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# THE IMPORTANCE OF PRIORITY

*Douglas G. Baird*†

## INTRODUCTION

American judges have long asserted that a portion of the assets of an insolvent firm should always be made available for its general creditors.<sup>1</sup> A secured creditor should not be able to enjoy all the assets, even if the secured creditor made the loan when the firm was solvent, properly recorded the interest, and otherwise cut square corners. General creditors can include tort victims, small trade creditors, and unpaid (and now unemployed) workers. After the fact, their claims have a greater moral force than those of a large, diversified financial institution. In recent years, these arguments have gained strength at the same time legal scholars have come to appreciate the difficulty of explaining the benefits of secured credit. That both should happen at the same time should come as no surprise. The less convincing the defense of the secured creditor's priority right, the easier it becomes to argue that it should be cut back.

In this Article, I identify some of the issues on which this ongoing debate is likely to focus. The first part of the Article suggests that changes in priority rights are unlikely to bring significant benefits or impose substantial costs. One must, of course, be cautious. The benefits of priority rights are indirect. They may affect the ability of entrepreneurs to find investors, but we cannot identify particular firms that never came into being as a result of a particular change in priority rights. It remains much easier to see the individual worker who is unpaid than those who would have received a job, but did not because an entrepreneur could not find the investors needed to start the firm. Nevertheless, it is worth understanding what follows if the stakes involved are small. Among other things, noninstrumentalist justifica-

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<sup>1</sup> Early cases combine concerns about leaving assets available for general creditors with concerns about notice. *See, e.g.,* *Clow v. Woods*, 5 Serg. & Rawle 275 (Pa. 1819). Later cases identified keeping some assets available for general creditors as a distinct issue. *See, e.g.,* *Benedict v. Ratner*, 268 U.S. 353, 359–61 (1925); *Zartman v. First Nat'l Bank of Waterloo*, 82 N.E. 127 (N.Y. 1907). One of the drafters of Article 9 later came to hold this view. *See* Grant Gilmore, *The Good Faith Purchase Idea and the Uniform Commercial Code: Confessions of a Repentant Draftsman*, 15 GA. L. REV. 605, 627 (1981).

tions for limiting the priority accorded to secured creditors become important.

Squarely confronting noninstrumentalist justifications, however, underscores their basic weakness. They are not attractive to those who want legal rules to work social change. It is one thing to protect a worker after the fact in the context of a particular case, but quite another to assert that such a rule makes workers as a group—or indeed anyone else—better off. The same forces that render the priority accorded to secured creditors relatively unimportant may dramatically limit the extent to which a change in priority rules can help those we want to protect. For instance, if a lender buys a machine and then leases it to the firm instead of taking a security interest in it, the change in the priority rule may have only a small effect on the investor,<sup>2</sup> but the response of the investor may undercut the value of the change to the intended beneficiary. The unpaid worker has priority, but the firm has fewer assets. The lesson here is that protecting workers or anyone who cannot protect themselves is much harder than merely changing priority rules.

The third part of this Article focuses explicitly on involuntary claims against the firm. Even if the stakes are small, changing priorities in this context may make sense. When investors in a firm can remove assets before tort victims, the firm does not adequately account for the harm its actions do to others. Limiting the priority of secured creditors may provide them with a set of incentives that rebound to the benefit of potential tort victims. The most significant challenge, I suggest, may be to understand how our analysis of the priority question is connected with the broader discussion of corporate tort liability.

The last part of this Article looks at an issue that scholars have largely neglected. One of the most important issues in corporate finance is the cost of restructuring firms that encounter financial distress. A full analysis of priority rights among creditors ought to take into account how different legal regimes affect the cost of a corporate reorganization. There are a number of reasons to think that these costs may be large enough to make them centrally important.

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<sup>2</sup> The effect turns on how burdensome it is to bear the incidents of ownership that characterize a true lessor, rather than a secured creditor. For a discussion of this issue below, see *infra* Part I.

## I

## THE STAKES IN THE PRIORITY PUZZLE

The bedrock of modern corporate finance is the Modigliani and Miller indifference proposition.<sup>3</sup> It establishes that, in perfect capital markets, a firm's capital structure has no effect on its value. By increasing its debt, a firm makes its cost of equity cheaper, but at the same time raises its cost of debt by an equal and offsetting amount.<sup>4</sup> The indifference proposition makes it hard to identify the benefits that flow from allowing some creditors to enjoy priorities over others. The harder it is to identify the benefits of secured credit, the easier it is to justify putting limits on it.

