, so long as oversecured parties remain entitled to postpetition interest. Thus a rule against postpetition interest simply puts a premium on vacuous legal expertise to derive the form that defeats the rule. If this is the case, then perhaps the rule is not worth the trouble.

253. This exact strategy of subdividing the loan into an unsecured and an oversecured part was present in *Marine Midland Bank, N.A. v. Ladycliff College (In re Ladycliff College)*, 56 Bankr. 765 (S.D.N.Y. 1985). The court managed to defeat it, but on most unconvincing and eventually useless grounds.

In *Ladycliff College*, the mortgage agreement provided that the debtor's real estate was: to secure the payment of a portion of a total indebtedness of \$370,000 to the Mortgagee to the extent of [\$150,000], together with interest thereon, which is payable according to the terms of a certain note in the amount of \$370,000.

Id. at 766. In this case, the land was worth in excess of \$150,000. *Id.* at 767 n.2. Therefore, the secured party seemed to be limiting itself to \$150,000 in security, plus security for any interest on the \$150,000.

The secured party took the position that it was entitled to postpetition interest beyond \$150,000, to the extent of the collateral. The court, however, disagreed. It read Section 506(b) as bidding it to compare *the property available to the secured party* against the amount of debt secured by such property. Under this interpretation, there was no equity cushion, and hence the secured party was not entitled to postpetition interest. *Id.* at 768 ("By definition, Marine cannot be oversecured since the amount of the property to be weighed in the balance is necessarily exactly the same as the secured claim.").

In fact, the refutation of the scheme is self-defeating. With regard to oversecured parties, the property available to the secured party is always precisely equal to the secured party's debt. For example, in a standard mortgage agreement whereby the secured party lends \$150,000 on land worth \$250,000, the secured party has an interest in land worth \$150,000—the rest is debtor equity. On the court's argument, the secured party is undersecured—an absurdity that reads Section 506(b) out of the Bankruptcy Code.

Furthermore, as I read the relevant language from the mortgage agreement, it specifically reserved the value of the land above \$150,000 for accruing interest. That is, the agreement itself contemplates that the real estate above \$150,000 should be reserved for interest. The court ignores this provision, however.

Even if the court were remotely persuasive, the decision can be easily avoided. Instead of trying to have a single loan agreement govern two loans—one secured and one unsecured—the lender can easily give two loans at two separate times. In such a case, a court would have to concede that *some* postpetition interest must be awarded to a secured party who, in the aggregate, is undersecured.

APPENDIX

This Article criticizes an economic claim that unless undersecured parties receive postpetition interest, management, as trustees in Chapter 11 for general creditors, has an incentive to reorganize a firm even though liquidation maximizes firm value more effectively. This incentive, it is alleged, derives from the fact that undersecured creditors are subsidizing the cost of production through forced interest-free loans.

Instead, this Article claims that, to the extent incentives are created, the incentives have to do with how quickly management decides to choose between liquidating and reorganizing. These incentives are explored in a mathematical model.

A. *The Case of Management Wishing to Maximize General Creditor Claims*

In the first part of the model, we assume that the DIP management imposes no agency costs on general creditors and genuinely pursues general creditor welfare. This claim is unrealistic in the extreme, but, unless we make it, the mathematical model cannot work, and a lot of numerate erudition will be down the drain. Although it may seem reprehensible to engage in such fanciful assumptions of human behavior just to make a mathematical model work, please be advised that microeconomic modelling *routinely* indulges in highly stylized notions of economic self-interest. For example, economic actors maximize their satisfaction by buying the cheapest commodity available, but they never *steal* the commodity. Shareholders signal dissatisfaction with management by selling their shares, but they never threaten to kill the manager's children if agency costs are imposed on shareholders. The assumption I am making here—that bankruptcy trustees take their fiduciary duty seriously—is on the same order as these common assumptions. Therefore, my model is just as valid as the usual microeconomic demonstration, which admittedly is not saying much. Some definitions:

V = firm value

V_u = firm value available to general creditors if undersecured creditors are present

V₀ = firm value available to general creditors if no undersecured creditors are present

R = expected firm revenue per year

C = relevant costs of production necessary to produce the income²⁵⁴

r = discount rate

254. These costs are more or less marginal in that the producer faces the issue of whether to

Since we are studying the incentives for extending the period after bankruptcy, but before a final decision between liquidation and reorganization need be made, we assume $R > C$. If $R < C$, no DIP (motivated solely by general creditor welfare) would engage in a strategy of judicial delay.

