THE LEGAL ANOMALY OF NON-RECOURSE FINANCING

by

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Section 1111(b) is one of the Bankruptcy Code's most complex and challenging provisions. The existing scholarship focuses on the so-called 1111(b)(2) election, in which an undersecured creditor, in order to protect against undervaluation of collateral, can sometimes opt to have its claim treated in Chapter 11 as a fully secured claim. This Article, in contrast, focuses on what can happen if that election is not made. Absent that election, § 1111(b)(1) automatically converts debt claims that are non-recourse under state law into full recourse claims. The consequence of this lobbied conversion is that non-recourse claims are no longer limited to the value of the collateral, creating unbargained and unfair benefits for non-recourse lenders to the detriment of debtors and unsecured creditors. This problem is important: domestic finance companies engage in roughly half a billion dollars of non-recourse financing yearly, non-recourse loans make up a significant portion of commercial real estate financing, and virtually all securitization and other structured financing is made on a non-recourse basis. The Article explains the questionable origin of the § 1111(b)(1) non-recourse-to-recourse debt conversion and analyzes how that section should be amended to fairly protect non-recourse lenders without harming third parties or impairing bankruptcy policies.

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INTRODUCTION

Although most financing is full recourse to the borrower,[3] a significant amount of high-end financing is made on a non-recourse basis. For the decade ending first quarter 2021, the non-recourse debt associated with the financing activities of domestic finance companies averaged around half a billion dollars.[4] Non-recourse loans also make up a significant portion of commercial real estate financing.[5] In addition, virtually all securitization and other structured financing transactions are made on a non-recourse basis.[6]

The term "non-recourse" is somewhat of a misnomer because it does not mean without recourse; rather, it means that a lender or other creditor has recourse only to the collateral securing the financing.[7] Because of that

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[3] Full recourse means that a lender has recourse not only to collateral but also to the other assets of the borrower if the collateral is insufficient to repay the loan.

[4] FED. RES. BK. ST. LOUIS, DOMESTIC FINANCE COMPANIES, NON-RECOURSE DEBT ASSOCIATED WITH FINANCING ACTIVITIES, LEVEL (updated Oct. 30, 2023), available at https://fred.stlouisfed.org/series/STFLFDNNQ. *Cf.* Adam J. Levitin & Susan M. Wachter, *The Commercial Real Estate Bubble*, 3 HARV. BUS. L. REV. 83, 89 (2013) (finding that such non-recourse debt ranged between $411,003.90 million and $648,143.24 million during that decade).

[5] *See id.* ("[Commercial real estate] loans are almost always nonrecourse . . . .").

[6] *See* Steven L. Schwarcz, *The Conundrum of Covered Bonds*, 66 BUS. LAW. 561, 572 (2011) (noting that "securitization constitutes non-recourse financing").

[7] *See, e.g.*, *Recourse vs. Nonrecourse Debt*, INTERNAL REVENUE SERV. (last accessed Jan. 24, 2024), https://apps.irs.gov/app/vita/content/36/36_02_020.jsp ("A nonrecourse debt (loan) does not allow the lender to pursue anything other than the collateral."); *see also Nonrecourse*, BLACK'S LAW DICTIONARY (11th ed. 2019) (defining the term non-recourse generally as "[o]f, relating to, or involving an obligation that can be satisfied only out of the collateral securing the obligation and not out of the debtor's other assets").

limitation on recourse, non-recourse lenders tend to be more sophisticated and risk-seeking than typical lenders.[8] Their quid pro quo for making non-recourse loans usually includes a higher interest rate.[9] Borrowers may be willing to pay higher rates because the limited recovery on non-recourse financing should not alarm their other creditors and might also be needed to comply with their covenant restrictions.[10]

This Article focuses on an extraordinary anomaly: that bankruptcy law protects these sophisticated and risk-seeking non-recourse lenders when companies become financially troubled by converting the non-recourse debt to full recourse debt (hereinafter, the "non-recourse to recourse conversion").[11] Remarkably, some bankruptcy observers and scholars are unaware of that protection. In part they can be forgiven because that protection is included in the most confusing provision of bankruptcy law:[12] § 1111(b) of the Bankruptcy Code.[13] Section 1111(b) "has earned a reputation for being one of the most complex provisions of the Code, both in terms of its basic tenets and in terms of its legal and practical applications in specific bankruptcy cases."[14]

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[8] *See, e.g.*, Kiah Treece, *Recourse Loans vs. Non-Recourse Loans*, FORBES ADVISOR (Aug. 12, 2020), https://www.forbes.com/advisor/personal-loans/recourse-loans-vs-non-recourse-loans ("Non-recourse debt. . . has higher interest rates and more restrictive borrower qualifications than recourse [[debt]] because non-recourse debt is riskier for lenders.").

[9] *See id. See also* Schwarcz, *The Conundrum of Covered Bonds*, *supra* note 7, at 571 (generally comparing full-recourse covered bonds to non-recourse securitizations, including the relative lending risk and return).

[10] Steven L. Schwarcz, *The Easy Case for the Priority of Secured Claims in Bankruptcy*, 47 DUKE L.J. 425, 463 (1997).

[11] Technically, the non-recourse to recourse comes into play when a debtor in a Chapter 11 reorganization wishes to retain the collateral securing a creditor's lien. Section 1111(b) then allows a non-recourse creditor to choose between the conversion, under § 1111(b)(1)(A), and a § 1111(b)(2) election. The election would protect the creditor's collateral from being undervalued by the debtor by making the full amount of the claim a secured claim regardless of the collateral valuation. Absent that election, a creditor's non-recourse claim would be automatically converted into a full-recourse claim.

[12] *Cf. supra* note 11 (describing how the almost incomprehensible § 1111(b)(2) election ties into the non-recourse to recourse conversion).

[13] 11 U.S.C. § 1111(b). Codified in Title 11 of the United States Code, the Bankruptcy Code was enacted by the Bankruptcy Reform Act of 1978. The Bankruptcy Code governs bankruptcy in the United States.

[14] Steven R. Haydon, *The 1111(b)(2) Election: A Primer*, 13 BANKR. DEV. J. 99, 101–

The non-recourse to recourse conversion is even more extraordinary because it violates both of bankruptcy law's principal policies. One policy is to enable a "fresh start" for the debtor,[15] which can be illustrated by § 524(a) of the Bankruptcy Code protecting a discharged debtor against creditor claims.[16] The non-recourse to recourse conversion violates this policy by granting a non-recourse creditor full repayment rights against the debtor if the collateral value is insufficient to repay the loan. The other policy is to foster equality of distribution to creditors based on their pre-bankruptcy claims.[17] This policy can be illustrated by § 547(b) of the Bankruptcy Code, which requires creditors to return preferential payments made by insolvent debtors within 90 days of their bankruptcy.[18] The non-recourse to recourse conversion violates this policy by granting a non-recourse creditor a new unsecured deficiency claim that would dilute the distribution to other creditors.[19] By creating that new claim, the non-recourse to recourse conversion also flouts the Bankruptcy Code's general respect for the substantive state law rights of creditors.[20]

Why does the non-recourse to recourse conversion exist? It did not

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02 (1996).