Reasonable people take opposite sides of the debate about whether net benefits flow from allowing a creditor to enjoy a priority in all the assets of a firm. From this fact alone, we might infer that the magnitude of either the benefits or costs may be quite small. Changing the secured creditor's priority right leaves unaffected many other rights that are of comparable value. By taking a security interest in a piece of equipment, a creditor sharply checks the ability of a debtor to sell it to someone else and squander the proceeds. Once the debtor grants the security interest, the debtor no longer can give someone else clean title. Limiting the secured creditor's priority right does nothing to undercut this power—a power to curtail mischief that redounds to everyone's benefit. Moreover, limiting the priority right leaves unaffected a creditor's ability to obtain subordination agreements. Indeed, one can understand limits on a priority right as

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<sup>3</sup> Franco Modigliani & Merton H. Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 AM. ECON. REV. 261 (1958); see also Merton H. Miller, *The Modigliani-Miller Propositions After Thirty Years*, J. ECON. PERSP., Fall 1988, at 99. The power and the broad acceptance of these propositions is hard to overstate. Put-call parity and option pricing theory derive from these irrelevance propositions. They are empirically tested (and vindicated) every day in options markets. Phenomena such as program trading simply would not exist if these propositions were wrong.

<sup>4</sup> See Thomas H. Jackson & Anthony T. Kronman, *Secured Financing and Priorities Among Creditors*, 88 YALE L.J. 1143, 1147-61 (1979); Saul Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 YALE L.J. 49 (1982); Alan Schwartz, *Security Interests and Bankruptcy Priorities: A Review of Current Theories*, 10 J. LEGAL STUD. 1 (1981); René M. Stulz & Herb Johnson, *An Analysis of Secured Debt*, 14 J. FIN. ECON. 501 (1985). The parts of these articles most often discussed are those that suggest possible ways in which secured financing may bring net benefits to a firm. Their importance, however, lies in identifying why making the case for secured credit is difficult and why conventional justifications are wanting. For a recent explanation of why the benefits of secured credit are elusive, see Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857, 880-903 (1996). Traditional law review scholarship has been quite slow in recognizing the difficulties in showing net benefits from secured credit. Arguments against the Modigliani-Miller indifference propositions that have long since disappeared from the economic literature retain respectability in law reviews. See, e.g., Homer Kripke, *Law and Economics: Measuring the Economic Efficiency of Commercial Law in a Vacuum of Fact*, 133 U. PA. L. REV. 929 (1985).

merely changing a default rule. If there are large gains to be had from priority, they can still be had even if priority rights are abolished altogether, provided only that transaction costs are sufficiently low.

A large firm may have only a few different categories of debtholders. In these cases, arranging for the contractual subordination of one group of creditors relative to another may not be significantly harder than having different tiers of security interests.<sup>5</sup> Small firms typically have only one institutional lender.<sup>6</sup> The institutional lender in these cases often finds that its biggest risk is that the firm will hemorrhage cash as it fails. Unless these payments can be recovered as voidable preferences, the priority right makes little difference.<sup>7</sup> The effect of limiting the institutional lender's ability to enforce its security interest in this context may be to accelerate the declaration of default or other event that precipitates a reorganization.

It is also worth noting that the priority among creditors in the event of default is only one way in which creditors sort themselves. Equally as important are the term of the debt and the sequence in which the obligations are paid off. In some leveraged buyouts during the late 1980s, for example, the different branches of debt had the same collateral and the same priority, but longer payout structures (and an interest premium of 75 to 125 basis points to compensate for the higher risk).<sup>8</sup> Limits on the priority rights of secured creditors could affect lending terms along any number of dimensions, such as duration, reporting, and conditions of default. This ability to adjust along other dimensions mitigates the harm that might flow from restricting the ability of a firm to create priorities among its creditors.

The consistent finding of empirical studies of capital structures is that these structures vary widely, even inside the same industry.<sup>9</sup> Priority rights are irrelevant if a firm has an all-equity capital structure; in fact, almost one-third of all firms with five hundred or fewer employees have no institutional debt.<sup>10</sup> But this does not mean that capital

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<sup>5</sup> Indeed, the use of subordination agreements might expand considerably if priority rights of secured creditors were limited. Much like large institutional lenders that do not insist on priority, firms that use standard forms when dealing with trade creditors and workers might add subordination clauses. There is no reason to think that these clauses would be less enforceable than any other clause in the standard contract. In fact, bankruptcy law traditionally respects such clauses to the extent that they are effective under nonbankruptcy law. See 11 U.S.C. § 510(a) (1994).

<sup>6</sup> See Mitchell A. Petersen & Raghuram G. Rajan, *The Benefits of Lending Relationships: Evidence from Small Business Data*, 49 J. FIN. 3, 10 (1994).

<sup>7</sup> Even if one can find out where the cash went, certain safe harbor rules may protect trade creditors. See 11 U.S.C. § 547(c)(2) (1994).

<sup>8</sup> See Jay R. Allen, *LBOs—The Evolution of Financial Structures and Strategies*, J. APPLIED CORP. FIN., Winter 1996, at 18, 20.

<sup>9</sup> See Petersen & Rajan, *supra* note 6, at 7–8.