Now, if delay could last forever:

$$V = \frac{R - C}{r}$$

Since all good things must come to an end, we cannot have such a simple, perpetual formulation. Instead, we need something more sophisticated. Some new definitions:

t = a variable time period exponent

y = number of years a firm expects it can delay before choosing

e = 2.71828, or one dollar continuously compounded at 100% interest for one year²⁵⁵

We now examine V for a firm that desires to maximize the value of general creditors by filing for bankruptcy and delaying a choice between liquidation and reorganization. The value of the cash flow during bankruptcy can be described as:

produce. In any case, they exclude any purely fixed costs. I am trying to capture a sense of economic rents in the expression $R - C$.

255. A. CHIANG, *FUNDAMENTAL METHODS OF MATHEMATICAL ECONOMICS* 289 (2d ed. 1974). The use of e implies continuously compound interest rates, an unrealistic assumption, but it greatly simplifies any notation that involves taking derivatives and integrals. The coefficient R or C allows us to use a principal amount other than one dollar. The exponent r (market rate of interest) allows us to vary the rate from 100% to more commonly encountered rates. And the exponent t allows us to vary from one year to any period we choose.

The model assumes that postpetition interest is paid out in cash, so that the secured party can reinvest and earn compound interest. If, instead, interest is allowed to accrue against existing or added collateral, compound interest would not be allowed. *Vanston Bondholders Protective Comm. v. Green*, 329 U.S. 156 (1946).

$$\begin{aligned}
\int_0^y R e^{-rt} dt &= R \int_0^y e^{-rt} dt = \\
&= R \left[-\frac{1}{r} e^{-rt} \right]_0^y = -\frac{R}{r} e^{-ry} - \left[-\frac{R}{r} e^{-0t} \right]_{t=0} \\
&= -\frac{R}{r} e^{-ry} - \left[-\frac{R}{r} e^{-0t} \right]_{t=0} \\
&= -\frac{R}{r} (e^{-ry} - 1) \\
&= \frac{R (1 - e^{-ry})}{r}
\end{aligned}$$

As for the costs of production (a negative cash flow), we can express it by substituting C for R :

$$\frac{C (1 - e^{-ry})}{r}$$

It should be emphasized that the costs of production (C) include interest only on prospectively created debt. The variable C excludes interest on prebankruptcy debt, which is represented by a different expression. The model assumes that general creditors and undersecured creditors may not receive postpetition interest on prebankruptcy debt. It assumes further that oversecured creditors are entitled to full interest payments until the equity cushion runs out. Although there is a respectable argument that the *rate* of this interest ought to be the relevant market rate,²⁵⁶ at least one prestigious case suggests that the bankruptcy trustee has the option of the lesser of contract or market.²⁵⁷ Other authorities hold that the contract rate is always appropriate.²⁵⁸ We assume in this model that the contract rate is the appropriate choice.

More definitions:

a = oversecured party's contractual interest rate

256. Fortgang & Mayer, *supra* note 111, at 1077.

257. Crocker Nat'l Bank v. American Mariner Indus., Inc. (*In re American Mariner Indus., Inc.*), 734 F.2d 426, 435 n.12 (9th Cir. 1984).

258. L. LOPUCKI, STRATEGIES FOR CREDITORS IN BANKRUPTCY PROCEEDINGS 244 (1985).

s = oversecured party's claim for principal and prepetition interest

c = equity cushion

Under the rules of bankruptcy, the trustee owes the oversecured parties as per year for c/as years. This negative cash flow has a present value of

$$\begin{aligned} \int_0^{c/as} as e^{-at} dt &= as \int_0^{c/as} e^{-at} dt = \\ &= as \left[\frac{-1}{a} e^{-at} \right]_0^{c/as} = \left[\frac{-as}{a} e^{-at} \right]_{t=0}^{t=c/as} \\ &= -s (e^{-ac/as} - 1) \\ &= s (1 - e^{-c/s}) \\ &= s - \frac{s}{s\sqrt{e^c}} \end{aligned}$$

This latter formulation represents the amount of postpetition interest a DIP will have to pay oversecured creditors, under the current bankruptcy rules. Of course, there might be numerous secured parties, some of whom are oversecured and some of whom are undersecured. Properly, we should write, for n different secured parties,

$$\sum_{i=1}^n = s_i - \frac{s_i}{s_i \sqrt{e^{c_i}}}$$

For the sake of simplicity, let us treat secured creditors as if they are homogenous. Note that when there is no equity cushion and there are only undersecured creditors, $c = 0$, and

$$s - \frac{s}{s\sqrt{e^c}} = 0$$

In other words, postpetition interest expense equals zero in such a case.