[15] Richard Lieb, *Eleventh Amendment Immunity of a State in Bankruptcy Cases: A New Jurisprudential Approach*, 7 AM. BANKR. INST. L. REV. 269, 276 (1999); *See* Boone v. I.S.S.C., 215 B.R. 386, 390 (Bankr. S.D. Ill. 1997) (providing that a fresh start and equality of distribution are two fundamental policies of bankruptcy). Sometimes, these policies must be balanced against each other. "While the Court agrees that providing debtors with a fresh start is one of the fundamental goals of bankruptcy, it is not the only interest that is entitled to protection. A debtor's fresh start must be *balanced* against the creditors' right to fair treatment. While such a rule may lead to harsh results, it is the only conclusion supported by the Code." *Id.*

[16] *See* Elaine Moorer, *The Case for Allowing Post-Discharge Actions Against Debtors*, 81 ILL. B.J. 468, 468 (1993) (noting that "[s]ection 524(a) of the Bankruptcy Code ensures debtors a fresh start by protecting them from collection activities of creditors whose claims have been discharged" (citations omitted)).

[17] *See* David A. Skeel, Jr., *The Empty Idea of "Equality of Creditors,"* 166 U. PA. L. REV. 699, 714 (2018). ("By the middle of the twentieth century, the equality of creditors meme pervaded bankruptcy law. It was seen as reflected in the preference provision, in the general rule that unsecured creditors are entitled to a pro rata share of the debtor's assets, and in the prohibition on unfair discrimination.").

[18] 11 U.S.C. § 547(b).

[19] *See infra* notes 142–146 and accompanying text (discussing that dilution).

[20] *See, e.g.*, *In re* Costas, 555 F.3d 790, 797 (9th Cir. 2009) (providing that respect for the substantive state law rights of creditors requires neither providing creditors new rights in debtors' property nor eliminating rights).

exist under the Bankruptcy Act of 1898, as amended, which was the main body of legislation governing bankruptcy law prior to enactment of the Bankruptcy Code in 1978. Prior to 1978, a non-recourse claim remained non-recourse. Non-recourse creditors were concerned, though, that their claims might be cashed out at a discount by debtors that undervalued the collateral. That concern became real in the case of *In re Pine Gate Associates, Ltd.*,[21] which occurred just prior to enactment of the Bankruptcy Code and provided the impetus for including § 1111(b).

In *Pine Gate*, a federal district court allowed a debtor to cash out a non-recourse creditor's claim by paying only the appraised value of the collateral, which was less than the amount of the claim. This result outraged many creditors, especially members of the real estate lending lobby. They argued that a non-recourse creditor faced the risk of underpayment if the collateral was undervalued or if the valuation occurred during a temporarily depressed market, whereas the debtor could retain the collateral and benefit from any future increase in its value.[22]

At the congressional hearings for the legislation that ultimately would become the Bankruptcy Code, the real estate lending lobby testified that the *Pine Gate* outcome would greatly reduce the availability of credit. Congress succumbed to that testimony, opening the door for over half a century of confusion.

This Article seeks to cut through the confusion surrounding § 1111(b) to explain what the language actually means, why it is illogical and economically harmful as written, and how it should be rewritten to become consistent with the Bankruptcy Code's policies. Our analysis proceeds in four parts. Part I discusses the *Pine Gate* case and the legislative and lobbying process that led to the enactment of § 1111(b). Part II analyzes what § 1111(b) means and the limits to the non-recourse to recourse conversion. Part III then analyzes § 1111(b)'s harmful consequences. Finally, Part IV reassesses and redrafts § 1111(b) to remove the non-recourse to recourse conversion.

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[21] *In re* Pine Gate Assocs., Ltd., No. B75-4345A, 1977 WL 373413 (N.D. Ga. Mar. 4, 1977), *vacated as moot*, No. B75-4345A, 1977 WL 373414 (N.D. Ga. Sept. 16, 1977).

[22] *See infra* Part I.A.

I. ORIGINS OF THE NON-RECOURSE TO RECOURSE CONVERSION

Due to hostility toward the idea of federalizing bankruptcy law, the United States had no permanent federal bankruptcy law until 1898.[23] Because state laws were unable to address problems resulting from nationwide financial calamities,[24] Congress finally garnered support to enact the Bankruptcy Act of 1898 ("Bankruptcy Act").[25] That Act remained in effect for eighty years—until the passage of the Bankruptcy Code.[26]

The Bankruptcy Act marked the beginning of a new era of liberal and favorable debtor treatment.[27] Prior to 1898, state laws generally sought to aid creditors in collecting on their debts.[28] The goal was relief *from* the debtors, not *for* the debtors.[29]

The Bankruptcy Act, however, may have swung too far in favor of debtors, giving rise to various attempts to "ameliorate" its "perceived extreme pro-debtor orientation."[30] Some of these attempts were successful; the Bankruptcy Act was amended many times, most notably by the Chandler Act in 1938.[31] During the Great Depression, however, Congress passed several pro-debtor amendments to the Bankruptcy Act.[32] This cemented Congress's pro-reorganization sentiment[33] and was yet another step in the centuries long shift from seeing bankruptcy as merely a mechanism to enable creditors to collect on their debt, toward a rehabilitation vehicle that can allow debtors to reform their financial

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[23] Charles Jordan Tabb, *The History of the Bankruptcy Laws in the United States*, 3 AM. BANKR. INST. L. REV. 5, 13–14 (1995).

[24] *See id.* at 23 (noting that "[s]tate laws were simply incapable of dealing with the financial problems created by . . . widespread calamities" such as "the panics of 1884 and 1893").

[25] *Id.*

[26] *Id.*

[27] *Id.* at 24.

[28] *See id.* at 15–16 (discussing the role of state law in regulating relationships between nineteenth-century creditors and debtors).

[29] *See id.* at 24 ("All prior bankruptcy laws had conditioned discharge upon the consent (or at least failure to object) of a specified percentage of creditors and a minimum dividend payment to creditors.").

[30] *Id.* at 27.

[31] *See id.* at 23 (describing the Chandler Act as the "most radical[]" amendment in the Bankruptcy Act's history).

[32] *Id.* at 28.

[33] *Id.*

circumstances.[34]

A. The *Pine Gate* Problem

As mentioned, Congress enacted §1111(b) largely in reaction to the *Pine Gate* decision.[35] Even given bankruptcy's pro-debtor tilt, critics viewed *Pine Gate* as "overly favorable to debtors and thus unfavorable to secured creditors."[36] Concerns associated with the case became known as the "*Pine Gate* problem."[37]

Pine Gate involved a debtor, Pine Gate Associates, Ltd. ("Pine Gate"), which was a limited partnership that owned and operated Pine Gate Apartments in Gwinnett County, Georgia.[38] In 1973, the Great National Life Insurance Company and the All American Life and Casualty Company (collectively, the "Class I Creditors" and their claims being the "Class I Claims") made non-recourse loans to Pine Gate to construct Pine Gate Apartments.[39] Those non-recourse loans were, in turn, secured by first mortgages against the apartments.[40]

In December of 1975, Pine Gate filed for bankruptcy relief and was granted permission to continue operating its property as a Debtor in Possession under Chapter XII of the Bankruptcy Act.[41] On May 14, 1976, Pine Gate filed and circulated its proposed plan of arrangement,[42] which would pay the Class I Creditors the total value of their collateral to extinguish their claims. Pine Gate valued the collateral at $1,200,000.00,[43]

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[34] *See generally id.* at 23–32 (outlining the historical evolution of the Bankruptcy Act of 1898).

