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Priority Matters

Abstract

Chapter 11 of the Bankruptcy Code is organized around the absolute priority rule. This rule mandates the rank-ordering of claims. If one creditor has priority over another, this creditor must be paid in full before the one junior receives anything. Many have suggested various modifications to the absolute priority rule. The reasons vary and range from ensuring proper incentives to protecting nonadjusting creditors. The rule itself, however, remains the common starting place.

This paper uses relative priority, an entirely different priority system that flourished until the late 1930s, to show that using absolute priority even as a point of departure is suspect. Much of the complexity and virtually all of the stress points of modern Chapter 11 arise from the uneasy fit between its starting place (absolute instead of relative priority) and its procedure (negotiation in the shadow of a judicial valuation instead of a market sale). These forces are leading to the emergence of a hybrid system of priority that may be more efficient than one centered around absolute priority.

The absolute priority rule is the organizing principle of the modern law of corporate reorganizations.[1] If one creditor has priority over another, then this creditor needs to be paid in full before the other is entitled to receive anything. It does not matter whether payment takes the form of cash from a sale or new securities in a reorganization. Priority is absolute. By its nature, priority requires a rank-ordering of claims. Such is the conventional thinking about priorities in bankruptcy.[2]

This state of affairs, however, is very far from inevitable. An alternative conception of priority—relative priority—once flourished.[3] "Rela-

[1] The doctrine was first established in Case v. Los Angeles Lumber Products, 308 U.S. 106, 116–19 (1939).

[2] There are many complications and many ways of sorting out rights in bankruptcy, but absolute priority remains the almost universal starting place. See, e.g., Barry E. Adler & Ian Ayres, A Dilution Mechanism for Valuing Corporations in Bankruptcy, 111 Yale L.J. 83, 88–90 (2001) (suggesting a novel valuation mechanism while asserting absolute priority should, as a normative matter, be the central principle of reorganization law).

For decades, academics simply assumed absolute priority was a fixed part of the reorganization landscape. Even those like Elizabeth Warren who advocated departures from absolute priority began with it. See, e.g., Elizabeth Warren, A Theory of Absolute Priority, 1991 Ann. Surv. Am. L. 9, 9 (1992) ("At the heart of corporate law is a fundamental ordering between the equity owners and the creditors: in the event of collapse, creditors will be paid in full before equity will receive any distribution from the company.").

[3] The concepts of "relative" and "absolute" priority were first explored in James C. Bonbright & Milton M. Bergerman, Two Rival Theories of Priority Rights of Security Holders in a Corporate Reorganization, 28 Colum. L. Rev. 127 (1928). Throughout the 1930s, the legal giants of the day debated the merits of each. See, e.g., William O. Douglas & Jerome Frank, Landlord's Claims in Reorganizations, 42 Yale L.J. 1003, 1012–13 (1933); Jerome N. Frank, Some Realistic Reflections on Some Aspects of Corporate Reorganization, 19 Va. L. Rev. 541, 541–42 (1933); Henry J. Friendly, Some Comments on the Corporate Reorganizations Act, 48 Harv. L. Rev. 39 (1934); Edward H. Levi, Corporate Reorganization and a Ministry of Justice, 23 Minn. L. Rev. 3, 19 (1938).

This debate, however, has largely been forgotten in the academy. A number of scholars have become increasingly skeptical of the absolute priority rule in recent years. See, e.g., Edward Janger, The Logic and Limits of Liens, 2015 U. Ill. L. Rev. 589; Stephen J. Lubben, The Overstated Absolute Priority Rule (March 20, 2015), available at http://ssrn.com/abstract=2581639. Only rarely, however, does anyone identify relative priority as a sensible alternative. Tony Casey's fine work is an exception. His "option-preservation priority" is a modtive priority" was the central feature of the reorganization regime that reigned until the reforms of the New Deal fundamentally changed the bankruptcy landscape.[4] This paper uses the relative-priority paradigm to illuminate structural weaknesses at the core of Chapter 11.

Traditional accounts of Chapter 11 take the combination of absolute priority and a nonmarket restructuring mechanism for granted,[5] but, as this paper shows, a reorganization regime that uses both is inherently unstable. Absolute priority is naturally suited for regimes in which the financially distressed firm is sold to the highest bidder. It is much less appropriate for a regime that puts a new capital structure in place without a market sale. Looking at Chapter 11 from this vantage point shows that much of the complexity and virtually all of the stress points of modern Chapter 11 arise from the uneasy fit between its priority regime (absolute instead of relative) and its procedure (negotiation in the shadow of a judicial valuation instead of a market sale).

ern incarnation of relative priority. See Anthony J. Casey, The Creditors' Bargain and Option-Preservation Priority in Chapter 11, 78 U. Chi. L. Rev. 759 (2011). Casey's focus, however, is on aligning the incentives of parties in deciding whether to sell the assets or reorganize the firm, not on the virtues of relative priority in a regime committed to reorganizing rather than selling the debtor.

Relative priority, however, may gain a second life. The American Bankruptcy Institute Commission, a high-profile group of practitioners and judges assessing changes in reorganization law, is proposing a number of reforms. Included among these reforms is a call for a return to to relative priority, although in a limited and dramatically altered form. See Am. Bankr. Institute, Commission to Study the Reform of Chapter 11 2012–2014: Final Report and Recommendations, 207–24 (2014) ("Commission Report"), available at https://abiworld.app.box.com/s/vvircv5xv83aavl4dp4h.

[4] For accounts of the evolution of the absolute priority rule, see John D. Ayer, Rethinking Absolute Priority After *Ahlers*, 87 Mich. L. Rev. 963, 969–79 (1989); Randolph J. Haines, The Unwarranted Attack on New Value, 72 Am. Bankr. L. J. 387, 397–416 (1998); Bruce A. Markell, Owners, Auctions, and Absolute Priority in Bankruptcy Reorganizations, 44 Stan. L. Rev. 69, 84 (1991); David A. Skeel, Jr., An Evolutionary Theory of Corporate Law and Corporate Bankruptcy, 51 Vand. L. Rev. 1325, 1353–76 (1998).

[5] See, e.g., Adler & Ayres, supra note 2, at 94 (putting forward a nonmarket mechanism to implement absolute priority in the face of imperfect markets); Warren, supra note 2, at 11 ("[T]he concept of absolute priority is central to the bankruptcy bargain . . . .").

In the absence of an actual sale, absolute priority requires some nonmarket valuation procedure. Such a valuation is costly and prone to error.[6] Chapter 11 attempts to minimize these costs by inducing the parties to bargain in the shadow of a judicial valuation, but this bargaining is itself expensive and hard to control.[7] Relative priority introduces some difficulties and weaknesses of its own, but not these.[8] It was precisely because nineteenth century reorganization law coupled relative priority with its nonmarket valuation mechanism that it was so successful.[9]

Part I of this paper reviews the modern understanding of capital structures and the rationale for respecting priority rights in bankruptcy. Parts II and III examine absolute and relative priority respectively. Each shows how the virtues of each turn crucially on the presence or absence of a market sale.[10] Parts IV shows that absolute priority is implemented only imperfectly in Chapter 11, and Part V suggests that much of modern commentary on reorganization law begins in the wrong place. Modern Chapter 11 might best be characterized as a hybrid system of absolute and relative priority, and such a system may be more efficient than one centered around absolute priority.

[6] The costs are illustrated below. See text accompanying notes 82–96 infra. That the valuations are error-prone is commonly acknowledged. A reorganization valuation, in a phrase usually attributed to Peter Coogan, is a "guess compounded by an estimate." See Peter F. Coogan, Confirmation of a Plan Under the Bankruptcy Code, 32 Case W. Res. L. Rev. 301, 313 n.62 (1982).

[7] For a discussion of these costs, see text accompanying notes 94–96 infra.

[8] The weaknesses of relative priority reorganization regime are explored below. See text accompanying notes 120–142 infra.

[9] See Douglas G. Baird, Present at the Creation: The SEC and the Origins of the Absolute Priority Rule, 18 Am. Bankr. Inst. L. Rev. 591, 595 (2010) (showing that, because of relative priority, creditors in an equity receivership focused on maximizing value of the firm rather than fighting for their own share in it).

[10] This paper focuses on the reorganization of large firms. The reorganizations of small businesses present an entirely different set of problems. See Am. Bankr. Institute, supra note 3, at 275–302 (recommending a different set of principles should govern small Chapter 11 cases); Douglas G. Baird & Edward R. Morrison, Serial Entrepreneurs and Small Business Bankruptcies, 105 Colum. L. Rev. 2310 (2005) (showing empirically that small Chapter 11s revolve around individual entrepreneurs).

I. Absolute and Relative Priority

When a firm has value as a going concern, the investors as a group are better off if it remains intact even when it is in financial distress and not able to pay all its bills. Nevertheless, each individual investor may find it in her self-interest to try to recover what she is owed without paying attention to the consequences for everyone else. These efforts can tear the firm apart. The investors are too dispersed to reach an agreement that would put a stop to a destructive race to the assets and give them time to negotiate a realignment of their rights against the firm. The law of corporate reorganizations overcomes this collective-action problem. It enables investors to put a new capital structure in place and at the same time respect the nonbankruptcy bargain among the investors.[11]

The simplest way to keep the firm intact is to sell it free and clear of all existing liabilities to a third party.[12] The new owner can impose a new capital structure that fits the circumstances in which the firm finds itself, and the proceeds of the sale can be divided among the existing investors. But sometimes a sale is not possible. The market may be illiquid. The most likely purchasers of the firm may be other businesses in the same industry. When a firm is distressed, these other firms may be distressed as well. They may not have the resources to take part in an auction. When those who value the firm the most are not able to bid, the auction will not yield what the firm is worth.[13]

Even if the industry is flourishing or the potential buyers lie outside the industry, there is another problem that limits the ability to sell the firm.[14] By the time a distressed firm is sold, the investors have organized

[11] Thomas Jackson is most responsible for developing this idea that, at its core, bankruptcy solves a collective action problem among creditors. Thomas H. Jackson, Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain, 91 Yale L.J. 857, 862 (1982) (bankruptcy serves to "eliminate[ ] strategic costs that would otherwise be associated with a race to the courthouse").

[12] Mark Roe was the first to promote the use of markets as an alternative to reorganizations. See Mark J. Roe, Bankruptcy and Debt: A New Model for Corporate Reorganization, 83 Colum. L. Rev. 527, 559 (1983).