<sup>10</sup> See *id.*

structure is irrelevant. It may be that the way in which firms operate, and the way they are monitored, turns on who their creditors are. If businesses can flourish with different capital structures, then it would seem that limiting the availability of one capital structure should not produce great costs.

Even if priority rights were important, investors could still enjoy them by entering transactions that, although not within the scope of the law governing secured transactions, give them the same priority rights. The single greatest challenge confronting the abolition or the scaling back of secured credit is distinguishing between secured transactions and other transactions that have almost the same economic effect.

The close similarities between the conditional sale and the lease are well known.<sup>11</sup> In general terms, the central difference lies in the reversionary interest that the true lessor holds after a lease.<sup>12</sup> A true lessor holds risks of ownership that a secured creditor does not. The burden of ownership may be too small to prevent conditional sellers from becoming lessors, if the alternative were a significant reduction in their priority rights. Moreover, markets evolve and change in response to changes in legal rules. It is not altogether implausible that a lender could engage in a true lease with its debtor and then convey its reversionary interest to someone well-equipped to bear the risk of ownership. Indeed, a debtor that wanted to buy a machine and finance it through a security interest might instead lease a machine from one person and buy a reversion in an identical machine from someone else.

The issue does not end with leases.<sup>13</sup> Can limits on a secured creditor's priority rights apply to possessory interests? What about trust receipts or field warehousing? What happens to the purchase of notes, chattel paper, and accounts receivable? Sharply limiting the ability of debtors to sell accounts is necessary in any system in which we want to effectively limit the priority rights of lenders who take accounts as collateral.<sup>14</sup>

Even if these limits could apply to accounts, a debtor might with little effort have customers, whose purchases they finance, execute documents that meet the criteria for negotiable instruments. Effectively limiting creditor priority in accounts might require wholesale changes in the rules of negotiability. The stakes involved in a debate

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<sup>11</sup> See Bebhuk & Fried, *supra* note 4, at 926-29.

<sup>12</sup> This oversimplification captures the basic spirit of what is a multi-factored test. See U.C.C. § 1-201(37) (1995) (defining a security interest).

<sup>13</sup> See Lynn M. LoPucki, *The Death of Liability*, 106 YALE L.J. 1, 61-63 (1996).

<sup>14</sup> The decision of the drafters of Article 9 to treat the two transactions identically underscores this point. See U.C.C. § 9-102(2) (1994).

over the scope of a secured creditor's priority right are necessarily small if we remain unwilling to alter certain aspects of our legal regime (such as the rules governing negotiable instruments) that have nothing to do with secured credit.<sup>15</sup> Even if all these transactions could be limited, firms might find an intermediary who extended credit to the firm's customers and then in turn paid the firm some discounted amount. Though the intermediary has never extended credit to the firm, it stands in the same position that it would have occupied if it had bought the accounts. Such intermediaries are merely the commercial equivalents of credit card issuers. One can also expect lenders to take advantage of the ability of a firm to sort separate activities into different corporate shells. An unsecured lender to a subsidiary corporation is in the same position vis-à-vis the creditors of the parent corporation as a secured lender of the parent. To close this avenue of replicating the rights of a secured creditor, one would again have to make radical changes in regimes that are ordinarily seen as unrelated to Article 9.

*Benedict v. Ratner*<sup>16</sup> is the case most often cited in support of the idea that the rights of secured creditors should be cut back. In *Benedict*, Justice Brandeis held that a lender could not enjoy a priority in the firm's accounts because the lender allowed the firm to exert too much control over them.<sup>17</sup> The case, however, is perhaps better seen as an example of how lenders can adjust to changes in legal rules. *Benedict's* effect on secured lending may not have been so much to limit priority rights in accounts, but rather to alter how it was done and by whom. In the years following the case, taking security interests in accounts became more common, and lenders who specialized in asset-based financing flourished.<sup>18</sup> While amateurs lost their way, professional lenders quickly learned how to navigate such terrain.

Grant Gilmore defended *Benedict v. Ratner* on the ground that it gave the account financiers an incentive to monitor their debtors, something that redounded to everyone's benefit.<sup>19</sup> In other words, in Gilmore's view, the case did not in fact change the secured creditors' priority rights as much as it changed the behavior of the secured creditors in a way that was beneficial. The lesson of the case may be not that limitations on priority rights are good or bad, but rather that we must be mindful of the many ways in which creditors respond to such limits.

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<sup>15</sup> We may, of course, overrate the value of negotiability. See James Steven Rogers, *The Myth of Negotiability*, 31 B.C. L. REV. 265 (1990). Nevertheless, it may be a battle that we do not want to pursue merely because of nonadjusting creditors.

<sup>16</sup> 268 U.S. 353 (1925).

<sup>17</sup> *Id.* at 360.

<sup>18</sup> See Gilmore, *supra* note 1, at 622.

<sup>19</sup> *Id.* at 626-27.