[35] *See* supra notes 21-22 and accompanying text; *see also In re* B.R. Brookfield Commons No. 1 LLC, 735 F.3d 596, 599 (7th Cir. 2013) ("Congress enacted § 1111(b) in response to the harsh result in *Pine Gate Associates*, when a debtor used the 'cramdown' powers to avoid a nonrecourse creditor's undersecured deficiency claim.").

[36] Theodore Eisenberg, *The Undersecured Creditor in Reorganizations and the Nature of Security*, 38 VAND. L. REV. 931, 932 (1985).

[37] Douglas G. Baird, *Remembering Pine Gate*, 38 JOHN MARSHALL L. REV. 5, 8 (2004).

[38] *In re* Pine Gate Assocs., Ltd., No. B75-4345A, 1976 WL 531549, at *3 (Bankr. N.D. Ga. Oct. 14, 1976).

[39] *Id.* at *3–4.

[40] *Id.* at *3.

[41] *Id.* at *1.

[42] *Id.* at *4–5.

[43] *Id.* at *58.

significantly less than the $1,454,421.14 of principal and interest due on the Class I Claims.[44] Because the Class I Claims were non-recourse,[45] the plan did not provide the Class I Creditors with unsecured deficiency claims for the difference between the face value of their claims and the appraised value of the collateral.[46]

The confirmation hearing for the proposed plan of arrangement was held on May 27, 1976.[47] Out of the five classes of claims affected by the plan, only the Class I Creditors failed to approve the plan.[48] They opposed the plan because it did not provide for payment of the accrued interest.[49] The plan provided that if it was rejected by a class of creditors, Pine Gate would ask the court to cramdown the plan on those creditors.[50] Section 468 of the Bankruptcy Act allowed such a cramdown if certain requirements were satisfied.[51] Those requirements included § 461(11),[52] mandating that a non-consenting class must have adequate protection.[53] The adequate protection standard could be met "(a) by the transfer or sale, or by the retention by the debtor, of such property subject to such debts; or (b) by a sale of such property free of such debts, at not less than a fair upset price, and the transfer of such debts to the proceeds of such sale; or (c) *by appraisal and payment in cash of the value of such debts*; or (d) by such method as will, under and consistent with the circumstances of the particular case, equitably and fairly provide such protection."[54]

The debtor argued that paying the Class I Creditors the appraised value of the Pine Gate apartments would provide them with "adequate protection" as required by § 461(11)(c).[55] The Class I Creditors contended, however,

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[44] *Id.* at *27.

[45] *See supra* note 39 and accompanying text.

[46] *In re* Tampa Bay Assocs., Ltd., 864 F.2d 47, 50 (5th Cir. 1989).

[47] *In re* Pine Gate Assocs., Ltd., No. B75-4345A, 1977 WL 373413, at *1 (N.D. Ga. Mar. 4, 1977), *vacated as moot*, No. B75-4345A, 1977 WL 373414 (N.D. Ga. Sept. 16, 1977).

[48] *Pine Gate*, 1976 U.S. Dist. LEXIS 17366, *4–5.

[49] *Id.* at *4.

[50] *See Pine Gate*, 1977 WL 373413, at *1.

[51] *Pine Gate*, 1976 U.S. Dist. LEXIS 17366, at *11.

[52] *Id.* at *12.

[53] *Id.* at *13.

[54] *In re* Perimeter Park Inv. Assocs., Ltd., 697 F.2d 945, 948 (11th Cir. 1983) (emphasis added).

[55] *Pine Gate*, 1976 U.S. Dist. LEXIS 17366, at *5.

that § 461(11)(c) required their claims to be paid in full or for the property securing their claims to be turned over to them.[56]

After hearing from both sides, a federal district court ruled that the debtor may extinguish the Class I Creditors' non-recourse claims by paying them the appraised value of the property securing those claims.[57] Adequate protection under § 461(11)(c) could not mean that non-recourse creditors were "entitled to the amount of their debts" because such creditors were not entitled to "greater protection than the value of the security."[58] Therefore, under the Bankruptcy Act, a non-recourse creditor faced the risk of underpayment of its loan if the collateral were undervalued in an appraisal. Furthermore, a non-recourse creditor could bear the brunt of a temporarily bad market where the property had dropped in value.[59] In either case, any upside in the future value of the collateral would benefit the debtor and be lost to the creditor.[60]

The court acknowledged the difficulty of determining the appraised value and the importance of getting the valuation correct, given the § 461(11) adequate protection requirement and applicable Fifth Amendment requirements of due process and just compensation. For these reasons, the court requested that the parties illustrate their methods of valuation at a subsequent hearing to settle issues of valuation.[61] At that hearing, the court

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[56] *Id.*

[57] As the *Pine Gate* Court summarized:

> [T]his Court concludes that as applied to the facts of the case at bar, where the dissenting secured creditors have, by contractual agreement, exculpated the Debtor and all persons associated with it from personal liability for any part of the debt, Section 461(11)(c) may be constitutionally applied to extinguish the debt of the dissenting secured creditors, and a Plan of Arrangement confirmed in spite of such dissenting class, so long as the dissenting class of creditors is compensated by the payment in cash of the value of the debt; i.e., the value of the secured property.

Pine Gate, 1976 U.S. Dist. LEXIS 17366, at *56–57.

[58] *Id.* at *27.

[59] *See In re* Tampa Bay Assocs., Ltd., 864 F.2d 47, 50 (5th Cir. 1989) ("After *Pine Gate* . . . a debtor could file bankruptcy proceedings during a period when real property values were depressed, propose to repay secured lenders only to the extent of the then-appraised value of the property, and 'cram down' the secured lender class . . . .").

[60] *Id.*

[61] *In re* Pine Gate Assocs., Ltd., No. B75-4345A, 1977 WL 373413, at *1 (N.D. Ga. Mar. 4, 1977), *vacated as moot*, No. B75-4345A, 1977 WL 373414 (N.D. Ga. Sept. 16, 1977).

determined that the correct appraised value of the property was only $1,032,000,[62] an amount even lower than the $1,200,000 original appraisal.[63] Although the Class I Creditors "object[ed] to any alteration of their contractual rights," the court disagreed—presumably because non-recourse creditors are contractually only entitled to the value of their collateral.[64]

The *Pine Gate* decision outraged the secured lending community. Secured lenders were troubled that a debtor could benefit from any increase in the value of collateral when a creditor has been forced to accept less than the full amount of its claim.[65] There was also concern that debtors could use the decision strategically to harm undersecured creditors.[66] For example, a debtor could file for bankruptcy when the value of the collateral, such as real property, was low, paying the then-undersecured creditor only that depressed amount and keeping for itself any future increase in value.[67]

B. The Bankruptcy Reform Act of 1978 and § 1111(b)

The legislative process leading to enactment of the Bankruptcy Code provided the next stage for addressing the *Pine Gate* problem.[68] The

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[62] *Id.* at *17.

[63] *See id.* at *1 (finding that payment of $1,200,000.00 provided "adequate protection and complete compensation to [the] Class I Creditors in complete satisfaction for" their claims).