[13] Shleifer and Vishny developed this explanation for the way in which illiquidity can limit the effectiveness of sales. See Andrei Shleifer & Robert W. Vishny, Liquidation Values and Debt Capacity: A Market Equilibrium Approach, 47 J. Fin. 1343 (1992).

[14] This justification for reorganizations sometimes being superior to sales is put forward in Douglas G. Baird & Donald S. Bernstein, Absolute Priority,

themselves. They have hired experts and spent time reviewing and assessing the quality of the managers and their plans for the business going forward. As a result, they may know much more about the value of the business than any potential buyer. Buyers may therefore fear that the existing investors want to sell the firm because things are worse than they appear. The existing investors possess private information. Buyers of firms are like buyers of used cars. They are not willing to pay top dollar because of the risk that the firm is being sold only because the current owners know it is going to fail and want to rid themselves of a lemon.[15]

The illiquidity of the market and the existence of private information explains why investors as a group may be better off with a bankruptcy regime that provides for a change in the capital structure rather than a sale to a third party. The new debt and equity can be parceled out to the existing investors in return for their old stakes in the firm. Instead of an actual sale, there is a virtual one. This is the common justification for reorganization regimes such as nineteenth century equity receiverships and modern Chapter 11 reorganizations.[16]

In every reorganization regime, there needs to be some rule that dictates how the rights of the old investors are recognized. It might seem that junior creditors should receive nothing when there is not enough value to pay the senior investors in full. Absolute priority among investors should be respected. Matters are not so obvious, however, when the reorganization leaves the senior investor with a stake in the firm.

Outside of bankruptcy, senior creditors facing a debtor in default sometimes prefer to maintain their stake in the firm rather than insist on a sale to a third party. They waive their right to declare a default and re-

Valuation Uncertainty, and the Reorganization Bargain, 115 Yale L.J. 1930, 1949 (2006). This private information problem may also make it impossible for junior investors to buy out senior ones. Id. at 1954 (noting that the "private information problem that makes a sale of the business unattractive also makes it difficult for the junior investor to borrow the funds needed to buy out the senior investor").

[15] For the iconic discussion of this problem, using the example of used cars that are "lemons," see George A. Akerlof, The Market for "Lemons": Quality Uncertainty and the Market Mechanism, 84 Q.J. Econ. 488 (1970).

[16] See Robert C. Clark, The Interdisciplinary Study of Legal Evolution, 90 Yale L.J. 1238, 1250–54 (1981) (setting out how a reorganization is a hypothetical sale with new securities being distributed instead of cash).

possess collateral.[17] When they do this, however, they must allow junior creditors to remain in place.[18] Outside of bankruptcy they cannot both keep their stake in the ongoing business and eliminate those junior to them in the capital structure. By analogy, when a firm is reorganized it may make sense to create a new capital structure that also keeps everyone in the picture. Such a new capital structure can be consistent with the firm's current financial condition (doing away with such things as the obligation to pay dividends and interest as well as stripping junior investors of voting or other control rights), yet still recognize the junior investors' right to any excess that remains when, at some time in the future, all the accounts are ultimately squared. This is the essence of relative priority.

An artificial example can highlight the difference between absolute and relative priority. Imagine Firm has only one project and two investors. At the outset, they agree that one will be entitled to $150 when project is wrapped up and the other to whatever remains. Their lawyers implement this deal by giving one investor a debt instrument and the other equity.[19] Time passes and it becomes clear that the project will yield $200 or $0 with equal probability. At this point, a government regulation unexpectedly requires Firm to eliminate all debt its capital structure in or-

[17] For a discussion of how creditors are sometimes willing to waive their rights on default and use them instead to exercise control over the debtor, see Frederick Tung, Leverage in the Board Room: The Unsung Influence of Private Lenders in Corporate Governance, 57 U.C.L.A. L. Rev. 115, 134–35 (2009) (private lenders likely to perform at least as well as directors at monitoring managers and influencing their decisionmaking).

[18] See Casey, supra note 3, at 775 (absolute priority "artificially eliminates all interests in future possibilities, ignoring the contract rights of junior creditors").

[19] Using debt is only one of several possible ways to implement priority among investors. There are other legal devices (such as call options or preferred stock) that can produce the same effect. Venture capital deals often use preferred stock instead of debt to give outside investors priority. The decision of which device to use is a matter of indifference to investors, other things being equal. It usually turns on peculiarities of the legal system, not on the druthers of investors. See Steven N. Kaplan, Frederic Martel & Per Strömberg, How do Legal Differences and Experience Affect Financial Contracts?, 16 J. Fin. Intermediation 273 (2007) (comparing VC contracts across legal regimes).

der for the project to move forward.[20] A market sale is not in the collective interest of the two investors. No outsider is willing to pay anything close to Firm's expected value.

Because the two investors can realize value from their investment only by putting a new capital structure in place, it is in their joint interest to do so. How should the securities in the reorganized firm be divided between the senior and the junior investor? Upon what allocation rule would the parties have agreed had they thought about the need for such a restructuring at the time of their original investment?[21]

There are two approaches. The first, of course, is absolute priority.[22] The restructuring is a day of reckoning. All future possibilities are col-

[20] One example of such an obstacle can be found in Case v. Los Angeles Lumber Products, 308 U.S. 106 (1939), the case that established the absolute priority rule. The inaptly named Los Angeles Lumber Products was a naval shipbuilder, and government regulations required naval shipbuilders to obtain surety bonds as a condition of bidding on government contracts. Sureties refused to issue a bond unless the shipyard dramatically reduced the amount of debt it was carrying. The shipyard was not in default to any of its creditors, but it was carrying an enormous debt load because of past misadventure in the lumber business. It would probably not be able to pay its creditors in full unless there was a world war on a scale no one had ever seen before. See Robert K. Rasmussen, The Story of *Case v. Los Angeles Lumber Products*: Old Equity Holders and the Reorganized Corporation, Bankruptcy Law Stories 157–58 (Foundation Press 2007).

[21] Framing the question as one about the hypothetical ex ante bargain among investors has been the standard trope in reorganization scholarship ever since Jackson introduced the creditors' bargain model in the early 1980s. See Jackson, supra note 11, at 860 (arguing bankruptcy should be understood as "a system designed to mirror the agreement one would expect the creditors to form among themselves were they able to negotiate such an agreement from an ex ante position").

[22] Many have suggested ways of modifying absolute priority to ensure junior parties have the right set of incentives. See note 51 infra. Strict adherence to absolute priority, for example, might lead to bankruptcy petitions being filed too late. See, e.g., Paul Povel, Optimal "Soft" or "Tough" Bankruptcy Procedures, 15 J.L. Econ. & Org. 659, 660 (1999) ("Clearly, if bankruptcy is a strong punishment, a borrower keeps the unpleasant information to himself and prefers to wait and pray."). But these alternatives to absolute priority all start by asking how assets would have been shared in the event of a sale in which all accounts were squared. None of these are the same as relative priority. Relative

lapsed to the present. The project has an expected value of $100, reflecting the equal chance that it will be worth $200 or $0. Even if Firm could be sold today for what it was worth, no buyer would pay more than this amount. This is less than the $150 that the senior investor is owed. Hence, the senior investor should receive 100 percent of the securities issued by the reorganized firm, and the junior investor should receive nothing.

The alternative is relative priority.[23] Before the need for restructuring arose, the senior investor had an equal chance of being paid $150 or $0. Her investment had a present value of $75. The junior investor had an equal chance of receiving $50 or $0. This was worth $25. By this logic, the most sensible division of value would be one that gives 75 percent to the senior investor and 25 percent to the junior investor. There is no reason for the mandate imposed on the investors from the outside to change the value of what each had.

The possibility that the project might ultimately be worth more than what is owed the senior investor gives "option value" to the junior investor's stake. A rational investor would be willing to pay up to $25 to acquire the option to acquire the project in a year from the senior investor in exchange for $150. Half the time, the project fails and the option is worthless. The holder of the option walks away with nothing. But the other half of the time, the project succeeds. The person holding the option exercises the option and enjoys the $50 of value that remains after the senior investor is paid off.[24]

Options are a component of every investment instrument. Whenever one investor has priority over another, whether absolute or relative, the

priority is not merely a "deviation" from absolute priority. It does not possess absolute priority's defining attribute—treating the bankruptcy as a day of reckoning.

[23] To explain his "option-preservation priority," Casey uses a similar example. See Casey, supra note 3, at 773–76.

[24] The presence of option value explains why the equity of a firm can trade for a positive price even when a firm is insolvent and lacks, in expectation, sufficient assets to meet its liabilities. See Michael Simkovic & Benjamin S. Kaminetz, Leveraged Buyout Bankruptcies, the Problem of Hindsight Bias, and the Credit Default Swap Solution, 2011 Colum. Bus. L. Rev. 118, 215 (2011) ("Because equity has option value, a firm can have significant positive equity value, even though, from the perspective of creditors, the firm is most likely insolvent.").

junior investor has what is in effect a call option.[25] The junior investor has the ability, set out in the investment instrument, to terminate the rights of the senior investor by paying her off.[26] This call option is the right to buy a particular position for a fixed price. Like a call option on any asset, it is defined by a strike price and an exercise date. The strike price is simply the amount owed the senior investor. The exercise date sets the time when the holder of the option must decide whether to exercise the option.

The essential difference between absolute and relative priority is the effect of bankruptcy on the exercise date of the call-option component of the junior investment instrument. Under absolute priority, the bankruptcy accelerates the exercise date; a regime of relative priority leaves it untouched. To return to the example, the difference between priority regimes lies in whether the junior investor has to pay off the senior investor (that is, whether she is forced to exercise her option to buy out the senior investor for $150) at the time the firm receives a new capital structure (absolute priority) or whether the junior investor can wait until after the project is over before deciding to pay off the senior investor (relative priority).

The choice between absolute and relative priority has little to do with the problem of financial distress. Financial distress arises because of other features of investment instruments, in particular cashflow and control rights. Investment instruments typically contain cashflow rights. A shareholder receives dividends; a debtholder is entitled to the repayment of principal and interest on a fixed schedule. Investment instruments also embody control rights.[27] Shareholders enjoy control rights

[25] Formalizing the priority right of junior investors in this fashion is a familiar feature of the law and economics of bankruptcy. See, e.g., Alan Schwartz, Bankruptcy Contracting Reviewed, 109 Yale L.J. 343, 356 (1999) ("[J]unior creditors have a call option on the insolvent firm . . . ."). What has not been appreciated is that the precise difference between absolute and relative priority is the identification of the exercise date of the call option.