## II

## NONINSTRUMENTALIST LIMITS ON PRIORITY

We routinely assess legal rules by the way they change behavior. Imposing tort liability on negligent drivers induces people to drive more carefully. Contract law facilitates trade because people perform knowing that they can sue if the other side breaches. Laws matter, however, even apart from the way they affect behavior before the fact. Deterrence is not the sole justification for our criminal laws. Regardless of whether anyone is deterred, we do not want to live in a community whose norms tolerate rape or murder. Noninstrumentalist justifications are less often put forward in debates about commercial law, but they may have a role to play here as well.

Let us posit the legal rule we should have for, say, a steel maker that has failed and is liquidating in Chapter 7. Suppose the steel maker's assets are not even enough to satisfy the most senior bondholders, all of which are large financial institutions. Also suppose that the firm promised medical benefits to its retirees. Although the retirees are likely to suffer from many diseases associated with years of work in the mills, the promises made to them have the status of unsecured claims. One can argue that the retirees should receive something in the liquidation, quite apart from whether the retirees could have contracted for priority over the bondholders before the fact: the retirees ought to receive something so they can leave the courthouse with their dignity intact, believing that the legal system respects the promises they were made and in reliance on which they devoted a major part of their lives. Although the large financial institutions leave with less, they should be able to anticipate this result. Given their diversified portfolios, their loss should have virtually no effect on their profits even over a short period of time.

Making the noninstrumentalist argument allows us to end the discussion at this point. The focus is exclusively on the parties who appear before the court. To the noninstrumentalist, the way in which the actual litigants are treated is the only issue. Many of us, however, are unlikely to stop here. We also want to know how granting this right affects retirees whose firm does not liquidate in Chapter 7. This is the instrumentalist question, and here the story becomes more complicated.

We bargain in the shadow of the law. The rights of retirees of failed firms outside of bankruptcy might be stronger if the retirees are granted priority inside. The power to force the firm into Chapter 7 empowers the retirees, but this does not end the inquiry.

Most of those who would choose to respect the rights of the retirees on noninstrumentalist grounds in the context of a bankruptcy proceeding would also want to ensure that they were treated well



outside of bankruptcy. Doing this, however, requires much more than adopting a rule that changes the priority of secured creditors in bankruptcy. The law, for example, could require that any promises made to retirees be fully funded. Or it could go further, requiring that the firm both make these promises and set aside resources to ensure that these promises would be kept even if the firm failed.

We cannot adopt a rule giving the retirees priority over secured creditors and, without further inquiry, believe that we are improving the lot of retirees as a general matter. Distributional rules in bankruptcy are at best an incomplete solution to larger issues of public policy. A legislator might favor such a rule if she lacks the votes for a broader solution, but if her goal is to protect retirees across the board, she would have to worry that such partial solutions might do more harm than good.<sup>20</sup> She would, for example, have to take into account the possibility that a priority would reduce the number of retirees to whom promises were made in the first place.

The point here is by no means a new one. Too often, bankruptcy scholars assert that matters of public policy in bankruptcy involve only balancing the interests of a particular group (such as workers) against the interests of creditors.<sup>21</sup> This Manichean approach is wrong. Most obviously, it dramatically overstates the normative claims of the creditors. The creditors in question are almost invariably those who, in the terminology of Bebchuk and Fried, are "perfectly adjusting."<sup>22</sup> Owners of capital have access to global financial markets. These competitive markets ensure that, when owners of capital hold a diversified portfolio, they will have, in expectation, the same risk-adjusted return regardless of where they invest. Viewed prospectively, changes in secured credit regimes may affect how much these owners of capital choose to invest in particular business enterprises, but they will not affect the return owners of capital receive from any investment. They can take priority rights into account by varying the interest rate and other terms and conditions of the loan.<sup>23</sup> Thus, if we focus exclusively on the balance between the interests of creditors and those of some-

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<sup>20</sup> Congress passed the Retiree Benefits Bankruptcy Protection Act in 1988, but its effects are even more limited than the rule discussed in the text. Retiree Benefits Protection Act of 1988, 11 U.S.C. § 1114 (1994). It protects retiree health benefits only to a limited extent, and only in the case of firms in Chapter 11 that successfully reorganized. See *id.* § 1114(e)-(f). Retirees of firms that fail to reorganize successfully or that fail outside of Chapter 11 are unprotected. See generally *Retiree Health Benefits: The Fair-Weather Promise, Hearing Before the Senate Special Comm. on Aging*, 99th Cong. (1986) (discussing the appropriate congressional response to the LTV bankruptcy).

<sup>21</sup> See, e.g., Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775, 775-97 (1987).

<sup>22</sup> Bebchuk & Fried, *supra* note 4, at 881-82.

<sup>23</sup> Even if owners of capital fail to take priority rights into account, there is no reason to think that legislators can fashion rules to protect them or that, as a normative matter, they should focus their energy trying.

one else, these other interests should always win. Casting the issue as a matter of balance is coherent only if one's approach is exclusively ex post and noninstrumental.