[64] *See In re* Pine Gate Assocs., Ltd., No. B75-4345A, 1976 U.S. Dist. LEXIS 17366, at *39 (Bankr. N.D. Ga. Oct. 14, 1976).

[65] Eisenberg, *supra* note 36, at 964.

[66] *See* Haydon, *supra* note 14, at 105 (observing that "a debtor could file bankruptcy proceedings during a period when real property values were depressed, propose to repay secured indebtedness only to the extent of the value of the collateral at that time, and preserve all potential future appreciation of that property solely for the benefit of the debtor").

[67] *Id.* at 105. *Cf. In re* Tampa Bay Assocs., Ltd., 864 F.2d 47, 50 (5th Cir. 1989) (discussing that the *Pine Gate* decision created a perverse incentive for debtors to file bankruptcy proceedings when real property values were low, then proposing a plan to repay secured creditors only the then-current value of the property, and finally using cramdown to override the secured creditors' objections and move forward with the plan; and suggesting that this would allow debtors to pay off secured loans by pennies on the dollar and then reap the benefits of any future appreciation of the formerly secured property).

[68] The remedy to the *Pine Gate* decision was originally included as § 502(i), but this section was later deleted and the remedy was written into § 1111(b). *See* S. Rep. No. 95-

bankruptcy system created by the Bankruptcy Act had come under fierce criticism[69] for allegedly being vague, complicated, and no longer aligned with the economic and social conditions of the second half of the twentieth century.[70] Moreover, the Bankruptcy Act had been amended so extensively and interpreted by judges so aggressively that bankruptcy law barely resembled the underlying statutory text.[71] To address these concerns, in 1970 Congress created a Commission on the Bankruptcy Laws of the United States ("Commission").[72] The Commission's purpose was to evaluate the bankruptcy laws and determine the extent to which revision was necessary.[73] In 1973, the Commission issued a report that criticized the state of bankruptcy law and proposed that Congress enact new legislation (the "Commission's Bill") to replace the Bankruptcy Act.[74] Bankruptcy judges, who were excluded from the Commission, proposed their own bill around the same time (the "Judges' Bill").[75]

After a failed attempt to introduce the Commission's Bill in 1973, it was reintroduced as House Bill 31 in 1974.[76] The Judges' Bill was introduced as House Bill 32 the same year.[77] In 1975 and 1976, the House Judiciary Committee's Subcommittee on Civil and Constitutional Rights held lengthy hearings on these bills, which culminated in a new House Bill 6 that

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989, at 65 (1978) (stating that § 502(i) "answers the nonrecourse loan problem and gives the creditor an unsecured claim for the difference between the value of the collateral and the debt in response to the decision in ⟦*Pine Gate*⟧"); 95 Cong. Rec. 33997 (1978) (statement of Sen. Dennis DeConcini) ("The House amendment deletes section 502(i) of the Senate bill but adopts the policy of that section to a limited extent for confirmation of a plan of reorganization in section 1111(b) of the House amendment.").

[69] Eric A. Posner, *The Political Economy of the Bankruptcy Reform Act of 1978*, 96 MICH. L. REV. 47, 61 (1997).

[70] *Id.* at 61.

[71] *Id.*

[72] *See* S.J. Res. 100, 90th Cong. § 1(a) (1968) ("⟦T⟧here is hereby established a commission to be known as the Commission on the Bankruptcy Laws of the United States . . . .").

[73] *See id.* § 1(b) ("⟦T⟧he Commission shall study, analyze, evaluate, and recommend changes to ⟦the Bankruptcy Act⟧ in order for such Act to reflect and adequately meet the demands of present technical, financial, and commercial activities.").

[74] Posner, *supra* note 69, at 68.

[75] *Id.* at 69.

[76] *Id.*

[77] *Id.*

combined features of the two proposals.[78] Further Subcommittee meetings on House Bill 6 led to the proposal of House Bill 8200 in July 1977. After much back and forth, the House finally passed House Bill 8200 in February 1978.[79] House Bill 8200 did not contain any language substantively similar to what later became § 1111(b) or involving a non-recourse to recourse debt conversion.[80]

The legislative process in the Senate paralleled the process in the House. In 1977, Senate Bill 2266 was proposed.[81] The original version of this bill, like House Bill 8200, did not contain any language substantively similar to what later became § 1111(b) or involving a non-recourse to recourse debt conversion.[82] A report by the Senate Committee on the Judiciary issued on September 8, 1977, which dealt with similar issues in the context of consumer bankruptcy, indicates that this omission may have been intentional:

> To the extent that his claim against the debtor exceeds the value of his collateral, he is treated as having an unsecured claim, and he will receive payment along with all other general unsecured creditors. *Of course, the holder of a non-recourse loan will not have an unsecured claim for the deficiency.*[83]

This report respects the contractual meaning of non-recourse debt claims.

That view, however, was challenged during hearings before the Senate Judiciary Committee on November 28 and December 1 of 1977.[84] Lobbyists for the real estate lending industry argued forcefully against the *Pine Gate* outcome, causing the Judiciary Committee to reconsider the rights of non-recourse secured creditors. One of those lobbyists argued that the *Pine Gate* outcome meant that "the creditor is in substantial part denied its security

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[78] *Id.*

[79] *Id.* at 69–70.

[80] *Compare* H.R. 8200, 95th Cong. (July 11, 1977) *with* H.R. 8200, 95th Cong. (Feb. 8, 1978).

[81] Posner, *supra* note 69, at 71.

[82] *See* S.B. 2266, 95th Cong. (Oct. 31, 1977).

[83] S. Rep. No. 94-735, at 124 (1977) (emphasis added).

[84] Hearings Before the Subcom. on Improvements in Judicial Machinery, 95 Cong. (1977).

and its contract rights."[85] That lobbyist further contended that *Pine Gate* had not only imposed harmful losses on secured lenders but that its outcome had caused disruption to "spread throughout the secured lending industry."[86] Additionally, the lobbyist expressed concern that debtors had been using the *Pine* Gate outcome to renegotiate loans or delay payment,[87] and that lenders had been forced to capitulate to debtor's demands.[88] As a result, it was inevitable that "the flow of funds into new mortgages will be greatly reduced."[89] To prevent this alleged disruption, he then asked that "Congress require that appropriate appraisal methods are used to arrive at 'value' and that appraisers appointed by the Courts understand that a secured creditor has the staying power and financial resources to restore distressed properties to their earlier value once the creditor has title."[90]

Evidently alarmed by the real estate lending lobby's arguments, Senator Dennis DeConcini asked whether, absent legal reform, the banking industry would really stop lending money.[91] The lobbyist responded that at least the life insurance industry "would channel more of ⟦their⟧ funds into direct placements and bond purchases," and less into mortgages.[92] After further questioning, a lawyer for the lobby clarified that it would not be the end of the home loan mortgage business, but lenders would be "much more conservative than they have been in the past."[93]

In connection with these hearings, the National Association of Real Estate Investment Trusts submitted a memorandum (the "REIT Memorandum") claiming that the *Pine Gate* decision created a dangerous precedent and suggesting a statutory solution to the problem. The REIT Memorandum argued that debtors were using cramdown to "divert values to junior interests in situations where the only beneficiary is the party that

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[85] *Id.* at 704 (statement of Edward J. Kulik).