[26] Using options to understand investment instruments is a central and familiar feature of modern finance, beginning with Fischer Black & Myron Scholes, The Pricing of Options and Corporate Liabilities, 81 J. Pol. Econ. 637 (1973).

[27] For a discussion of control rights and the way in which they inhere in all investment instruments, see George G. Triantis, Debt Financing, Corporate Decision Making, and Security Design, 26 Canadian Bus. L.J. 93, 100–02

directly.[28] They have voting rights. They elect the board of directors. By virtue of their ability to waive defaults instead of accelerating their loans, creditors can also influence the behavior of their debtor.

Creditor control is not readily visible, but it is nevertheless strong because of the number and variety of covenants found in loan agreements.[29] Even when the firm is enjoying the sunniest of times, the debtor often needs permission from its lead lender to make major capital investments or take on additional debt.[30] When the firm encounters financial distress, it inevitably breaches one or more covenants.[31] The breach itself might not be of great moment. It may be nothing more than a delay in filing a financial report, but the breach is a default nevertheless, and it gives a creditor the power to terminate its loan. Creditors are usually willing to waive many defaults, but they subject their waiver to conditions. Enormous creditor control comes from their ability to impose these conditions.

(1996); George G. Triantis, The Interplay Between Liquidation and Reorganization in Bankruptcy: The Role of Screens, Gatekeepers, and Guillotines, 16 Int'l Rev. L. & Econ. 101, 104–08 (1996).

Old accounts of control rights used to locate control rights exclusively in the hands of shareholders. This is wrong. A growing body of work focuses on the role that creditors play in corporate governance and their ability to control corporate decisionmaking. For a review of this work, see Kenneth Ayotte, Edith S. Hotchkiss & Karin S. Thorburn, Governance in Financial Distress and Bankruptcy, in The Oxford Handbook of Corporate Governance 496–503 (Mike Wright, Donald S. Siegel, Kevin Keasey & Igor Filatotchev eds, Oxford University Press 2013).

28 Shareholder control rights and their mediation through the board of directors are set out in Frank H. Easterbrook & Daniel R. Fischel, The Economic Structure of Corporate Law 91 (1991).

29 For empirical evidence of this control, see Greg Nini, David C. Smith & Amir Sufi, Creditor Control Rights and Firm Investment Policy, 92 J. Fin. Econ. 400, 401 (2009) (finding, among other things, that almost a third of private credit agreements contain explicit restrictions on capital expenditures and that these increase as a debtor's financial condition deteriorates).

30 Id. at 404 (capital expenditure restrictions and leverage ratios relatively common in private credit agreements).

31 For a study showing the incidence of covenant violations, See Michael R. Roberts & Amir Sufi, Control Rights and Capital Structure: An Empirical Investigation, 64 J. Fin. 1657, 1658 (2009) (over 25 percent of publicly traded firms have a covenant violation over a 10-year period).

Financial distress requires altering the cashflow and control rights of junior investors.[32] Indeed, control rights and cashflow rights are the principal drivers of financial distress.[33] Once a firm is in financial distress, it cannot pay creditors what they are owed, and the control rights established in good times typically no longer make sense when the firm cannot pay its bills.[34]

But neither cashflow nor control rights are relevant to the choice between absolute and relative priority. Priority is about what each investor receives at the end of the day when all accounts are squared. Until senior investors seize the assets and sell them, the firm continues. As long as the firm continues, there is no need to square the accounts, no matter how financially distressed the firm may be. As long as the assets are not sold to some third party, the ultimate division of the value of firm between junior and senior investors can be put off. It can be resolved at the time of the restructuring, but it does not have to be.

Implementing relative priority is simple. The senior investor is given all the equity in the reorganized firm, and the junior investor is given a call option on this equity with a strike price equal to the amount owed the senior investor.[35] The cashflow and control rights of the junior in-

[32] "Financial distress," as distinct from "economic distress," refers to firms that cannot meet their obligations to creditors even if profitable on an operating basis.

[33] For an empirical investigation of the characteristics of financial distress and in particular the connection between cashflow rights and financial distress, see Gregor Andrade & Steven N. Kaplan, How Costly Is Financial (Not Economic) Distress? Evidence from Highly Leveraged Transactions That Became Distressed, 53 J. Fin. 1443 (1998). For an analysis of the role of control rights and financial distress, see Douglas G. Baird & Robert K. Rasmussen, Control Rights, Priority Rights, and the Conceptual Foundations of Corporate Reorganizations, 87 Va. L. Rev. 921, 922 (2001).

[34] See Baird & Rasmussen, supra note 33, at 922 (arguing that the central focus of corporate reorganizations should be on control rights).

[35] Half the time the equity will prove worthless. The other half it will be worth \$200 and the junior investor will exercise the call option and give the senior investor \$150. In expectation, the senior investor receives \$75. The automatic conversion feature of the senior investor's stake into 100% of the equity of the firm is quite similar to Adler's chameleon equity proposal. See Barry E. Adler, Financial and Political Theories of American Corporate Bankruptcy, 45 Stan. L. Rev. 311, 323–33 (1993). There is a critical difference, however.

vestor no longer interfere with the operation of the business. The senior investor will be paid first. But the junior investor still receives its share if the reorganized firm ultimately flourishes.

This way of restructuring the firm has a distinct advantage over absolute priority. Absolute priority requires knowing the value of the firm, but relative priority does not. Return to the example. Consider what would happen if it were not clear how much the project would yield if it succeeded. Under absolute priority, the judge cannot confirm a plan that wipes out the junior investor unless she believes that Firm, in expectation, is worth less than $150. Absolute priority requires keeping the junior investor in the picture if Firm is worth more than $150, the amount the senior investor is owed. To implement the absolute priority rule, the judge must decide whether the firm is worth more than $150 and, if it is, how much more. Absolute priority, by its nature, requires assessing the value of Firm against the amount owed the senior investor.

Under relative priority such knowledge is not required. There is no need to value the equity given to the senior investor. The investment instrument that is given to the junior investors, the call option, has only two components—the strike price and the exercise date. Neither requires knowing anything about the value of Firm. When implementing relative priority, the judge needs to know only how much the senior lender is owed and the ultimate date on which accounts need to be settled (the strike price and the exercise date of the option respectively).

In making the choice between absolute and relative priority, normative intuitions have little role to play. When large firms are reorganized, the important battles are between different layers of institutional debt.[36] Firms in bankruptcy are typically so far from being solvent that the equity lacks even option value.[37] There are some cases in which workers, tort

Chameleon equity implements absolute priority and all implementations of absolute priority require a liquid market, a judicial valuation, or both.

[36] For a discussion of the players in large modern Chapter 11s, see Harvey R. Miller, Chapter 11 in Transition—from Boom to Bust and into the Future, 81 Am. Bankr. L.J. 375, 390 (2007) (discussing the rise of distressed debt traders with different motivations and objectives).

[37] The option value of class of claims or interests is virtually worthless unless the immediately senior class is being paid more than 50 cents on the dollar. See Am. Bankr. Institute, supra note 3, at 222. Distributions to general creditors in large bankruptcies have been running less than 15 cents on the dollar

victims, or small suppliers are at risk of not being paid, but these are not the typical cases.[38] The operations of the firm usually continue much as before. Workers and suppliers are paid as if the bankruptcy never happened.[39]

The typical large reorganization affects only the rights of sophisticated investors.[40] Whether junior or senior in the capital structure, the investor will be a hedge fund, a large pension fund, an insurance company, or a bank.[41] By the time the bankruptcy starts, claims will have been transferred, often multiple times, and will rest in the hands of those

over the last decade, see Douglas G. Baird, Chapter 11's Expanding Universe, 87 Temple L. Rev. 975, 979 (2015).

[38] From In re Johns-Manville Corp., 801 F.2d 60 (2d Cir. 1986) to McMillan v. LTV Steel, Inc., 555 F.3d 218 (6th Cir. 2009), it is, of course, easy to find cases in which rights of tort victims, workers, and retirees are implicated. In cases involving large retailers, suppliers often incur substantial losses. These cases, however, are a minority of large cases in Chapter 11. See Baird, supra note 37, at 985 n.42.

[39] The prepackaged Chapter 11 of the Indiana Toll Road in September 2014 provides an illustration of the practice. See In re ITR Concession Company LLC, 2014 WL 4955913 (Bankr. N.D. Ill. 2014).

As a matter of blackletter law, of course, unsecured claims are supposed to receive nothing if the secured creditors cannot be paid in full. See, e.g., In re Kmart, 359 F.3d 866, 871 (7th Cir. 2004). But it often does not work out this way in practice. Many times, the unsecured debt is so small that trying to extinguish it is more trouble than it is worth. Even if it is not, refusing to pay workers and suppliers threatens to disrupt the operation of the business.

Even if it mattered much more, however, focusing on the treatment of nonadjusting creditors misses the thrust of this paper, which is to confront the virtues of absolute priority on its strongest ground, one on which the only players are professional, sophisticated investors.

[40] See, e.g., Douglas G. Baird & Robert K. Rasmussen, Antibankruptcy, 119 Yale L.J. 648, 687–88 (2010). ("[K]ey players are not hapless public investors and small trade creditors, but sophisticated parties who have invested in this business because of the special expertise they bring.").