Firm value, V , also includes the present value of the firm *after* a bankruptcy court terminates the delaying strategy. But let's ignore this factor, since postplan or postliquidation values must award both secured and unsecured creditors present value as of the date of the plan or liquidation. This amount expands or contracts, of course, as the trustee adjusts the expected period of y . Because we have left out

the present value of income after y years, V represents the value of the firm's net income only during the bankruptcy. Later, when we define the alternative opportunities of secured parties (assuming no strategy of delay is adopted), we likewise exclude the value of income to be received after y years, so that the alternatives are comparable.

We can now express V , in the case involving undersecured creditors, in which management wishes to maximize V_u , not V . V_u covers the condition:

$$y > \frac{c}{as}$$

In other words, the delay before a reorganization/liquidation decision is expected to result in a time period during which at least some undersecured creditors receive no postpetition interest. In such a case, we can express V_u as follows:

$$V_u = \int_0^y R e^{-rt} dt - \int_0^y C e^{-rt} dt - \int_0^{c/as} a s e^{-at} dt$$

$$V_u = \frac{R(1 - e^{-ry}) - C(1 - e^{-ry})}{r} - \left[s - \frac{s}{s\sqrt{e^c}} \right]$$

$$V_u = \frac{(1 - e^{-ry})(R - C)}{r} - \left[s - \frac{s}{s\sqrt{e^c}} \right]$$

Note that, as y increases, V_u increases, or

$$\frac{\partial V_u}{\partial y} = e^{-ry}(R - C) > 0$$

The above is true for the case of $y > c/as$. If

$$y < \frac{c}{as}$$

then all secured creditors are oversecured for the entire period of feasible judicial delay. No wealth transfers from secured creditors to unsecured creditors are possible. In this case, the formula for postpetition interest must be written as follows:

$$\int_0^y a s e^{-at} dt = s - \frac{s}{e^{ay}}$$

Under these conditions:

$$V_o = \frac{(1 - e^{-ry})(R - C)}{r} - \left[s - \frac{s}{e^{ay}} \right]$$

No longer is it clear that an increase in y increases V_o . V_o 's derivative becomes:

$$\frac{\partial V_o}{\partial y} = \left[e^{-ry}(R - C) \right] - \left[\frac{as}{e^{ay}} \right]$$

In other words, V_o increases when

$$e^{-ry}(R - C) > \frac{as}{e^{ay}}$$

Otherwise, it does not increase.²⁵⁹

V_u and V_o should be understood to represent the value of aggregate general creditor claims. In other words, V_u and V_o represent the amount of the firm that the general creditors will receive when the firm is finally reorganized or liquidated.

It is now necessary to determine when a DIP, wishing to maximize the return for general creditors, will choose a strategy of judicial delay. If the choice does not maximize total firm value in comparison to an immediate liquidation, then the bankruptcy rules are not optimal. For this we need a definition of immediate, piecemeal liquidation value:

x = the time at which secured parties would receive cash proceeds in a piecemeal liquidation.

L = the present value of the total bankrupt estate between x and y years, including the senior entitlements of the secured parties.²⁶⁰

We can write the present value of the secured parties' right to cash proceeds as follows:

259. V might increase whenever the debtor signs loan agreements that now have below-market contract rates. See Bulow & Shoven, *The Bankruptcy Decision*, 19 BELL J. ECON. 437 (1978). Such contracts can be "de-accelerated" under Section 1124 of the Bankruptcy Code and thereby preserved for the benefit of the general creditors.

260. L is limited to the time between x and y years to make L comparable to V .

$$\begin{aligned}
 \int_x^y r s e^{-rt} dt &= r s \int_x^y e^{-rt} dt = \\
 &= r s \left[\frac{-1}{r} e^{-rt} \right]_x^y = \left[\frac{-rs}{r} e^{-rt} \right]_{t=x}^{t=y} \\
 &= \frac{-rs}{r} (e^{-ry} - e^{-rx}) \\
 &= s(e^{-rx} - e^{-ry})
 \end{aligned}$$

Since secured parties are senior for this amount, the position of the general creditors under an immediate liquidation can be defined as:

$$L - s(e^{-rx} - e^{-ry})$$

When undersecured creditors exist, this expression should be compared by the DIP to the present value of the general creditors interest under a delaying strategy:

$$V_u = \frac{(1 - e^{-ry})(R - C)}{r} - \left[s - \frac{s}{s\sqrt{e^c}} \right]$$