[86] *Id.*

[87] *Id.*

[88] *Id.* The testimony was buttressed by the then explosive growth in Chapter XII filings by large complex commercial real estate enterprises. *Id.*

[89] *Id.*

[90] *Id.* They also asked that "in all fairness, the secured lender in the single asset, non-recourse loan bankruptcy should be permitted to enforce fully its contract rights." *Id.* at 710.

[91] *Id.* at 715 (statement of Dennis DeConcini).

[92] *Id.* (statement of Edward J. Kulik).

[93] *Id.* (statement of Robert E. O'Malley).

originally executed the note and mortgage and where the collateral consists of property acquired for investment in a speculative venture, often for tax reasons."[94] The REIT Memorandum also emphasized that "what has been particularly offensive in recent cram-down cases is the use by speculators of cram-down as a device to shift equity risk to parties who entered into the transaction on a credit basis."[95] It went on to suggest that the following language, which would convert non-recourse to recourse claims, be included in any new bankruptcy law[96]:

> A claim secured by an interest enforceable against property of the estate which is by law or by contract unenforceable against the debtor shall be allowed . . . if the holder of such claim shall be precluded for any reason under this title from enforcing such claim against such property.[97]

Following the Senate Judiciary Committee hearings, the Senate revised its Bill 2266 and passed the revised bill as an amendment to House Bill 8200.[98] Thereafter, the legislation was referred to as House Bill 8200 as amended by the Senate.[99] That legislation included the REIT Memorandum's non-recourse to recourse conversion language.

The report submitted by the Senate Judiciary Committee to accompany House Bill 8200 as amended by the Senate explains that language as "answer[ing] the non-recourse loan problem and giv[ing] the creditor an unsecured claim for the difference between the value of the collateral and the debt in response to the decision in *Great National Life Ins. Co. v. Pine Gate Associates, Ltd.*"[100] As one senator later remarked, that language addressed the perceived danger of real estate lenders hesitating to make loans given the uncertainty in creditor rights created in the wake of the *Pine*

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[94] *Id.* at 720 (statement of the National Association of Real Estate Investment Trusts).

[95] *Id.* at 721.

[96] *Id.*

[97] *Id.* The REIT Memorandum additionally proposed that in cases where the debtor retains collateral, the secured creditor should generally keep its lien against the collateral until a careful determination has found that it is "not of sufficient value at the time of confirmation and will not achieve such value in the reasonably foreseeable future." *Id.*

[98] House Bill 8200 passed in the House in February of 1978. Posner, *supra* note 69, at 71.

[99] *Id.* at 71–72.

[100] S. Rep. No. 95-989, at 65 (1978).

Gate decision.[101] That language was included in § 1111(b) of the final version of the legislation which, after being signed by the President in early November 1978, became the Bankruptcy Code.[102]

II. EXPLAINING SECTION 1111(B)

Section 1111(b) currently reads as follows:

> (b) (1) (A) A claim secured by a lien on property of the estate shall be allowed or disallowed under section 502 of this title the same as if the holder of such claim had recourse against the debtor on account of such claim, whether or not such holder has such recourse, unless—
>
> > (i) the class of which such claim is a part elects, by at least two-thirds in amount and more than half in number of allowed claims of such class, application of paragraph (2) of this subsection; or
> > (ii) such holder does not have such recourse and such property is sold under section 363 of this title or is to be sold under the plan.
>
> (B) A class of claims may not elect application of paragraph (2) of this subsection if—
>
> > (i) the interest on account of such claims of the holders of such claims in such property is of inconsequential value; or
> > (ii) the holder of a claim of such class has recourse against the debtor on account of such claim and such property is sold under section 363 of this title or is to be sold under the plan.

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[101] *See* 124 Cong. Rec. 28,258 (1978) (statement of Sen. Malcolm Wallop) ("The problems of the recent Pine Gate case which has given lenders pause in making real estate loans will be solved by the addition of specific guidelines as to the manner in which real estate loans can be dealt with in reorganization cases . . . .").

[102] Posner, *supra* note 69, at 73.

> (2) If such an election is made, then notwithstanding section 506(a) of this title, such claim is a secured claim to the extent that such claim is allowed.[103]

Section 1111(b) has been called "one of the most extraordinary provisions in the history of bankruptcy law."[104] This section upset fundamental rules of debtor-creditor law, first by allowing an undersecured claim to be treated as fully secured and, second, by converting non-recourse debt into recourse debt.[105] Although the ramifications of treating an undersecured claim as fully secured are important, this Article focuses on the disruptive consequences of converting non-recourse debt into recourse debt.

A. Explaining the Non-Recourse to Recourse Conversion

Section 1111(b)(1)(A) states that "[a] claim secured by a lien on property of the estate shall be allowed or disallowed under § 502 of this title the same as if the holder of such claim had recourse against the debtor on account of such claim, whether or not such holder has such recourse."[106] This means that in a Chapter 11 case, a secured creditor's non-recourse claim is treated as a full-recourse claim, despite its being non-recourse under state law.[107]

The consequence of that treatment is that § 506 of the Bankruptcy Code now creates separate secured and unsecured claims out of the original loan amount.[108] Under § 506, the claims of undersecured creditors—that is, creditors whose claims exceed the value of their collateral[109]—are

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[103] 11 U.S.C. § 1111(b).

[104] Eisenberg, *supra* note 36, at 932.

[105] *Id.*

[106] 11 U.S.C. § 1111.

[107] Kenneth C. Weil, *Recourse and Non-recourse Debt: What Are the Federal Income Tax Consequences When the Character of Debt Changes*, 74 TAX LAW. 141, 151 (2020).

[108] Section 506(a)(1) of the Bankruptcy Code states that:

> 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 or the amount so subject to setoff is less than the amount of such allowed claim.

[109] Eisenberg, *supra* note 36, at 934.

automatically bifurcated into secured and unsecured claims.[110] The undersecured creditor has a secured claim up to the value of its collateral[111] and an unsecured claim for the difference, or deficiency, between the total debt and the value of the collateral.[112] Without § 1111(b)(1)(A), a non-recourse creditor's claim would be limited to the value of the collateral,[113] and § 502(b)(1) would disallow any portion of the claim that exceeded that value.[114]

The so-called 1111(b)(2) election puts a possible limit on the non-recourse to recourse conversion.[115] A non-recourse claimant may not have its claim receive recourse treatment if it elects under § 1111(b)(2) to have its claim treated as fully secured, instead of bifurcated into secured and unsecured claims under § 506. A creditor would make this election if it believed, for example, that the value of its collateral was close to the amount of its claim or that the recovery of unsecured claimants would be relatively small.[116] Another limit is that the non-recourse to recourse conversion does not apply if the collateral is sold under a § 363 sale or a plan of reorganization.[117] The rationale is that these are arm's length sales, and the creditor would have the right to credit bid for the collateral—that is, to offset

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[110] Haydon, *supra* note 14, at 107. *See In re* Philadelphia Newspapers, LLC, 599 F.3d 298, 315 (3d Cir. 2010), for more explanation of the basics of § 1111(b).

[111] Haydon, *supra* note 14, at 107.

[112] *Id.*

[113] *See supra* notes 45–46 and accompanying text.

[114] Weil, *supra* note 107, at 151.