[41] See Marshall S. Huebner & Benjamin A. Tisdell, As the Wheel Turns: New Dynamics in the Coming Restructuring Cycle, in The Americas Restructuring and Insolvency Guide 2008/2009, at 77, 80 (2008) (detailing how Chapter 11 is evolving "into a forum by which sophisticated players in an increasingly liquid claims market resolve financial distress").

who, far from wanting to avoid navigating the hazards of bankruptcy, relish doing battle there.[42]

Professional investors can accommodate themselves to any priority regime.[43] To be sure, absolute priority is better for senior investors after the fact and relative priority worse. But interest rates should adjust in a well-functioning capital market. In equilibrium, both junior and senior investors should enjoy the same return on their capital regardless of the priority rule. There is no fairness argument that requires paying the senior investor before anyone else. Nor is there any reason to insist that everyone share the hurt. Mandating sharing for its own sake makes little sense when the stakeholders are sophisticated professionals who hold diversified portfolios.[44]

Priority rights should work to the mutual benefit of the investors as a group.[45] But it is not easy to identify how priority rights matter. A pizza does not get bigger or smaller depending upon how it is sliced. So too with cashflows. A firm's capital structure determines which investor enjoys the cash it generates, but at first blush the division of cashflows does not itself affect the amount of cash that the firm makes.[46] It is rea-

[42] Glenn E. Siegel, Introduction: ABI Guide to Trading Claims in Bankruptcy (Part 2), 11 Am. Bankr. Inst. L. Rev. 177, 177 (2003) ("Perhaps nothing has changed the face of bankruptcy in the last decade as much as the newfound liquidity in claims. . . . Now, in almost every size case, there is an opportunity for creditors to exit the bankruptcy in exchange for a payment from a distressed debt trader . . . .").

[43] Alan Schwartz, A Contract Theory Approach to Business Bankruptcy, 107 Yale L.J. 1807, 1812–13 (1997) (assuming that creditors receive market rate of return).

[44] The ability to minimize risk through diversification is a fundamental principle of modern finance. See, e.g., Paul Samuelson, General Proof that Diversification Pays, 2 J. Fin. & Quantitative Analysis 1 (1967).

[45] For a justification that is based on the paradigm of what a sole owner would do, see Douglas G. Baird & Thomas H. Jackson, Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy, 51 U. Chi. L. Rev. 97, 104–109 (1984).

[46] Franco Modigliani and Merton Miller proved in the 1950s that capital structures have no effect on the value of a firm as long as a handful of specified assumptions hold. Their foundational article is Franco Modigliani & Merton H. Miller, The Cost of Capital, Corporation Finance and the Theory of Investment, 48 Am. Econ. Rev. 261 (1958). For an accessible overview, see

sonable to start with the assumption that a firm with a capital structure built around relative priority will be worth at least as much as one built around absolute priority.[47]

Assume that under a regime of absolute priority, a firm raises $95 from outside investors. It receives $49 from a senior lender in return for a promise to pay $50 in a year's time, and at the same time, it receives $46 from a junior investor in return for a promise to pay $50 in a year's time. To provide an efficiency explanation for absolute priority, one must explain why the firm could not also obtain a total of $95 from senior and junior investors under a regime of relative priority in return for a promise to pay $100 in a year. Because of the higher risk, the senior investor, everything else equal, will put up less than $49 for the right to receive $50 in the future, but the junior investor faces correspondingly less risk and should be willing to put up more.

Some justifications for absolute priority posit an agency problem.[48] An owner-manager of the firm seeks outside investment. She seeks to maximize the amount she can raise. The outside investors have no easy way to tell whether the owner-manager is doing everything she can to make the venture succeed. Nor can they tell whether she is taking unnecessary risks. The owner-manager and the outside investors can minimize this agency problem by maximizing the share that the outside in-

Merton H. Miller, The Modigliani-Miller Propositions After Thirty Years, 2 J. Econ. Perspectives 99 (1988). The Modigliani and Miller "irrelevance propositions" are the starting place for every modern discussion of capital structures. To make sense of capital structures, one needs to identify which of their assumptions does not hold and why it matters.

[47] It has long been known that the choice between absolute and relative priority has no effect on firm value when the Modigliani and Miller assumptions hold. See Eugene F. Fama, The Effects of a Firm's Investment and Financing Decisions on the Welfare of its Security Holders, 68 Am. Econ. Rev. 272, 272 (1978). It is an unfortunate accident that modern economists returned to the study of corporate reorganizations in earnest when this point was not clear. The idea of absolute priority started as a convenient assumption. See, e.g., Jerold B. Warner, Bankruptcy, Absolute Priority, and the Pricing of Risky Debt Claims, 4 J. Fin. Econ. 239, 239–41 (1977). Over time, it became an unfortunate article of faith.

[48] Schwartz, supra note 25, at 1207–11.

vestors receive in bad states of the world.[49] When the owner-manager takes nothing until and unless the investors are paid in full, she has every incentive to make the business succeed. She enjoys the benefit of each marginal dollar the firm makes and incurs the cost of each marginal dollar the firm loses. In the presence of this or other similar agency costs, it makes sense to implement a regime of absolute priority.

Under this view, reducing agency costs is the main event. Departures from absolute priority have the effect of making outside investors less willing to lend in the first place and capital harder to secure.[50] There might be competing considerations. For example, owner-managers might not be inclined to trigger a reorganization if they will be wiped out completely, and they may need to be given some incentive to remain with the firm.[51] But departures from absolute priority undermine the need to ensure that the manager has the right incentives.[52] They require justification. Absolute priority is, in any event, the starting place.

This agency-cost rationale, however, fits poorly with modern debates about priority, at least as applied to large corporate enterprises. There is no agency problem between the investors holding the different layers of debt. None of them are charged with operating the firm. In large corporate enterprises, investors entrust the operations of the business to professional managers.

[49] See Lucian Arye Bebchuk, Ex Ante Costs of Violating Absolute Priority in Bankruptcy, 57 J. Fin. 445, 447 (2002) (deviations from absolute priority have an adverse effect on managerial decisionmaking in the presence of moral hazard).

[50] Alan Schwartz, The Absolute Priority Rule and the Firm's Investment Policy, 72 Wash. U. L.Q. 1213, 1224 (1994).

[51] See, e.g., Povel, supra note 22, at 660. There are a large number of papers that offer additional reasons for deviating from absolute priority, without identifying relative priority as the alternative. See, e.g., Lucian Arye Bebchuk & Randal Picker, Bankruptcy Rules, Managerial Entrenchment, and Firm-Specific Human Capital, The University of Chicago Law School, Law & Economics Working Paper No. 16, 4 (1993) (deviations from absolute priority encourage development of firm-specific human capital); Robert Gertner & David Scharfstein, A Theory of Workouts and the Effects of Reorganization Law. 46 J. Fin. 1189, 1212–14 (1991) (departures from absolute priority may be needed to minimize risk-taking and underinvestment problems).

[52] See Bebchuk, supra note 49, at 457.

There is, of course, an agency problem between the investors as a group and the managers. The managers do need to be incentivized,[53] but this has nothing to do with the choice of priority regimes. If it makes sense to give managers the highest possible payoffs in good states and the lowest in bad states, they can be given equity. If it makes sense to align the managers' incentives with the firm as a whole, they can be given a package of securities whose value tracks the value of the firm as a whole.[54] But one can choose between absolute priority and relative priority without limiting the ability of investors to realign the incentives of the managers in any fashion they choose.[55]

It was once common to suppose that there was an agency problem in large corporate reorganizations because the managers were beholden to the shareholders. Shareholders, however, no longer are in the picture.[56] Moreover, when a firm is in financial distress, the allegiances of the managers shift to the creditors.[57] Managers begin to pay more attention

[53] Steven N. Kaplan & Per Strömberg, Leveraged Buyouts and Private Equity, 23 J. Econ. Perspectives 121, 130–31 (2009) (reviewing different incentive packages across public and private firms).

[54] Compare Lucian A. Bebchuk & Holger Spamann, Regulating Bankers' Pay, 98 Geo. L.J. 247, 282–85 (2010), with Sanjai Bhagat, Brian J. Bolton & Roberta Romano, Getting Incentives Right: Is Deferred Bank Executive Compensation Sufficient?, Yale Law & Economics Research Paper No. 489, 19–30 (Feb. 2, 2014), available at http://ssrn.com/abstract=2395982.

[55] The essential lesson of put-call parity holds that the cashflow rights associated with any investment instrument can be recreated with a bundle of other investment instruments and derivatives. For an accessible overview, see Alvin C. Warren, Jr., Commentary, Financial Contract Innovation and Income Tax Policy, 107 Harv. L. Rev. 460, 461 (1993).

[56] See note 37 supra.

[57] As a matter of blackletter law, the fiduciary duty of the board is to maximize the value of the firm as a whole, not to shareholders or any other constituent group. As shareholders are typically the ones who gain or lose from the board's decisions, the board typically looks to them, but it does this only to a point. Creditors gain the ability to bring derivative actions against the board when the firm becomes insolvent. It is at that point that they are its residual claimants. See Quadrant Structured Products Co. v. Vertin, 102 A.3d 155, 176 (Del. Ch. 2014). In addition, quite apart from their duties, managers pay attention to those who control the firm because they want to keep their jobs. That creditors exercise such control as firms become more financially distressed is empirically established. See Nini, Smith & Sufi, supra note 29, at 400.

to the creditors than the shareholders even as the firm approaches financial distress.[58] By the time of the bankruptcy, creditors are in control.[59]

In short, when the priority question is between sophisticated outside investors holding different layers of debt, one cannot use simple agency-cost theory to identify the optimal priority rule. There are, to be sure, more theories that try to explain why some creditors bargain for priority over others.[60] Consistent with the structure of Anglo-American law, many of these theories are asset-based. A creditor may take a security interest in a particular asset because of that creditor's ability to monitor that asset. A seller of a particular type of equipment may finance the sale and be able to ensure that the debtor properly takes care of the equipment and insures it. And the seller of the equipment may also be best equipped to repossess and sell it in the event of default.[61] But asset-

[58] The dismissal of the CEO of Krispy Kreme at the behest of its principal creditor is one example. See Press Release, Krispy Kreme Doughnuts, Inc., Krispy Kreme Announces Management Changes (Jan. 18, 2005), available at http:// phx.corporate-ir.net/phoenix.zhtml?c=120929&p=irol-newsArticle&ID=663642.

[59] See Huebner & Tisdell, supra note 41, at 77 (in large reorganizations "creditors effectively playing the same role as shareholders of a solvent enterprise").