In other words, for a strategy of delay (in lieu of immediate liquidation or even immediate reorganization) to pay general creditors, it must be true that:

$$\frac{(1 - e^{-ry})(R - C)}{r} - \left[s - \frac{s}{s\sqrt{e^c}} \right] > L - s(e^{-rx} - e^{-ry})$$

Similarly, if *no* creditors are undersecured—that is, if

$$y < \frac{c}{as}$$

—then the following is the condition for a strategy of bankruptcy delay:

$$\frac{(1 - e^{-ry})(R - C)}{r} - \left[s - \frac{s}{e^{ay}} \right] > L - s(e^{-rx} - e^{-ry})$$

Now if

$$y > \frac{c}{as}$$

then

$$s\sqrt[s]{e^c} > e^{ay}$$

This means that

$$V_u > V_o$$

In other words, the delaying strategy yields greater gains to general creditors when undersecured creditors exist. It is much less effective when all creditors have adequate collateral cushions to cover postpetition interest during y years.

It is possible to imagine an optimal rule for the above formulas. The first reform should guarantee all secured parties their postpetition interest entitlements, so that we can substitute y for c/as . Second, we should require that the rate of interest be the market rate, r , instead of the contract rate, s . And third, the postpetition interest entitlements of secured parties should commence, *not* when the petition is filed, indicated by $t = 0$ in the above formulas, but at x , the time when a secured party could expect to receive cash proceeds from an immediate liquidation. With these substitutions, instead of

$$\int_0^{c/as} ase^{-rt} dt = s - \frac{s}{s\sqrt[s]{e^c}}$$

we could write

$$\int_x^y rse^{-rt} dt = rs \int_x^y e^{-rt} dt =$$

$$= rs \left[\frac{-1}{r} e^{-rt} \right]_x^y = \left[\frac{-rs}{r} e^{-rt} \right]_{t=x}^{t=y}$$

$$= \frac{-rs}{r} (e^{-ry} - e^{-rx})$$

$$= s(e^{-rx} - e^{-ry})$$

This expression now describes the optimal entitlement to postpetition interest. Substituting it for our suboptimal expression, we find that the conditions for a profitable strategy of bankruptcy delay become:

$$\frac{(1 - e^{-ry})(R - C)}{r} - s(e^{-rx} - e^{-ry}) > L - s(e^{-rx} - e^{-ry})$$

or, simplifying,

$$\frac{(1 - e^{-ry})(R - C)}{r} > L$$

Now we see that, under the suggested optimal rule, the DIP's incentive to delay the decision between reorganization and liquidation occurs only when the firm's going concern value exceeds the firm's immediate liquidation value. This formula guarantees that bankruptcy delay is not desirable for the reason that it allows for wealth transfers from secured to unsecured creditors. Instead, it guarantees that DIPs will engage in Chapter 11 filings only under conditions in which the expected result exceeds the value of an immediate liquidation.

B. Agency Costs

It is widely suspected that bankruptcy trustees are not motivated solely by altruistic concerns, but might in fact try to maximize their own welfare. In such a case, judicial delay will occur, even if

$$R < C$$

in which C includes the administrative expense of keeping the bankruptcy proceeding alive.

Although the same formulation of V will hold, as before, it is no longer possible to claim that the conditions for a strategy of delay are

$$\frac{(1 - e^{-ry})(R - C)}{r} - \left[s - \frac{s}{s\sqrt{e^c}} \right] > L - s(e^{-rx} - e^{-ry})$$

Self-regarding DIP management is just as apt to engage in delay when the opposite condition holds.

Assuming that DIP management is not able to expropriate value from the secured creditors,²⁶¹ the outward limit of managerial expropriations of general creditor entitlements might be something less than

$$L - s(e^{-rx} - e^{-ry})$$

261. Not even this is a good assumption. For example, management could embezzle cash collateral and could steal noncash collateral. Although criminal penalties exist, they do not always deter such behavior.

an amount that can be described as the DIP's unencumbered liquid assets. It might also constitute something *more* than

$$L - s(e^{-rx} - e^{-ry})$$

because there could still be a positive value to

$$\frac{(1 - e^{-ry})(R - C)}{r} - \left[s - \frac{s}{s\sqrt{e^c}} \right]$$

For these reasons, it is too difficult to factor in a mathematical description of the incentives that management of a DIP possesses to maximize its own position.