[115] 11 U.S.C. §§ 1111(b)(1)(A)(i) & (b)(1)(A)(ii).

[116] *See* Weil, *supra* note 107, at 152. The § 1111(b)(2) election "is best considered in the context of confirmation." 95 Cong. Rec. 34005 (1978) (statement of Sen. Malcolm Wallop). Section 1129(a) of the Bankruptcy Code, governing confirmation of a plan or reorganization, lists the requirements for a plan to be confirmed. 11 U.S.C. § 1129(a). If the § 1129(a)(8) requirement, that every impaired class accept the plan, is not met, a judge still may confirm the plan over one or more dissenting classes if § 1129(b)(1) is satisfied. This method, called cramdown, John Hancock Mutual Life Insurance Co. v. Route 37 Business Park Associates, 987 F.2d 154, 157 (3d Cir. 1993), requires the plan to be fair and equitable and not to discriminate unfairly. *In re* Barakat, 99 F.3d 1520, 1524 (9th Cir. 1996). These requirements effectively mean, with limited exceptions, that a plan cannot cramdown the claim of a creditor that makes a § 1111(b)(2) election unless it either pays the claim in full or gives the creditor title to the collateral.

[117] *See* 11 U.S.C. § 1111(b)(1)(A)(ii).

its claim against the purchase price if it submits the winning bid.[118]

B. Apologia for the Non-Recourse to Recourse Conversion

One leading bankruptcy treatise contends that the non-recourse to recourse conversion was added to § 1111(b) to strike a balance between bankruptcy's policies of debtor rehabilitation and equality of distribution.[119] As we later explain, that makes little sense because that section undermines both of those policies.[120] A slightly more apt justification, perhaps, is tied to the limits of judicial valuation of collateral: that the non-recourse to recourse conversion "allow[s] a creditor's loan to surpass the limitations of non-recourse agreements and state law, and instead receive treatment as a recourse claim because the judicial valuation specific to Chapter 11 'was not part of a non-recourse creditor's bargain.'"[121]

The idea that judicial valuation specific to Chapter 11 is "not part of a non-recourse creditor's bargain" is ridiculous, however. "The entire bankruptcy process depends on accepting valuations that often are little more than educated guesses."[122] The amount of a secured claim, whether a creditor has adequate protection against the automatic stay, and how much a business is worth as a going concern all depend on valuing the collateral.[123] Additionally, the Bankruptcy Code requires that future payments to creditors be discounted to present value.[124] Valuation problems are inherent in the structure of bankruptcy.[125]

Furthermore, the non-recourse to recourse conversion itself requires valuation. Recall that § 506(a) of the Bankruptcy Code calls for an undersecured creditor's claim to be divided into a secured claim for the value

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[118] *See* Haydon, *supra* note 14, at 110–11.

[119] 7 COLLIER ON BANKRUPTCY ¶ 1111.03 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2013).

[120] *See infra* Part III.A.

[121] *In re* B.R. Brookfield Commons No. 1 LLC, 735 F.3d 596, 600 (7th Cir. 2013).

[122] Eisenberg, *supra* note 36, at 944.

[123] *See id.* ("Both the timing and accuracy of valuations are factors that the law, particularly bankruptcy law, must live with. The entire bankruptcy process depends on accepting valuations that often are little more than educated guesses.").

[124] *Id.*

[125] *See id.* ("Unless and until someone creates a satisfactory market-based mechanism for valuing a failing enterprise, valuation problems necessarily will continue.").

of the collateral and an unsecured claim for the deficiency.[126] Further illustrating that valuation problems are inherent in bankruptcy, the standard that should be used for that valuation is itself unclear.[127] Section 506(a)(1) provides that a secured claim's value "shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest."[128] According to a House Report on § 506(a), Congress had chosen not to specify a standard so that courts would have to look at the facts and competing interests of each case, and thereby "determine value on a case-by-case basis."[129]

The Supreme Court has provided limited valuation guidance. In *Associates Commercial Corp. v. Rash*,[130] it focused on the language from § 506(a)(1) that valuation depends on the "proposed disposition or use" of the collateral.[131] It found that whatever valuation standard is chosen must give meaning to the words "disposition or use."[132] In other words, the valuation method must capture the different outcomes that will occur depending on whether the debtor chooses to keep the collateral or surrender it to the secured creditor[133] The Court clarified, however, that even this valuation must be based on the collateral's actual use by that party.[134]

Although the Supreme Court looked specifically at a Chapter 13 case in *Rash*, lower courts have found that similar reasoning applies to the Chapter 11 context.[135] Additionally, the Bankruptcy Code does not explicitly lay out what date should be used for valuations made under Chapter 11.[136] Courts once again use the guidance provided by *Rash* to determine the appropriate

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[126] *See supra* note 108 and accompanying text.

[127] *In re* Heritage Highgate, Inc., 679 F.3d 132, 141 (3d Cir. 2012).

[128] 11 U.S.C. § 506(a)(1).

[129] H. Rep. No. 95-595, at 356 (1977).

[130] Assocs. Com. Corp. v. Rash, 520 U.S. 953 (1997).

[131] *Id.* at 962.

[132] *Id.*

[133] *Id.*

[134] *See id.* at 963 ("That actual use, rather than a foreclosure sale that will not take place, is the proper guide under a prescription hinged to the property's 'disposition or use.'").

[135] *In re* Heritage Highgate, Inc., 679 F.3d 132, 141 (3d Cir. 2012).

[136] *In re* Houston Reg'l Sports Network, L.P., 886 F.3d 523, 528 (5th Cir. 2018).

valuation date based on the specific circumstances of the case.[137] Indirectly, therefore, even the Supreme Court has found valuation to be essential to the non-recourse to recourse conversion.

We therefore believe that the backlash to *Pine Gate* should not have been over disagreement with the concept of valuation but, rather, over the actual valuation. Bankruptcy law cannot work without a valuation process.[138] Giving non-recourse creditors full-recourse rights does not improve the valuation process. Rather, as we next show, it significantly harms the bankruptcy process itself by undermining its essential policies.

III. CONSEQUENCES OF THE NON-RECOURSE TO RECOURSE CONVERSION

We next analyze the consequences of including the non-recourse to recourse conversion in § 1111(b). We show that it only benefits non-recourse creditors while impairing bankruptcy law's fundamental policies. It also provides non-recourse creditors with far greater rights than what the real estate lending lobby had originally contemplated.

A. The Non-Recourse to Recourse Conversion Impairs Bankruptcy Policy

As discussed, bankruptcy law has two principal policies—to provide debtors with a fresh start and to ensure equality of distribution among creditors.[139] In a Chapter 11 context, a "fresh start" refers to enabling firms to recapitalize their unsustainable debt.[140] Equality of distribution among creditors refers to bankruptcy's equal treatment of claims accordingly to their pre-bankruptcy priorities, not to changing those priorities.[141] Section 1111(b) works against

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[137] *See*, *e.g.*, *id.* at 530–31.

[138] See supra notes 122–125 and accompanying text.

[139] United States v. Copley, 591 B.R. 263, 287–88 (E.D. Va. 2018), *vacated by* 959 F.3d 118 (4th Cir. 2020).

[140] *See* Bosiger v. U.S. Airways, 510 F.3d 442, 448 (4th Cir. 2007) (observing that the principal purpose" of bankruptcy is to give the debtor a "fresh start," allowing it to "restructure its financial obligations" so it no longer faces "the weight of oppressive indebtedness").