The policy questions that arise from an instrumentalist approach to priority rights must involve an assessment of all the benefits and costs, both direct and indirect. Those whose interests need to be taken into account are everyone (except creditors) whom a business enterprise affects. The trade-offs that need to be made are often not between different groups, but between different costs and benefits *within the same group*. This is analogous to the minimum wage, which provides a direct benefit to those workers whose wage it increases, but an indirect cost to those who remain unemployed because the law has reduced the number of jobs that are available. No one denies that such a trade-off must be made, but people differ as to the relative importance of the two effects. The same sort of calculus lies at the heart of public policy in bankruptcy. When we ask whether to give retirees a priority in bankruptcy when promised health benefits, we have to consider if the grant of the priority will affect whether such promises are made in the first place. We have to ask whether we want to increase the value of the promise for a smaller number of retirees. This may or may not be an easy question, but it has nothing to do with protecting the rights of creditors.

This need to focus upon such trade-offs is now central to studies of regulation.<sup>24</sup> Scholars are now cautious about analyzing regulation as if the central issue were one of balancing dollars against health and safety. Now we realize increasingly that casting the question in this form made things too easy. When we consider banning a substance that may be carcinogenic, we have to ask whether people will turn to a product that, while not carcinogenic, brings with it a high risk of heart disease.<sup>25</sup> If we delay the widespread introduction of a drug to the market, we may ensure that it is safe, but at the same time people who might benefit from it must wait.<sup>26</sup> How we strike the balance may vary from case to case; an AIDS drug is different from a new tranquilizer. It is not a question of dollars versus lives, but how we make trade-offs within groups that need the protection of the law.

So too in bankruptcy; taking the moral high ground is not as easy as assuming that the question is one of weighing the rights of creditors against others. We must take account of indirect costs and benefits that are hard to see and that cut across a wide range of issues. Changing priority rights affects retirees, trade creditors, workers, utilities, and every other kind of general creditor, as well as consumers and

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<sup>24</sup> See CASS R. SUNSTEIN, *FREE MARKETS AND SOCIAL JUSTICE* 298-317 (1997).

<sup>25</sup> See *id.* at 301.

<sup>26</sup> See *id.*

everyone else in the community who is affected by whether a firm comes into being and whether it survives. As long as our approach is in part instrumentalist, we have to confront these issues. If we care about shaping our bankruptcy laws to make our society a better place, we cannot simply assert that one regime of priority rights is more attractive than another.

When we alter priorities in bankruptcy in an effort to effect broader change, we can be most confident about what we are doing when we think that the change in priority itself will have a salutary effect on the way people behave. Because this is most likely to happen in the case of involuntary claims against the firm, it is that problem to which I now turn.

### III

#### INVOLUNTARY CREDITORS AND INVESTOR LIABILITY

Scholars have long noted that firms can shift the risk of insolvency onto tort victims and other involuntary creditors by granting their creditors security interests.<sup>27</sup> A firm is more likely to engage in a hazardous activity if any of its investors, including secured creditors, can prime tort victims. As long as investors can enjoy the benefits when a firm engages in a hazardous activity, but avoid some of the costs, a firm will not fully account for the harm it causes to others.

This point, of course, has long been recognized, and it applies to all investors, not just secured creditors.<sup>28</sup> Even if there were no security interests at all, we would have the same debate about whether tort victims should have to share bankruptcy proceeds with general creditors. If tort victims came before general creditors, general creditors would have a greater incentive to ensure that the firm took precautions than they would if they shared with them *pari passu*. Limited liability itself creates the same problem: by doing business in limited liability form, investors undervalue the harms the business venture imposes on the rest of the world.

This problem might be solved without any change to the law governing secured credit. Some scholars, for example, have proposed that firms be required to insure against tort liability.<sup>29</sup> Alternatively, we could allow involuntary creditors to pierce the corporate veil<sup>30</sup> or

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<sup>27</sup> See, e.g., Schwartz, *supra* note 4, at 33–34; Christopher M.E. Painter, Note, *Tort Creditor Priority in the Secured Credit System: Asbestos Times, the Worst of Times*, 36 STAN. L. REV. 1045, 1046 (1984).

<sup>28</sup> See FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 52–62 (1991).

<sup>29</sup> See, e.g., S. Shavell, *The Judgment Proof Problem*, 6 INT'L REV. L. & ECON. 45, 54–55 (1986).

<sup>30</sup> See, e.g., Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879, 1931–32 (1991).

sue the managers of the firm.<sup>31</sup> To the extent that any of these devices proves effective, adjusting the priority of secured creditors is moot.<sup>32</sup> Examining the rights of involuntary creditors and secured creditors in the context of the larger debate matters for a second and much more important reason: it may not even be possible to have a legal regime that forces firms to internalize all their costs and, at the same time, distinguishes among the rights of different investors in a firm.