[60] For a comprehensive account of the extent to which private information can account for secured credit, see George G. Triantis, Secured Debt under Conditions of Imperfect Information, 21 J. Leg. Stud. 225 (1992). Others argue that priority among creditors allows the debtor to tap sources of finance throughout its life. Creditors who take security interests early can be confident the debtor will not be able to borrow later and take on excessively risky projects. See, e.g., Barry E. Adler, Priority in Going-Concern Surplus, 2015 U. Ill. L. Rev. 811, 813 (2015) (noting that priority prevents "the debtor's pursuit of excessive risk that might be financed by subsequent loans from other creditors"). An account of priority that assumes that the debtor borrows at multiple points in time, however, does not explain the common phenomenon of multiple layers of debt being put in place simultaneously. See Gary D. Chamblee, Reducing Battles Between First and Second Lien Holders Through Intercreditor Agreements: The Role of the New ABA Model Intercreditor Agreement Task Force, 12 N.C. Banking Inst. 1, 1 (2008) (reviewing the rise of second-lien financing, one type of multi-tiered debt created in a single transaction).

[61] For the classic analyses of monitoring and secured credit, see Thomas H. Jackson & Anthony T. Kronman, Secured Financing and Priorities Among

based priority justifications have a harder time explaining capital structures in which some creditors have blanket priority over all the assets of the firm.[62]

There are some plausible justifications for blanket security interests over all of a firm's assets. For example, the optimal priority structure may depend upon which creditor is better positioned to monitor the debtor. A senior position might be more appropriate for an investor who is distant and has limited ability to detect misbehavior. A junior position might be better suited for an investor who is close to the debtor and able to monitor what is going on. When an investor can monitor at low cost, she may find it worthwhile to bear the added risk in return for a higher rate of return.[63]

A creditor who puts in place a revolving credit facility might want priority over other investors.[64] Such a creditor needs to be close to the debtor and understand its business. More to the point, her loan is constantly in flux. She needs to be confident that she will recover each new penny she injects into the firm's operations.

Investors as a group might be better off with the liquidity and the oversight such a senior lender provides. The senior investor with control rights may exercise them in a way that benefits the firm as a whole. She might, for example, insist on the replacement of the CEO long before junior investors and shareholders sense trouble.[65] Alternatively, she

Creditors, 88 Yale L.J. 1143, 1149–61 (1979), and Saul Levmore, Monitors and Freeriders in Commercial and Corporate Settings, 92 Yale L.J. 49, 83 (1982).

[62] The law requires that investors acquire priority through taking security interests in each of the firm's various assets, but this is an artifact—and not necessarily a desirable artifact—of Anglo-American law. See Douglas G. Baird, The Rights of Secured Creditors After *ResCap*, 2015 U. Ill. L. Rev. 849, 856–60.

[63] This is one of the most conventional justifications for a mix of secured and unsecured credit. For a recent example of it being used, see Douglas G. Baird & Anthony J. Casey, No Exit? Withdrawal Rights and the Law of Corporate Reorganizations, 113 Colum. L. Rev. 1, 14 (2013).

[64] Cheol Park, Monitoring and the Structure of Debt Contracts, 60 J. Fin. 2157, 2158 (2000) (justifying such a lender's priority on the ground that a "lender's incentive to monitor is maximized when he appropriates the full return from monitoring").

[65] The dismissal of the CEO of Krispy Kreme, discussed supra note 58, may have been such an instance. See Douglas G. Baird & Robert K. Rasmus-

might install a chief restructuring officer to sort out the financial condition of the firm.[66] These steps may benefit investors as a whole.

Of course, a senior investor's exercise of control rights is not necessarily efficiency-enhancing. The senior investor is no Good Samaritan. She will focus narrowly on what advances her own self-interest. Because the senior investor enjoys priority, she may play things too safe. She may decide, for example, not to go forward with a risky product launch even though from the perspective of the investors as a group it makes sense. For the senior creditor's exercise of control rights to be efficient, her self-interest has to align more or less with the interests of the firm as a whole. It may be, however, that the interests of the junior and senior investors align over most dimensions.[67]

There are still more explanations for priority. For example, one can argue that when one creditor has priority over another, no one wastes time or resources just to keep a place in line.[68] But each such explanations is in tension with the others. The presence as well as the absence of monitoring is used to explain why a creditor is senior or junior to another, but not in ways that are consistent.

Of course, the way investors structure their deals suggests that there must some benefits from priority. For example, over the last fifteen years, there has been a dramatic rise in second-lien financing.[69] In these transactions, two sophisticated creditors enter into a bargain with each other and with a common debtor. Under this bargain, one creditor takes a position junior to another. This creditor explicitly agrees to remain

sen, Private Debt and the Missing Lever of Corporate Governance, 154 U. Pa. L. Rev. 1209, 1209–11 (2006).

66 For a discussion of who these CROs are and what the work they do, see Alvarez & Marsal, The ABCs of the CRO, http://www.alvarezandmarsal.com/sites/default/files/sidebar-callouts/chief-restructuring-officer.pdf.

67 See Joshua D. Rauh & Amir Sufi, Capital Structure and Debt Structure, 23 Rev. Fin. Stud. 4242, 4276 (2010) (new bank credit facility elicits positive equity price response and bank's imposition of tighter controls improves borrower's market valuation).

68 This explanation of secured credit can be found in Randal C. Picker, Security Interests, Misbehavior, and Common Pools, 59 U. Chi. L. Rev. 645, 646–48 (1992).

69 See Chamblee, supra note 60, at 1 (second-lien lending exceeded $29 billion in 2006).

passive and allow the senior creditor to exercise her control rights without interference.[70] Sophisticated parties would not establish such priorities between themselves and parcel out control rights in this fashion unless it was in their mutual interest. Priority must be doing something more than making one investor safer at the expense of another.

But even if we can infer that priority enhances the value of some firms, we still do not know what form of priority best advances the parties' mutual interest. Under both absolute and relative priority, senior creditors are paid first up to the amount they are owed to the exclusion of others whenever there is a day of reckoning.

Nor do existing practices do much to identify which priority regime parties prefer when the firm is being reorganized. Loan agreements do give the senior creditor an unqualified right to foreclose in the event of default and the definition of "default" almost always includes the filing of bankruptcy. This might seem to suggest a preference for absolute priority. But it is wrong to draw such an inference. A debtor cannot waive its right to file for bankruptcy.[71] The ability of the debtor and junior creditors to file a bankruptcy petition limits the senior creditor's ability to foreclose no matter what the agreement says. Because the power of junior investors to trigger a bankruptcy cabins the right to foreclose, having the theoretical right to foreclose in the event of bankruptcy imposes no costs even if such an unqualified right is suboptimal. It is therefore a mistake to conclude that the priority embedded in a blanket right to foreclose in the event of default is efficient on the ground that the arms' length ex ante bargain calls for it.[72]

[70] See C. Edward Dobbs, Negotiating Points in Second Lien Financing Transactions, 4 DePaul Bus. & Com. L.J. 189 (2006) (summarizing the significant issues faced in intercreditor agreements); George H. Singer, The Lender's Guide to Second Lien Financing, 125 Banking L.J. 199 (2008) (discussing common provisions of intercreditor agreements and issues that may arise should the debtor file for bankruptcy).

[71] See United States v. Royal Business Funds Corp., 724 F.2d 12, 15 (2d Cir. 1983).

[72] The catalogue of those who have made this mistake of assuming that foreclosure rights inform the appropriate priority rule in bankruptcy is long and distinguished. It begins with Jerome Frank, see Frank, supra note 3, at 541–42, and includes most law-and-economics scholars who write about bankruptcy. They usually fail to understand that the presence of broad foreclosure rights in bonds today reflects considerable path dependence. Bonds take the form they

Parties can (and do) enter into subordination agreements with one another, and these are enforceable in bankruptcy.[73] But such agreements are also written in the shadow of existing law. The way two parties would allocate value between themselves when other investors enjoy absolute priority is not necessarily the same when all parties were subject to relative priority. Moreover, the priority rights bargained for today take account of the constraints that current law places on the ability of junior creditors to waive their right to participate in a reorganization.[74] For example, it is not clear that parties can change through agreement such things as the ability of junior creditors to object to asset sales.[75] A senior lender might insist today on absolute priority only because other parts of the bargain are fixed. Subordination agreements are in any event elaborately negotiated, and junior investors rarely commit to refrain from asserting their rights unless and until senior creditors are paid in full.[76]

The debate about relative and absolute priority must therefore take place in an empirical vacuum. It is not even easy to draw inferences

do because when they were first adopted (for railroad reorganizations in the nineteenth century), they followed the form of real estate mortgages. See William Z. Ripley, Railroads: Finance and Organization 121–26 (1915) (discussing the real estate roots of railroad bonds). Given that the senior party does not have the ability to foreclose when a reorganization is value-maximizing for the group, there has been no evolutionary pressure to qualify the foreclosure right in the loan agreement. It might still make sense, but it might not.

73 The Bankruptcy Code explicitly makes such agreements enforceable to the same extent they are enforceable under nonbankruptcy law. See 11 U.S.C. §510(a).

74 Courts treat some protections granted to creditors as nonwaivable, regardless of the agreements they have reached with other creditors. See, e.g., In re 203 North LaSalle Street Partnership, 246 Bankr. 325, 330–32 (Bankr. N.D. Ill. 2000) (refusing to enforce terms of subordination agreement allowing senior investors to vote claims of juniors). For discussions of possible limits on the ability of parties to waive bankruptcy rights in subordination agreements, see Edward R. Morrison, Rules of Thumb for Intercreditor Agreements, 2015 U. Ill. L. Rev. 721 (2015); Shane G. Ramsey, Are Subordination Agreements Really Enforceable?, Am. Bankr. Inst. J., April 2012, at 52.

75 Jeffrey N. Pomerantz et. al., Delaware Bankruptcy Court Weighs in on Intercreditor Agreements, Am. Bankr. Inst. J., July 2012, at 14, 14 (discussing published and unpublished cases in which courts faced this question).

76 See Dobbs, supra note 70 (detailing the many rights that second-lienholders commonly insist upon).

from the relative priority regime that existed before the absolute priority rule took hold. Although largely consensual, this regime was norm-based. An investor, whether junior or senior in the capital structure, would depend upon J.P. Morgan to come up with capital structures that made sense.[77] Formal legal rules entered only at the margins in this world, usually to protect nonparticipants.[78] No legal rules developed to adjudicate fights among those seated at the negotiating table as none were needed. Norms and long-term reputational capital ensured that relative priority was respected among those actively participating in the reorganization.[79]

The desirability of any priority regime turns in large measure on bankruptcy costs. If a firm is prospering, the priority one enjoys as against another does not matter. Only when a firm's assets are likely insufficient to pay everyone in full does priority matter. Hence, it makes sense to pay attention first to the way priority rules affect behavior when things fall apart.