[141] *In re* Delta Air Lines, 359 B.R. 454, 459 (Bankr. S.D.N.Y. 2006); *see In re* Cybermech, Inc., 13 F.3d 818, 823 (4th Cir. 1994) (noting that the "prime bankruptcy policy of equality of distribution among creditors" could be advanced "by ensuring that all similarly-situated creditors will receive the same pro rata share . . . ."); *see also* Weil, *supra*

each of these policies.

By converting non-recourse claims to recourse claims, § 1111(b) harms unsecured creditors by reducing their recovery.[142] For example, if $100 of unsecured creditor claims are payable from $80 of an insolvent debtor's unencumbered assets, each creditor would receive 80 cents on the dollar. But the conversion to recourse of a $50 non-recourse claim, secured by collateral worth $30, would create under § 506(a) a $30 secured claim and a $20 unsecured deficiency claim. That $20 unsecured deficiency claim would be pari passu in priority with, and thus add to, the original $100 of unsecured creditor claims. The result is that unsecured creditors are now harmed because they would receive only 66 cents on the dollar.[143]

The Supreme Court's reasoning in the case of *United Savings Ass'n of Texas v. Timbers of Inwood Forest Associates, Ltd.*,[144] helps to further illustrate the point that unsecured creditors are harmed by § 1111(b)'s non-recourse to recourse conversion. In *Timbers*, the Supreme Court affirmed the Fifth Circuit's holding that an undersecured creditor is not entitled to post-petition interest on its collateral as a part of fulfilling the requirement of adequate protection provided by § 362(d)(1).[145] The Court found that providing an undersecured creditor with post-petition interest would dilute the recovery of, and thus would be inequitable to, unsecured creditors.[146]

The non-recourse to recourse conversion also gives non-recourse creditors more rights than they have under non-bankruptcy law. Giving a non-recourse, undersecured creditor a recourse claim can increase the creditor's power and can improve the terms of the bargain beyond what the creditor originally agreed to.[147] The undersecured creditor now has a recourse loan when it originally negotiated for a much riskier non-recourse

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note 107, at 151 (describing the priority of creditor claims under § 1111(b)(1)(A)).

[142] Eisenberg, *supra* note 36, at 966.

[143] Eighty dollars of unencumbered assets divided by $120 (that is, $100 + $20) of unsecured claims equals 66.67 cents on the dollar recovery.

[144] United Sav. Ass'n of Texas v. Timbers of Inwood Forest Assocs., Ltd., 108 S. Ct. 626 (1988).

[145] *Id.* at 636 (1988).

[146] *Id.* at 631.

[147] *See* Eisenberg, *supra* note 36, at 968–69 ("Section 1111(b) . . . can transform a creditor who was merely a factor in the reorganization into the dominant factor, all in the name of preventing the debtor from enjoying the benefit of postvaluation appreciation of collateral.").

loan.[148] Furthermore, the non-recourse creditor now has the power to vote for the plan through its newly created recourse claim, which enables it to influence the confirmation of the plan of reorganization.[149]

This unbargained-for conversion can distort the lending market. To compensate a non-recourse creditor for the additional risk that accompanies a non-recourse loan, the terms of the original lending agreement would likely have required the debtor to pay the creditor a higher rate of interest.[150] However, when § 1111(b) changes the loan from non-recourse to recourse, it upsets the original terms of the agreement and puts the secured creditor into a far better financial position.[151] The creditor already factored in the risk of the collateral being worth less than its claim and therefore charged a higher interest rate.[152] Turning the claim into a recourse claim essentially gives the non-recourse creditor double protection and hurts the debtor and other creditors as a result.[153]

This raises the question of why a non-recourse creditor should receive these special protections.[154] Non-recourse creditors have the knowledge and skill to understand the consequences of their bargain.[155] They understand that non-recourse means that they can only look to the collateral securing the claim for repayment.[156] The conversion from non-recourse to recourse actually changes the state law bargain made and the non-recourse creditor's rights, giving that creditor an unfair and unbargained-for benefit.[157]

Finally, the non-recourse to recourse conversion impairs debtor

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[148] *See id.* ("[I]n bankruptcy, the intentionally undersecured creditor finds itself with the option of being treated as fully secured.").

[149] *Id.* at 966–67.

[150] *Id.* at 969.

[151] *Id.*

[152] *Id. See also supra* note 13 and accompanying text.

[153] *See* Eisenberg, *supra* note 36, at 969. More remarkably, the Seventh Circuit has held that § 1111(b)(1)(A) gives a non-recourse creditor a full recourse claim even if the collateral has no value. *See In re* B.R. Brookfield Commons No. 1 LLC, 735 F.3d 596 (7th Cir. 2013). This absurd ruling means that the recourse transformation can increase a non-recourse creditor's recovery from nothing to potentially 100%.

[154] Eisenberg, *supra* note 36, at 967.

[155] *Id.*

[156] *Id.*

[157] *See id.* ("Fidelity to the state law bargain . . . disappears as a consideration when recasting nonrecourse debt as recourse debt. By recasting that bargain, section 1111(b) alters state law . . . without any clear benefit to the bankruptcy process.").

rehabilitation. One of the key goals of the Bankruptcy Code is to provide the debtor with a "fresh start" that makes its debt burden sustainable.[158] Section 1111(b) impairs that goal by increasing the debtors' debts.[159] The non-recourse to recourse conversion also gives non-recourse creditors the ability to block confirmation of a debtor's reorganization plan.[160]

B. The Non-Recourse to Recourse Conversion Fails to Address the Original Concerns

During the Senate hearings in the 1970s, the real estate lending lobby raised concerns about how the *Pine Gate* outcome would disrupt the secured lending industry by essentially giving debtors too much power over creditors.[161] To prevent this disruption, the lobbyists requested that Congress require appropriate appraisal methods to address valuation issues.[162] However, instead of limiting § 1111(b) to only single asset, non-recourse bankruptcies or adjusting the valuation method, Congress passed the overbroad solution (which was also proposed by the real estate lending industry) of turning non-recourse claims into recourse claims.

The real estate lending lobby was really looking for a guarantee that non-recourse claims could not be extinguished at a time when the collateral has a temporarily low valuation. However, under price theory, a valuation of property includes "all projections of future movements in the market."[163] This means, that any future appreciation or depreciation in property value

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[158] *See* Randall A. Heron, Erik Lie & Kimberly J. Rodgers, *Financial Restructuring in Fresh-Start Chapter 11 Reorganizations*, 38 FIN. MGMT. 727, 727 (2009) (noting that firms emerging from Chapter 11 bankruptcy "get a unique opportunity to establish a new capital structure").

[159] *Cf.* Eisenberg, *supra* note 36, at 965 (observing that § 1111(b) has the effect of increasing the leverage of undersecured and non-recourse creditors against all other parties to a reorganization).

[160] *Id.* at 966.

[161] *See* Hearings Before the Subcom. on Improvements in Judicial Machinery, 95 Cong. 704 (1977) (statement of Edward J. Kulik) (claiming that *Pine Gate* would lead to major ramifications for the secured lending industry).

[162] Additionally, they requested that secured lenders in a single asset, non-recourse bankruptcy be allowed to fully enforce its contract rights. *Id.* at 710.