Modern finance theory shows that, in well-developed capital markets, one can transform any investment contract into another through the purchase of options and other kinds of derivative instruments.<sup>33</sup> In a world in which secured credit and equity are simply slightly different flavors of investment contracts, it may be hard to create legal regimes that allow tort creditors to reach one type of investor (such as shareholders), but not others (such as secured creditors).<sup>34</sup> Without a coherent theory of investor liability and a set of laws to match, corporate tort liability may disappear.<sup>35</sup> Once we make the case that equityholders should be liable to involuntary creditors, we may not be able to reach their assets unless we extend the net of liability to include secured creditors. In a world of put-call parity and global financial markets, distinctions among different kinds of investors tend to vanish. The problem is already manifest in corporate taxation.<sup>36</sup>

Let us assume, however, that we can effectively separate the rights and obligations of secured creditors from those of other investors. To understand the priority right secured creditors should enjoy, we need to isolate the ways in which changes in the legal regime governing secured credit raise discrete problems. Let us assume, for example, that secured creditors are well positioned to ensure that a firm takes proper precautions when it engages in activities that might harm others, and that this burden is small relative to the cost of gaining priority through vehicles that are not themselves secured transactions.

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<sup>31</sup> See, e.g., EASTERBROOK & FISCHER, *supra* note 28, at 61–62.

<sup>32</sup> See Bebchuk & Fried, *supra* note 4, at 883.

<sup>33</sup> See Note, *Investor Liability: Financial Innovations in the Regulatory State and the Coming Revolution in Corporate Law*, 107 HARV. L. REV. 1941, 1942–45 (1994).

<sup>34</sup> Stephen Choi has made this point most forcefully. See *id.* at 1955–58.

<sup>35</sup> See *id.* Lynn LoPucki has taken this argument one step further and has suggested that by creating bankruptcy-remote entities, leasing physical assets, and selling accounts receivable, a legal regime that focuses merely on investors cannot be effective. LoPucki, *supra* note 13, at 54–61.

<sup>36</sup> See Alvin C. Warren, Jr., *Financial Contract Innovation and Income Tax Policy*, 107 HARV. L. REV. 460, 460–61 (1993).

In this case, as many have suggested, the most appropriate course is to allow tort victims to prime secured creditors.<sup>37</sup>

This approach dominates an across-the-board reduction of the secured creditor's priority right. Such a reduction is, among other things, massively under- and over-inclusive. Most insolvent firms do not have significant uninsured tort claims against them. In cases in which the tort claims are massive, general changes in priority rights distribute assets not only to tort victims, but also to creditors who may have been as lax as the secured creditor, and might themselves have done something to prevent the harm.

#### IV

#### PRIORITY RIGHTS AND THE COSTS OF CORPORATE REORGANIZATION

It is commonplace that a restructuring of a firm involves a sale. When a firm is liquidated piecemeal, individual assets are sold. Firms in economic distress, like firms that are prospering, can be sold outright to other firms. Workouts and restructurings inside Chapter 11 may involve actual sales of some or all of the firm's assets. Likewise, the creation of a new capital structure is itself best understood as a hypothetical sale in which creditors exchange their old claims against the firm for new ones.<sup>38</sup>

In assessing the relative strengths and weaknesses of Chapter 11, we have long compared the Chapter 11 mechanism with alternative forms of selling the firm, such as mandatory auctions or the issuance of option rights to different classes of investors.<sup>39</sup> The central issue in this debate has been the relative costs of the different forms of sale. Defenders of Chapter 11 can point to recent empirical work that suggests that, for large firms, the cost of Chapter 11 reorganization is small relative to the costs of other types of sales.<sup>40</sup> They can also extend the argument by pointing out that the most obvious alternatives to Chapter 11, all of which are market-based, seem likely to work best for large firms, for which robust markets can most easily develop. If

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<sup>37</sup> See, e.g., Barry E. Adler, *A World Without Debt*, 72 WASH. U. L.Q. 811, 826 (1994); David W. Leeborn, *Limited Liability, Tort Victims, and Creditors*, 91 COLUM. L. REV. 1565, 1646-49 (1991).

<sup>38</sup> See Robert C. Clark, *The Interdisciplinary Study of Legal Evolution*, 90 YALE L.J. 1238, 1250-54 (1981).

<sup>39</sup> See, e.g., Philippe Aghion et al., *The Economics of Bankruptcy Reform*, 8 J.L. ECON. & ORG. 523, 526-32 (1992); Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J. LEGAL STUD. 127, 136-45 (1986); Lucian Arye Bebchuk, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775, 781-97 (1988); Mark J. Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganization*, 83 COLUM. L. REV. 527, 597-600 (1983).

<sup>40</sup> See Lawrence A. Weiss, *Bankruptcy Resolution—Direct Costs and Violation of Priority of Claims*, 27 J. FIN. ECON. 285, 288-90 (1990).