A few observations are possible. First, while reputation factors and the stock market act to minimize agency costs with nonbankruptcy firms, such factors are not available for DIPs. In many cases, DIPs have substantial monopsony power over the providers of managerial services. In other words, management, having driven the DIP into bankruptcy, might have only a few attractive alternative employment opportunities. If arms length bargaining is the rule, this monopsony power ordinarily might lead to lower management salaries, but quite the opposite is true in Chapter 11. The "next best opportunity" of management represents a touchstone by which the incentives of management milk the DIP. This opportunity is frequently a function of reputation. If so, as this opportunity sinks in value, the less reputation matters, and the greater the incentive will be to take what can be received from the DIP. If the next best opportunity is comparatively attractive, reputation factors could be expected to temper the judgment of DIP management.

A second observation is that old fashioned judicial vigilance is needed to counteract this incentive, in order to make the performance of management more in line with the fiduciary ideal. The model presented above depends on the success of such endeavors.

C. *Implications of the Model*

The optimal reforms suggested above are empirically weak. In fact, each involves unverifiable propositions—"but for" the automatic stay in bankruptcy, how long would it take to liquidate collateral, the variable x ? Statements like this cannot be verified in the laboratory.

In addition, the optimal reforms depend entirely on the altruistic instincts of DIP management. In other words, the optimal reform is designed to address the problem of a DIP seeking to maximize general creditor welfare, even at the expense of secured creditor welfare. When DIP management fails to be altruistic and is self-interested, the

reforms are useless, or at least not optimal. Incidentally, if it is acceptable to assume that fiduciary standards are effective in inducing altruistic behavior, the easiest reform of all is simply to rewrite the standard and to require DIP management to maximize firm value or national welfare, rather than general creditor welfare.

Even if we can base a set of optimal bankruptcy rules on the altruistic behavior of DIP management, it is still true that postpetition interest entitlements produce short term, rather than long term, incentives.²⁶² We have seen that postpetition interest does not affect the choice between a Chapter 11 plan and a liquidation. Rather, it affects the choice between immediate liquidation and an extended proceeding, during which an eventual decision between liquidation and reorganization will be made. Given that disincentives are short term, there is no compelling need to "mimic the market" by providing secured creditors with their opportunity costs. Judicial vigilance could be used so that Chapter 11 reorganizations proceed apace. We have also seen that judicial vigilance is already mandated by the need to assure that fiduciaries do not act in a self-serving manner. Therefore, judicial vigilance to shorten the period of delay for the benefit of undersecured creditors promises to achieve economies of scale. The tools for judicial vigilance are already built into the Bankruptcy Code. For example, the DIP loses the exclusive right to propose a reorganization plan within 120 days.²⁶³ Further extensions of time are subject to judicial control,²⁶⁴ and any interested party can demand that the Chapter 11 proceeding be converted to a Chapter 7 liquidation.²⁶⁵

One thing that the model does suggest is that, when a DIP truly maximizes general creditor welfare, court vigilance should become a function of the size of collateral cushions. In other words, when few secured creditors are undersecured, a court can relax vigilance because the DIP has somewhat less incentive to maximize delay until the choice between reorganization or liquidation is made. When the proceeding includes a large number of undersecured creditors, how-

262. Data on the time it takes to present a plan are presented in LoPucki, *The Debtor in Full Control—Systems Failure Under Chapter 11 of the Bankruptcy Code?*, 57 AM. BANKR. L.J. 247, 269-70 (1983). The average delay of this study of Missouri cases was a little over 10 months. *Id.* at 269. LoPucki concluded that the 120 days granted by the Bankruptcy Code had lengthened the delay over the previous Bankruptcy Act of 1898, in which the court was permitted to fix the date by which the plan was to be proposed. *Id.* at 271.

263. 11 U.S.C. § 1121(c) (1982 & Supp. IV 1986); see *Grothouse v. P.A.G., Inc. (In re Southwest Oil Co.)*, 84 Bankr. 448, 450-51 (Bankr. W.D. Texas 1987) (refusing to extend time of debtor exclusivity for submitting plan).

264. 11 U.S.C. § 1121(d) (Supp. IV 1986).

265. 11 U.S.C. § 1112 (1982 & Supp. IV 1986); see *Mauna Lani Resort, Inc. v. Endrex Inv. Inc. (In re Endrex Inv., Inc.)*, 84 Bankr. 207, 212 (Bankr. D. Colo. 1988).

ever, the court should be comparatively more insistent that the DIP promptly decide the future of the firm.

In short, the arguments for adding a postpetition interest entitlement have no good economic basis. There is no clear instrumental purpose to such an entitlement that is not also served by an already present judicial surveillance of bankruptcy proceedings. Any claim for such entitlements must therefore rest on deontological grounds, not on welfare economic arguments.