[163] David Gray Carlson, *Bifurcation of Undersecured Claims in Bankruptcy*, 70 AM. BANKR. L.J. 1, 17 (1996).

is already subsumed into the valuation.[164] Therefore, protecting a secured party against the risk of depreciation in the value of its collateral was not part of the original contractual bargain.[165]

IV. REASSESSING SECTION 1111(B)

We have shown that the non-recourse to recourse conversion provided by § 1111(b)(1)(A) undermines the fundamental policies of the bankruptcy, is inconsistent with economic theory, and goes far beyond what the real estate lending lobby originally requested. This Part addresses how § 1111(b) should be revised. To that end, we first examine how Chapter 9 of the Bankruptcy Code, governing municipal bankruptcies, has adopted § 1111(b) to show that the non-recourse to recourse conversion is not necessarily an integral part of bankruptcy law. Second, taking what we learned from Chapter 9, we will show that the § 1111(b)(2) election alone should be enough to address the concerns of the real estate lending lobby and non-recourse creditors more generally. We conclude with proposed language that removes the non-recourse to recourse conversion from § 1111(b), while keeping the rest of the section relatively intact.

A. Chapter 9 of the Bankruptcy Code Informs the Non-Recourse to Recourse Conversion

Chapter 9 municipal bankruptcy illustrates that a non-recourse to recourse conversion is unnecessary because the § 1111(b)(2) election already sufficiently protects creditors' rights. A local government can finance its operations and make necessary improvements by issuing municipal bonds.[166] There are two types of municipal bonds. One is the general obligation bond, which is backed by the local government's full faith and credit—that is, full recourse.[167] The other is the revenue bond, which is

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[164] *Id.*

[165] *Id.*

[166] *See* Joel A. Mintz et al., *Fundamentals of Municipal Finance* 47 (2010) (discussing the key features of municipal bonds as financial instruments).

[167] *See id.* at 2 (noting that the "distinguishing feature" of a general obligation bond "is the fact that it is secured by the 'full faith and credit' of the issue. In other words, the issuing government pledges to use all revenue sources that are available to it . . . to repay the principal and interest on the bonds in a timely manner").

paid through the revenues that accrue from a specific project.[168] In other words, revenue bonds are non-recourse obligations that are paid only through the revenue produced by the specific project that the revenue bonds are financing.[169]

A financially troubled municipality may seek relief under Chapter 9 of the Bankruptcy Code.[170] During the 1988 amendments to Chapter 9, Congress sought to "harmonize" corporate and municipal bankruptcy law.[171] The non-recourse to recourse conversion under § 1111(b) was of special concern because state and municipal provisions restricted the payment of revenue bonds to the stream of cash emanating from the funded project, and not to full-faith-and-credit recourse against the municipality.[172] The 1988 amendments prohibited Chapter 9 from converting revenue bonds into general obligation bonds.[173]

Congress nonetheless included the equivalent of a § 1111(b)(2) election into Chapter 9.[174] This meant that revenue bonds are deemed to be secured by their project up to the full amount of the outstanding debt.[175] Congress apparently believed this would avoid the *Pine Gate* problem.[176]

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[168] *See id.* at 4 ("[[R]]evenue bonds, unlike general obligation bonds, are not backed by the taxing power or the full faith and credit of the public body that issues them.").

[169] *See id.* ("[[Revenue bonds]] are payable solely from the income generated by the particular capital project that their proceeds are used to fund.").

[170] *See* Juliet M. Moringiello, *Goals and Governance in Municipal Bankruptcy*, 71 WASH. & LEE L. REV. 403, 405 (2014) (noting that municipal bankruptcy is governed under Chapter 9).

[171] S. Rep. No. 100-506, at 24 (1988).

[172] *See id.* at 22 ("Many municipal obligations are, by reason of constitutional, statutory or charter provisions, payable solely from special revenues and not the full faith and credit of the municipality.").

[173] *See id.* ("This amendment leaves [[state]] legal and contractual limitations intact without otherwise altering the provisions with respect to non-recourse financing. Thus, this section avoids the potential conversion of revenue bonds into General Obligation bonds under Section 1111(b).").

[174] *See* FED. R. BANKR. P. 3014 (providing procedures for "application of § 1111(b)(2) of the Code by a class of secured creditors in a chapter 9 . . . case").

[175] David Lemke, Blake Roth, & Courtney Rogers, *United States: Municipal Debtors: "Cram Down" of Special Revenue Debt* (Apr. 28, 2014), https://www.mondaq.com/unitedstates/insolvencybankruptcy/314920/municipal-debtors-cram-down-of-special-revenue-debt.

[176] *See id.* ("Although Congress recognized that the existing chapter 11 choice for full recourse treatment of non-recourse debt would be unavailable to chapter 9 creditors due to

B. Redrafting Section 1111(b)

We believe it is long past the time for § 1111(b) to be revised. We propose the language provided below. Given that the § 1111(b)(2) election should adequately address the *Pine Gate* problem, and that the non-recourse to recourse conversion harms unsecured creditors and the debtor and also impairs fundamental bankruptcy law principles, we propose that the conversion be removed.

> (b) (1) (A) A claim secured by a lien on property of the estate shall be allowed or disallowed under section 502 of this title ~~the same as if the holder of such claim had recourse against the debtor on account of such claim, whether or not such holder has such recourse,~~ unless—
>
> > ~~(i)~~ the class of which such claim is a part elects, by at least two-thirds in amount and more than half in number of allowed claims of such class, application of paragraph (2) of this subsection; ~~or~~
> > ~~(ii) such holder does not have such recourse and such property is sold under section 363 of this title or is to be sold under the plan.~~
>
> (B) A class of claims may not elect application of paragraph (2) of this subsection if—
>
> > (i) the interest on account of such claims of the holders of such claims in such property is of inconsequential value; or
> > (ii) ~~the holder of a claim of such class has recourse against the debtor on account of such claim and~~ such property is sold under section 363 of this title or is to be sold under the plan.
>
> (2) If such an election is made, then <u>for purposes of</u>

state constitutional limitations on recourse financing, it did not intend for the result to be the continued impairment of special revenue financing by results such as that reached in *Pine Gate*.").

> notwithstanding section 506(a) of this title, such claim is deemed to be a secured claim for the face value of such claim to the extent that such claim is allowed.[177]

CONCLUSION

Section 1111(b) is one of the Bankruptcy Code's most complex and challenging provisions.[178] Insofar as it converts non-recourse to recourse debt, it also is one of the Bankruptcy Code's most preposterous provisions.

That non-recourse to recourse conversion arose out of lobbying, in response to creditor outrage over the spectre of unfair or manipulative collateral valuation raised by the *Pine Gate* case. Congress's enactment of § 1111(b) went much too far, however, creating unbargained and unfair benefits for non-recourse lenders to the detriment of debtors and unsecured creditors, as well as undermining bankruptcy law's fundamental policies.

Congress needs to amend § 1111(b) to correct these problems. We show how such an amendment could protect non-recourse lenders against the risk of improper collateral valuation, without harming third parties or impairing bankruptcy policies.

* * *

[177] The base text is the same as 11 U.S.C. § 1111(b).

[178] Haydon, *supra* note 14, at 101–02.