[77] J.P. Morgan took the lead in reorganizing the Santa Fe, the Erie, and the Northern Pacific among others. Alfred D. Chandler, Jr., The Visible Hand: The Managerial Revolution in American Business 171 (Belknap Press 1977); Carlos D. Ramirez, Did J. P. Morgan's Men Add Liquidity? Corporate Investment, Cash Flow, and Financial Structure at the Turn of the Twentieth Century, 50 J. Fin. 661, 664 (1995) (finding that Morgan's participation likely lowered the cost of capital).

[78] See, e.g., Northern Pacific Railway Company v. Boyd, 228 U.S. 482 (1913). In protecting such creditors, the Court emphasized that ensuring the right to participate was not the same as vindicating a substantive entitlement: "If he declines a fair offer he is left to protect himself as any other creditor of a judgment debtor, and, having refused to come into a just reorganization, could not thereafter be heard in a court of equity to attack it." Id. at 508.

[79] For an account of the role investment bankers and their lawyers played in equity receiverships, 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, 101–105 (Gerald L. Geison, ed., 1983).

II. The Sale Paradigm

A going-concern sale of the firm is the most straightforward way to resolve the problem of financial distress.[80] The new buyers can put in place whatever capital structure makes the most sense for the firm, given the condition in which it finds itself. If there is an actual sale, the most obvious priority rule is one of absolute priority. The investors' role in the ongoing enterprise has come to an end. The only question is one of dividing cash, and the easiest way to do this is to collapse all future possibilities to present value.

Of course, it is possible to implement a regime of relative priority even when there is an actual sale. One can always require the judge to determine how much the junior investments would have been worth if there had not been a sale. Recognizing option value in this environment, however, requires a judge to engage in a valuation exercise.[81] The sale price gives her a valuation of the firm as a whole, but the sale price alone is not enough to establish how much out-of-the-money options are worth. One must also estimate how likely the firm is to change in value. The more likely value of the firm will change, the greater the chance that it might ultimately be worth enough to make the option worth exercising. Measuring asset volatility is essential when allocating sale proceeds under relative priority, but unnecessary under absolute priority. The amount realized in the sale provides all the information needed.

Matters are reversed, however, when the firm is reorganized instead of being sold to a third party. Relative priority requires no valuation of the firm, but absolute priority does. To decide who gets what under absolute priority in the absence of a sale, the judge must determine the value of the firm. The empirical evidence does suggest that, in large reorganizations, judicial valuations are unbiased, but these unbiased valua-

[80] See Douglas G. Baird, The Uneasy Case for Corporate Reorganizations, 15 J. Legal Stud. 127, 136 (1986) (advocating mandatory going-concern sales of firms in Chapter 11).

[81] The ABI Commission recognized this difficulty. See Am. Bankr. Institute, supra note 3, at 221 (discussing the need to account for volatility in estimating the value of an option and suggesting volatility could "be determined for a particular debtor by looking at the historical volatility of comparable companies, using an agreed upon volatility rate, or using a set metric like the average 60-day forward volatility of the S&P 500 Index").

tions are made with high variance.[82] Even if bankruptcy valuations could be improved,[83] a major problem remains. "All estimates of value are noisy."[84] Coming within ten percent of the true value of the firm merits high praise even when the best experts do it.[85]

Valuation of a large corporation in an adversary process is particularly costly. Parties can find it in their self-interest to expend millions to shift a valuation only a few percent, and a virtually unlimited amount of evidence is available to move the valuation in one direction or another. In the reorganization of Residential Capital, more than $100 million was spent in a dispute over how much to value the claim of a single secured creditor.[86] Or, to provide another example, the valuation hearing in the

[82] See Stuart C. Gilson, Edith S. Hotchkiss & Richard S. Ruback, Valuation of Bankrupt Firms, 13 Rev. Fin. Stud. 43, 44 (2000) ("We find that estimates of value are generally unbiased, but the estimated values are not very precise.").

[83] For example, a mechanism might be designed to induce each party to reveal their own private assessments of value by penalizing those who stray farthest from an expert benchmark. See, e.g., Keith Sharfman, Valuation Averaging: A New Procedure for Resolving Valuation Disputes, 88 Minn. L. Rev. 357 (2003).

[84] Fischer Black, Noise, 41 J. Fin. 529, 533 (1986). For Black, a market was efficient if the price at which a security traded was somewhere between half and twice its true value. Black, of course, was hardly hostile to efficient markets. He was one of the co-discoverers of the Black-Scholes option pricing model. See Black & Scholes, supra note 26.

[85] See, e.g., Steven N. Kaplan & Richard S. Ruback, The Valuation of Cash Flow Forecasts: An Empirical Analysis, 50 J. Fin. 1059, 1076 (1995) (finding that between 37 and 58 percent of valuations sampled showed errors of less than 15 percent).

[86] At the end of one of the many long opinions in the reorganization of Residential Capital, the plainly exasperated judge singled out one particularly recalcitrant creditor. See In re Residential Capital, LLC, 501 Bankr. 549, 624 (Bankr. S.D.N.Y. 2013) (judge observing that one group of creditors "have pursued from the start a strategy where they contest everything and concede nothing" and vowing he would "continue to decide all issues fairly . . . but it should not be lost on anyone that [these creditors] stand virtually alone in this case in failing to reach a consensual agreement to resolve their issues"). This one creditor group's postpetition fees and expenses (paid for out of the estate as the creditors were secured) alone amounted to $128 million. See Stewart Bishop, Rising Star: Kelley Drye's Jason Adams, Law360, Apr. 3, 2015, availa-

reorganization of Mirant continued for twenty-seven days over an eleven-week period, with separate experts testifying for the debtors, various creditor constituencies, and equity holders. The experts' valuations ranged from $7.2 billion to $13.6 billion.[87]

Valuations, of course, are not infinitely costly. The marginal benefits of providing the judge with more information are diminishing. A few key assumptions drive valuations, and a good judge can establish ground rules that limit costs.[88] Nevertheless, the prospect of a contested valuation hearing casts a shadow over every large reorganization.

It might seem that a bankruptcy valuation is similar in spirit to the appraisal remedy in corporate law.[89] But the appraisal remedy has come in for its own share of criticism,[90] and it is far more benign than a valuation in a reorganization. First, the stakes are greater in bankruptcy. The contest is between different layers of the capital structure. As soon as a junior stakeholder pushes a valuation above the amount owed to those senior to her in the hierarchy, she enjoys the benefit of the entire increase. By contrast, if a five-percent stakeholder persuades the judge in an appraisal hearing that the firm is worth one dollar more, she receives only five additional cents.

In the context of a reorganization, a small change in any variable can change who is and who is not in the money. Over the course of the few weeks that the valuation hearing might take, the change in the Treasury rate can be enough to bring another investor class into the money. Because large consequences attach to small changes, those involved in a

ble at http://www.law360.com/articles/639427/rising-star-kelley-drye-s-jason-adams.

[87] In re Mirant Corp., 334 Bankr. 800, 824 (Bankr. N.D. Tex. 2005).

[88] The basic elements of bankruptcy valuation of firms are set out in Christopher S. Sontchi, Valuation Methodologies: A Judge's View, 20 Am. Bankr. Inst. L. Rev. 1 (2012). Judge Sontchi has limited efforts to derail a valuation by disqualifying witnesses on the grounds that they lacked sufficient expertise. See In re Nellson Nutraceutical, Inc., 356 Bankr. 364, 374–75 (Bankr. D. Del. 2006).

[89] For an analysis of the appraisal remedy, see Hideki Kanda & Saul Levmore, The Appraisal Remedy and the Goals of Corporate Law, 32 U.C.L.A. L. Rev. 429 (1985).

[90] See George S. Geis, An Appraisal Puzzle, 105 Nw. U. L. Rev. 1635, 1676 (2011) (urging reform of existing appraisal remedy to deal with competing types of abuse by majority and minority shareholders).

reorganization are willing to invest more in the outcome of the litigation than those involved in an appraisal hearing.

In addition, a valuation battle in bankruptcy affects the operation of the firm, while appraisal hearings generally do not. As long as the reorganization is ongoing, the firm lacks direction. Board members fail to act decisively. They are not rewarded for taking the long view, as they are typically replaced when the reorganization is over.[91] Their interest lies in minimizing the harm the failure of the firm does to their reputation.[92] They are unlikely to take bold steps, even when they are necessary. Their freedom of action is limited in any event, as nonordinary-course business decisions require the blessing of the bankruptcy judge.[93] The firm cannot make major strategic changes without vetting them first in open court. While rights are being sorted out, investors can threaten to upend transactions that are in everyone's interest in order to gain a larger share for themselves.[94]

Another difference between appraisals and reorganizations is the relative ease of reaching a settlement that avoids the necessity of a costly valuation. In an appraisal dispute, the contesting parties come in two flavors, majority and minority shareholders respectively.[95] Negotiations are harder in Chapter 11 where multiple competing groups of investors

[91] See Douglas G. Baird & Robert K. Rasmussen, Chapter 11 at Twilight, 56 Stan. L. Rev. 673, 697 n.80 (2003) (in Chapter 11s that were not prenegotiated, creditors appoint new boards majority of the time).

[92] Board members pay a penalty for the financial failure of their firms. See, e.g., Stuart C. Gilson, Bankruptcy, Boards, Banks, and Bondholders: Evidence on Changes in Corporate Ownership and Control When Firms Default, 27 J. Fin. Econ. 355, 376 (1990) (the number of boards on which a director sits declines by a third when one of the firms defaults); Suraj Srinivasan, Consequences of Financial Reporting Failure for Outside Directors: Evidence from Accounting Restatements and Audit Committee Members, 43 J. Accounting Research 291, 331 (2005) (evidence consistent with consistent with directors, particularly audit committee members, bearing a reputational penalty for weak board and audit committee oversight).

[93] See 11 U.S.C. §363(b).

[94] In re Adelphia Communications Corp., 368 Bankr. 140, 159 (Bankr. S.D.N.Y. 2007) (creditor group threatens to delay plan confirmation at great cost to estate to gain a larger share for itself).