Chapter 11 works well in the case of large firm reorganizations, one might argue that it should work even better for small firms.

Any discussion of a substantial change in the treatment of secured creditors should connect itself to the literature that examines the costs of Chapter 11 reorganization and other procedures for recapitalizing a firm in economic distress. The cost of selling an asset can range from a fraction of 1% to almost 20% of the asset's value.<sup>41</sup> For a very small fee, a share of stock can be sold through a discount broker. A real estate broker might earn a 5% commission for selling a house. By contrast, an auctioneer's commission at a sale of fine art or the fees associated with an initial public offering are at the other end of the spectrum. Typically, the costs of bankruptcy under current law are less than 5% of asset value for large firms, but are sometimes significantly larger for smaller firms.<sup>42</sup> In some cases the costs can approach the value of the firm.

Each regime of secured credit brings with it different costs in a reorganization. These costs are, of course, incurred only in those instances in which the firm fails and needs to be reorganized. The priority right of the secured creditor, however, only matters because of the possibility that the firm will become financially distressed. The expected costs of a reorganization rise and fall with the importance of the priority right. The history of corporate reorganizations may identify a risk associated with changing priority rights.<sup>43</sup>

Railroads, the first large modern corporations, were financed almost entirely with secured credit. The only general creditors were trade creditors, and they were such a small part of the picture that in many cases they were paid off in full as a matter of routine. The central issue in the late nineteenth century was not weighing the rights of secured and unsecured creditors, but rather sorting out the rights of the many different kinds of secured creditors.

The reorganization of the Atchison, Topeka, & Santa Fe Railroad is a representative case.<sup>44</sup> It had grown through mergers and expansion into a giant with an unwieldy capital structure. Its rails connected the American Southwest with the West Coast, the Gulf of Mexico, and Chicago. By 1888, the system had 7010 miles of track, almost half of what existed in Britain at the time. The corporation had forty-one

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<sup>41</sup> See Robert G. Hansen & Randall S. Thomas, *Auctions in Bankruptcy: Theoretical Analysis and Practical Guidance* 9-13 (Mar. 27, 1994) (unpublished manuscript, on file with author).

<sup>42</sup> See Weiss, *supra* note 40, at 289.

<sup>43</sup> For a history of the railroad reorganizations of the 1890s, see STUART DAGGETT, *RAILROAD REORGANIZATION* (1908).

<sup>44</sup> See *id.* at 192-219.

classes of bonds and an outstanding indebtedness of \$164 million.<sup>45</sup> The secured creditors faced two problems. First, there was no easy way to assess the value of any creditor's claim. A security interest in ten miles of track between nowhere and nowhere had no value apart from the railroad as a whole. But each secured creditor was entitled to some portion of the value of the entire road.

Second, there was no easy means of determining how much a particular class of secured creditor should receive. Moreover, many of the creditors were in England or in other parts of Europe. They had many reasons not to trust the insiders who were running the firm, but no way to displace them. Intermediaries emerged who had the expertise to understand these large transactions, the reputational capital to gain the trust of the investors, and the genius to understand how the firm's capital should be restructured. These intermediaries were among the most gifted bankers and lawyers of the day, and their firms flourish even today.<sup>46</sup> They saw that the simpler the capital structure, the better. The Atchison, Topeka, & Santa Fe eventually emerged with only one issue of preferred stock, one issue of common stock, and two classes of bonds.<sup>47</sup> The new capital structure proved sound, and the railroad thrived in subsequent years.<sup>48</sup> The principal on the last of the bonds issued in the second reorganization in 1895 was paid in full in October 1995.<sup>49</sup>

The reorganization of the Atchison, Topeka & Santa Fe, like so many others, teaches us that simplicity is the single most important virtue of the law of corporate reorganizations. We should remember it as we contemplate limiting the priority right of secured creditors, a change that necessarily increases both the number of people with claims to a firm's assets and the complexity of their claims. Limiting the priority right directly affects the costs of a reorganization. For example, limiting the priority right of secured creditors creates a pool of assets—of unencumbered assets to be sure—but under current law these assets go first not to the general creditors, but rather to the pool used to pay administrative claims.<sup>50</sup> In other words, limiting priority

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<sup>45</sup> See *id.* at 198. Revenues were \$28 million and operating expenses were \$22 million. See *id.* Net earnings were insufficient to pay fixed interest costs and were expected to remain so. See *id.* at 199.

<sup>46</sup> Among the more prominent figures were Paul Cravath and J.P. Morgan. For a personal account of these professionals' involvement, see 1 ROBERT T. SWAIN, *THE CRAVATH FIRM AND ITS PREDECESSORS* 502-10 (1946). For a more general account of the thought and practice of the leading academic and practicing lawyers of the day, see Robert W. Gordon, *Legal Thought and Legal Practice in the Age of American Enterprise, 1870-1920*, in *PROFESSIONS AND PROFESSIONAL IDEOLOGIES IN AMERICA* 70 (Gerald L. Geison ed., 1983).

<sup>47</sup> See DAGGETT, *supra* note 43, at 211.

<sup>48</sup> See *id.* at 216.

<sup>49</sup> See Floyd Norris, *After 114 Years, It's Payday*, N.Y. TIMES, July 1, 1995, at 33.

<sup>50</sup> See 11 U.S.C. § 507(a) (1994).

rights immediately increases the assets available to pay lawyers and other professionals. It is possible that as this pool increases, fees and other expenses will rise correspondingly.

Although fees in the larger cases are, on average, quite small relative to the value of the firm's assets as a whole,<sup>51</sup> they can consume the unencumbered assets of a closely held firm.<sup>52</sup> It is not hard to find instances in which the Chapter 11 case ends as soon as the assets available to pay the lawyers dry up.<sup>53</sup> It could be that insufficient resources are now being spent reorganizing firms, and that too many firms now fail to reorganize successfully because there are insufficient assets to pay the costs of administering the bankruptcy. But whether this effect on reorganizations is good or bad, it is an issue that should be front and center in any analysis of how we might change priority rights.

The dynamics of Chapter 11 are likely to change in other ways as priority rights change. Under 11 U.S.C. § 362, for example, a secured creditor is sometimes allowed to lift the automatic stay and retrieve its collateral when the debtor has no equity in the collateral.<sup>54</sup> Limits on priority, by their nature, ensure that the debtor always has equity in the collateral. Hence, the primary means by which the secured creditor now brings a Chapter 11 case to an early end necessarily disappears if priority rights are limited and nothing else changes.

The benefit of Chapter 11 turns on the willingness of investors to take advantage of it. Investors who want to avoid Chapter 11 are able to do so under current law through a variety of different devices. The less costly these devices relative to Chapter 11, the more apt creditors will be to use them, and thus, the benefits that Chapter 11 brings will be lost.

The basic virtue of the equity receivership was its creation of a simple way in which a firm could be recapitalized. New investment instruments could be substituted for the old ones. Information could be gathered, and investors could hold securities in the new entity, confident that they had clean title to the firm's underlying assets. Priority rights may serve much the same purpose. Article 9 makes it possible for firms with many different kinds of personal property to create a simple capital structure with only a few classes of investors.

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<sup>51</sup> See Weiss, *supra* note 40, at 289; Michelle J. White, *Bankruptcy Liquidation and Reorganization*, in HANDBOOK OF MODERN FINANCE 35-1, 35-32 tbl.35.4 (Dennis E. Logue ed., 1984) (stating that costs of a representative sample of all firms that successfully reorganize are only 3% of the amounts paid to creditors under the reorganization plan).

<sup>52</sup> For a case that shows these dynamics at work, see *In re Pullman Constr. Indus., Inc.*, 107 B.R. 909, 942 (Bankr. N.D. Ill. 1989).

<sup>53</sup> Eastern Airlines is perhaps the most notorious example. See Claudia MacLachlan, *Blame Flies in Demise of Airline*, NAT'L L.J., May 27, 1991, at 1, 35-36.

<sup>54</sup> 11 U.S.C. § 362(d)(2) (1994).



When a firm needs to be reorganized, investors as a group may care much more that one can easily determine who owns which assets, than that the assets are distributed in a particular way. Indeed, one may be able to make a broader claim: all else being equal, one would prefer legal regimes that pushed firms to have simpler capital structures. Changing priority rights may push firms in the opposite direction. A corporate reorganization is about bargaining. Its ambition should be to keep this bargaining as simple and inexpensive as possible. We must be cautious about legal rules that increase the number of people at the bargaining table.

#### CONCLUSION

Before Article 9 was drafted, firms could encumber virtually all of their personal property. Creditors had to use arcane devices such as field warehousing or the trust receipt, but it could be done. After a century of seeing how investors created these interests notwithstanding the many legal obstacles put in their path, Article 9 was in some sense a surrender to the inevitable. If investors are going to create security interests anyway, legal rules might as well reduce the costs they encounter in doing so.

Whenever an economy is going through dramatic change concurrently with massive technological and regulatory change, it is hard to find one's bearings. Although the capital of many firms has a neat, hierarchial structure on its balance sheet, looks are deceiving. Even the simplest firms have many stakeholders, ranging from the landlord who has modified the premises, to suppliers who build custom parts, to workers who have invested firm-specific human capital in the enterprise. The industries most in flux have the most complicated structures. The network of contracts that binds health-care providers to one another is only one conspicuous example; a look at any high technology firm will provide others. When these firms fail, as some will, our law of corporate reorganizations will be the means by which we try to put them back on track. How easily and cheaply we can do this may depend upon the rules governing priorities among creditors.