[95] An appraisal pits the majority shareholder against the minority shareholders it wants to cash out. See Geis, supra note 90, at 1641–43.

occupy different parts of the capital structure. Under some facts, a Coasean bargain may not even be possible. The core may be empty.[96]

These difficulties make actual sales attractive in a legal regime committed to absolute priority.[97] It should be no surprise that going-concern sales have become commonplace in bankruptcy.[98] They are shorter and less costly than full-blown reorganizations.[99]

The bankruptcy forum assembles the firm's assets for sale at a single place and time, something that is hard outside of bankruptcy, especially when the firm's assets consist of land, hard assets, and intellectual property scattered across multiple jurisdictions.[100] Moreover, when the sale takes place in bankruptcy, buyers can be confident that they will receive

[96] Under some conditions, the set of stable, mutually beneficial bargains has no members. No matter what deal is struck, one or more parties will always have an incentive to defect. This is what it means to say that the core is empty. For a discussion of the empty-core problem in corporate reorganizations, see Baird & Rasmussen, supra note 40, at 690–94.

[97] See, e.g., Baird, supra note 80. In addition to those who have advocated outright sales, there are those who propose market-mimicking mechanisms that avoid judicial valuations and attempt to minimize bargaining costs. See Philippe Aghion, Oliver Hart & John Moore, Improving Bankruptcy Procedure, 72 Wash. U. L.Q. 849 (1994); Lucian Arye Bebchuk, A New Approach to Corporate Reorganizations, 101 Harv. L. Rev. 775 (1988); Lucian Arye Bebchuk & Jesse M. Fried, A New Approach to Valuing Secured Claims in Bankruptcy, 114 Harv. L. Rev. 2386 (2001). These proposals, embodying as they do a commitment to absolute priority, are cut from the same cloth. They depend upon a well-functioning capital market. As long as the junior creditors face liquidity constraints, these mechanisms have the same virtues and face the same problems as an actual sale of the entire firm. See Baird & Bernstein, supra note 14, at 1954.

[98] See Melissa B. Jacoby & Edward J. Janger, Ice Cube Bonds: Allocating the Price of Process in Chapter 11 Bankruptcy, 123 Yale L.J. 862, 879 (2014) ("[I]t is common for debtors to enter bankruptcy announcing an intended going-concern sale . . . .").

[99] Jacoby & Janger, supra note 98, at 879 (for large Chapter 11s, median time between filing and final sale approval is 110 days); Jared A. Wilkerson, Defending the Current State of Section 363 Sales, 86 Am. Bankr. L. J. 591, 625 (2012) (reviewing benefits of going-concern sales).

[100] See Janger, supra note 3, at 603–05 (reviewing difficulties of realizing firm value using nonbankruptcy remedies).

good title.[101] This confidence brings higher prices.[102] Bankruptcy serves its purpose of protecting the rights of investors and ensuring that assets are put to their best use. Sales do not require the judge to value the firm.

Conducting an actual sale, however, is neither easy nor cheap. Moreover, senior lenders have an incentive to bring about premature sales that do not bring top dollar. When a firm is financially distressed, the most senior investors in the capital structure will tend to push for an early sale.[103] As long as the sale yields enough to pay them in full, they have no interest in spending time looking for a buyer who will pay more. The senior creditors can often use their ability to withhold financing as a lever to ensure the speedy sale happens.[104]

As sales in Chapter 11 have become more common, courts have devised rules and procedures to protect the integrity of the sale process.[105] A number of reform proposals have been put forward to ensure that sales are better run, and more are in the offing.[106] But the most finely

[101] See 11 U.S.C. §363(f).

[102] See Janger, supra note 3, at 607–08 (arguing that higher realizations in bankruptcy should change priorities).

[103] See Baird & Jackson, supra note 45, at 106 (senior lender "tends to favor immediate liquidation").

[104] Harvey R. Miller & Shai Y. Waisman, The Creditor in Possession: Creditor Control of Chapter 11 Reorganization Cases, 21 Bankr. Strategist 1, 2 (2003). There is empirical evidence of fire sales. See, e.g., Kenneth M. Ayotte & Edward R. Morrison, Creditor Control and Conflict in Chapter 11, 1 J. Legal Analysis 511, 528–38 (2009).

[105] For a survey of some court rules, see George W. Kuney, Let's Make It Official: Adding an Explicit Preplan Sale Process as an Alternative Exit from Bankruptcy, 40 Hous. L. Rev. 1265, 1305–22 (2004). Courts, for example, approve paying break-up fees to stalking horse bidders. See Casey, supra note 3, at 787 (practice of permitting break-up fees to stalking horse bidders cures the lemons problem). The procedures used to sell assets are themselves contested. See, e.g., Christopher Norton, Sun-Times Creditors, Trustee Question Asset Sale, Law360, Sept. 21, 2009, available at http://www.law360.com/articles/123524/-sun-times-creditors-trustee-question-asset-sale?article_related_content=1 (discussing objections to bidding procedures in the Sun Times reorganization).

[106] The American Bankruptcy Institute has proposed a number of narrow reforms of the sale process. See Am. Bankr. Institute, supra note 3, at 83–87 (proposing 60-day moratorium on going-concern sales, absent "the most extraordinary of circumstances"). Academics have made more sweeping pro-

crafted procedures cannot solve all the problems an actual sale presents. In some substantial fraction of large reorganizations, an outright sale may not be in the interests of the parties.[107]

Many of the debates about corporate reorganizations are debates about how to best mimic a sale that never happens. Some take the view, for example, that the senior creditor is entitled only to what she would have received had she foreclosed on the property outside of bankruptcy.[108] To the extent that the bankruptcy process created value that would not otherwise have existed, the secured creditor should be able to lay no claim to it. On the other side of the coin, others argue that, if the secured creditor is not to enjoy any of the upside that the reorganization brings with it, she should not be exposed to the downside either. If she is limited to foreclosure value, the time value of her interest should be respected as well.[109] Those who participate in these debates, however, have failed to appreciate that their starting place is suspect. They accept uncritically reorganization procedures that require judicial valuations. They fail to ask why the sale paradigm was imported into the reorganization mechanism in the first place.

III. Relative Priority

Existing reorganization law is built around the paradigm of a sale.[110] The bankruptcy brings about the same reckoning as a foreclosure sale.[111] It is useful to ask what a reorganization regime would look like if did not treat bankruptcy as a day of reckoning. Valuations are unnecessary when junior investors are given call options. The court's inability to value

posals. See, e.g., Melissa B. Jacoby & Edward J. Janger, Ice Cube Bonds: Allocating the Price of Process in Chapter 11 Bankruptcy, 123 Yale L.J. 862 (2014).

107 Some take the view, however, that the domain is small in which reorganizations as opposed to sales are even necessary, see Douglas G. Baird & Robert K. Rasmussen, The End of Bankruptcy, 55 Stan. L. Rev. 751, 751–52 (2002).

108 See Janger, supra note 3, at 605–06.

109 See, e.g., Douglas G. Baird & Thomas H. Jackson, Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy, 5l U. Chi. L. Rev. 97, 114–25 (1984).

110 See Clark, supra note 16, at 1250–54.

111 The New Deal reformers who pushed for the absolute priority rule made this link explicit. See Frank, supra note 3, at 541–42.

businesses accurately and at reasonable cost is irrelevant. When the restructuring keeps priority rights in place, there is no need to decide whether the firm is worth enough to pay the senior creditors in full.

Of course, any mechanism that alters investors' rights gives some parties an incentive to trigger it and others an incentive to avoid it.[112] But the stakes are much lower when the priority rights of the junior creditor are untouched. Junior investors are worse off to the extent that they lose cashflow and control rights, but they do not lose the investment outright as they would if the reorganization required a final reckoning. The reorganization gives the junior creditors an investment instrument in the restructured firm that, at first approximation, has the same value as the investment instrument they had before the process was triggered.[113]

Under a regime of relative priority, no one has an incentive to fight many of the battles that currently plague Chapter 11. During the era of equity receiverships, senior and junior creditors did not have interests adverse to each other. As a result, they accepted conflicts of interest that would be unthinkable today, such as hiring the same lawyer to represent them in the same case at the same time.[114] Relative priority minimizes conflicts among different tranches of debt.

If judicial valuations drive bankruptcy costs and if the benefits of absolute priority over relative priority are otherwise small, the optimal reorganization regime might be one of relative priority. Under a regime of relative priority, there is little that the bankruptcy judge needs to do. Claims might be disputed, but such claims can be adjudicated inde-

[112] Douglas G. Baird, The Initiation Problem in Bankruptcy, 11 Int'l Rev. L. & Econ. 223, 223 (1991) (those who trigger a bankruptcy proceeding will look to their self interest, which may not correspond to the collective interest of the group).

[113] This is only an approximation. Junior investors are worse off to the extent that cash may continue to be returned to others senior to them in the capital structure. They are also worse off from the loss of control rights, as these have value too. A bundle of derivatives against a firm are worth less than bonds with the same cashflow rights. See Peter Feldhütter, Edith S. Hotchkiss & Oğuzhan Karakaş, The Value of Creditor Control in Corporate Bonds, 5 (Nov. 10, 2014), available at http://ssrn.com/abstract=2405036.

[114] In the Atchison, Topeka, and Santa Fe reorganization, for example, the same lawyer represented the senior and junior bondholders at the same time. No one perceived a conflict. See Robert T. Swaine, The Cravath Firm and Its Predecessors 1819-1947, 502–10 (Ad Press 1946).

pendently of what happens to the firm. Under absolute priority, the resolution of a disputed claim requires holding back some of the cash proceeds of the sale. Under relative priority, the court can simply dilute the equity or the options to the extent that those holding disputed claims prevail. The eventual payout to the junior creditors is entirely market-driven.

It is also worth noting that we do not see anything as simple as the absolute priority rule in an analogous environment in which free contracting is permitted.[115] Consider the way in which venture capital deals are structured. The providers of outside capital typically have preferred stock.[116] The venture capitalist and the entrepreneur strike an explicit deal about what happens to the entrepreneur's equity stake when additional capital is needed to keep the firm going.[117] These deals often provide for granting a share of the equity in return for additional capital. The effect of this restructuring is to dilute the equity stake. The entrepreneur ends up with a much smaller share of the firm.[118] But the equity stake is diluted, not eliminated altogether. The entrepreneur still holds a stake.[119]

Whether relative priority makes sense turns on whether it avoids the costs of absolute priority without introducing costs of its own. The most obvious, but perhaps least problematic challenge is the need to establish

[115] See Steven N. Kaplan & Per Strömberg, Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts, 70 Rev. Econ. Stud. 281, 286–95 (2002) (discussing structure of venture capital deals).

[116] See Kaplan & Strömberg, supra note 115, at 286 ("convertible preferred stock is the most commonly used security, appearing in 204 of 213 financing rounds").

[117] V. Ravi Anshuman, John Martin. & Sheridan. Titman, An Entrepreneur's Guide to Understanding the Cost of Venture Capital, 24 J. Applied Corp. Fin. 75, 75 (No. 3 2012).

[118] See Robert Bartlett, Venture Capital, Agency Costs, and the False Dichotomy of the Corporation, 54 U.C.L.A. L. Rev. 37, 64 (2006).

[119] When there is no debt in the capital structure, the venture capitalist does not have foreclosure rights analogous to a creditor. The dispute is typically over the extent of the dilution, not whether it is eliminated altogether. See Jose M. Padilla, What's Wrong with a Washout: Fiduciary Duties of the Venture Capitalist Investor in a Washout Financing, 1 Hous. Bus. & Tax L.J. 269 (2001).

the exercise date of the call option that junior investors receive. The exercise date in theory should be at the end of the term of the loan to the senior lender.[120] But many senior tranches of debt are revolving credit arrangements with no definite term. Defaults give the senior creditor the option of foreclosing on the assets, but as long as the senior creditor chooses not to exercise this right, the call option remains intact. Hence, the exercise date of the call option is uncertain.

It is necessary to pick an arbitrary time for the duration of the options—perhaps three or five years. This exercise date can be thought of as an approximation of the time at which the senior debt would have been paid off in the absence of financial distress. It should be long enough to allow industry conditions and the operations of the firm to stabilize. By postponing the day of reckoning until after the future of the firm becomes clear, one can also be confident that the uncertainties of financial distress and the valuation difficulties it brings are not driving the market's assessment of the junior investor's claim.

Relative priority might prove costly if the simplicity of the reorganization process set the stage for advantage-taking after it was over. Once senior lenders become the equityholders of the firm, they have the ability to sell it. Like any sale, such a sale is a recognition event that accelerates call options. Senior lenders might trigger such a sale even if it was a fire sale.[121] Alternatively, they could extract value from the firm by awarding themselves dividends or spinning off subsidiaries.[122]

[120] When the loan comes to an end, the lender is entitled to insist on being paid. If she is paid, her rights are terminated. If she is not, she can choose to exercise her default rights. If she does exercise them, she force a sale of the assets that wipes out junior interests as well as her own. See U.C.C. 9-617(a)(3) (secured party's disposition of collateral after default discharges any subordinate security interest). If she does not exercise them, the status quo is preserved. The junior interests remain in place.

[121] For evidence that senior lenders sell firms suboptimally, see Kenneth M. Ayotte & Edward R. Morrison, Creditor Control in Chapter 11, 1 J. Legal Analysis 511, 518 (2009); LoPucki & Doherty, supra note **Error! Bookmark not defined.**, at 31–32.

[122] Modern corporate law places relatively few limits on the ability of a firm with no debt to issue dividends or repurchase stock. For a discussion of the limitations that do exist, see Edward B. Rock, Adapting to the New Shareholder-Centric Reality, 161 U. Pa. L. Rev. 1907, 1949 (2013) ("board may . . . repur-

In this postbankruptcy environment, there is no longer a bankruptcy judge to ensure that the sales procedure protects everyone's rights. There is room for strategic behavior if the senior investor is better informed than the market as a whole. The senior investor, for example, might know that the firm could be eventually sold for more than it is owed and the market did not yet recognize it. The senior investor could postpone such a sale until after the options had lapsed. The junior investors can protect themselves only if they both know what the firm is worth and possess sufficient liquidity to exercise the options before they expire.

It is important, however, not to overstate the possibility of misbehavior. Sales are comparatively easy to monitor.[123] As long as the equity is publicly traded, it should be possible to learn whether dividends are being made.[124] Moreover, the risk of fire sales is largely self-policing. Senior investors have every reason to be zealous in ensuring a sale price at least equal to the full amount they are owed. Up until that point, they enjoy a dollar for every additional dollar that the sale yields, and once they initiate a sensible sales process, competition between bidders may drive the price at which the firm is sold, more than their own efforts at the margin. The problem is in any event small as long as there is a market for the options and those holding the options have enough time to act before a sale is consummated. Those who hold the can either exercise them or, if they lack the liquidity, can sell them to someone else.

A rule that protects relative priority rights after the reorganization may not need to be that elaborate, at least if there is a short period of time after the reorganization is over in which sales and dividends are not permissible. One might craft special rules that protect the junior option holders. But once the market for the equity and the call option develops (perhaps after three months or so), it might be enough to make only

chase shares or pay dividends so long as total assets are greater than total liabilities plus capital").

123 Even though the directors will have been put in place by the senior lender, they will find it hard to keep a sale secret, given their duty to seek the highest bidder once the firm is going to be sold. See Revlon, Inc. v. MacAndrews & Forbes Holdings, 506 A.2d 173, 182 (Del. 1986).

124 Generally Accepted Accounting Principles require disclosure in the financial statements of "material related-party transactions." Accounting Standards Codification 850-10-50-1. This would include large distributions or dividends to directors or managers.

modest changes in existing director duties to protect the option holders.[125]

Implementing relative priority in this fashion distorts incentives in one other way. A capital structure in which so many out-of-the-money options exist for an extended period of time seems to create a mismatch between control rights and ownership rights. After the reorganization is over, the senior investors are in control of the firm, but they do not enjoy the entire upside. Once the senior investors improve the firm's fortunes sufficiently, the options will be in the money and the senior investors will be cashed out. Beyond a certain point, they are not compensated with greater returns for taking greater risks.[126] They may adopt inefficiently cautious strategies.

But these costs may not be large either. Creditors today exercise substantial control even though they are not the residual owners of the firm. During the equity receiverships, voting trusts put control of the firm in the hands of senior investors and returned it to junior investors only after things stabilized.[127] Venture capital investors typically have preferred stock and exert considerable control over those junior to them in the capital structure.[128] They too might be inclined to take actions that are in their own interests and contrary to those of the firm as a whole, but sophisticated parties bargain for these arrangements nevertheless.[129]

The old senior stakeholders are unlikely to have many opportunities to make decisions about running the firm that favor them at the expense of those junior to them.[130] Those in control of large publicly traded

125 As noted, directors already have a duty to obtain the highest price they can once they decide to put the firm on the auctioneer's block. See note **Error! Bookmark not defined.** supra. One can imagine a legal rule that gave option holders some forms of equitable relief to ensure that the old senior creditors maximized value when they tried to sell the firm.

126 The incentives of senior stakeholders are always skewed in this fashion. See Roe, supra note 12, at 542–43.

127 See Ripley, supra note 72, at 403–04 (1915).

128 See Kaplan & Strömberg, supra note 115.

129 See William W. Bratton & Michael L. Wachter, A Theory of Preferred Stock, 161 U. Pa. L. Rev. 1815, 1819 (2013).

130 In presenting his option-preservation mechanism designed to ensure the choice between going-concern sales and reorganizations is made efficiently, Casey discusses granting call options to junior creditors as a possible back-stop and argues, as here, that there are "a number of reasons to think that this prob-

firms rarely choose between strategies with radically different risk profiles. Rare is the firm that finds itself at a crossroads in which it must invest in either pizza ovens or fusion reactors. Even when such choices are made, they typically come from the initiative of the CEO rather than the board. Although the old senior creditors can pick the CEO, it is unlikely that they will pick a CEO by screening for the one whose risk profile best suits them. Picking a CEO is sufficiently hard that finding the executive who is best for the firm is almost always the only first-order concern.[131]

In short, it seems unlikely that the presence of out-of-the-money options would create large inefficiencies. Even if call options seriously interfered with the incentives of the senior lenders, the senior lenders have the ability and the incentive to fix the problem by buying the options themselves and returning to a more traditional all-equity capital structure. The price at which the call options trade puts the upper limit on their potential costs. They do not even need to buy all the options. They can ensure that the firm remains on its existing trajectory by buying the options necessary to ensure they remain in control. Buying a majority of the call options would necessarily be sufficient.[132] Control can often be gained with significantly less.[133]

Alternatively, during the reorganization, senior creditors can bargain with the junior creditors and propose a plan in which the juniors receive cash or some other consideration instead of call options.[134] Bargaining in the shadow of these options is easier than bargaining in the shadow of a full-blown valuation hearing. The junior stakeholders cannot demand more than the costs that the senior stakeholders would incur if they

lem [of inefficient incentives on the part of equityholders subject to call options] might be small in practice." See Casey, supra note 3, at 805.

131 For an exploration of these ideas, see Douglas G. Baird & Robert K. Rasmussen, The Prime Directive, 75 U. Cin. L. Rev. 921, 931–34 (2007).

132 If the senior stakeholders own the majority of the call options, then the remaining options, representing as they do a less-than-controlling interest in the firm, will never be sufficient to acquire control even if exercised.

133 For a discussion of what is required to become a controlling shareholder as a legal matter and examples where control was found when the largest shareholder owned less than 50%, see In re Crimson Exploration Inc. Stockholder Litig., 2014 WL 5449419, at *10 (Del. Ch. 2014).

134 The ABI Commission provides for cashing out call options as alternative to issuing them. See Am. Bankr. Institute, supra note 3, at 221.

simply walked away from the negotiations.[135] In any event, senior creditors cannot be made worse off by having the ability to negotiate with junior investors in addition to the option of giving them call options.

There are, however, at least two other obstacles that will make relative priority hard to implement, at least given the credit transactions and capital structures that we find today. First, it is too simple to equate the strike price of the option with the amount of debt that is outstanding. The strike price needs to include the entire amount that is owed the senior creditor.[136] This includes interest and other costs associated with the extension of credit. In the absence of a simple rule, calculating these amounts may itself prove costly. Many recent bankruptcy cases involve protracted disputes over interest rates and other rights to payment to which the senior creditor is entitled, such as make-whole premiums. [137]

More important, any justification for a relative priority regime must contend with structural priority. The assets of large firms are commonly dispersed among different corporate entities.[138] A key asset essential to the firm's survival as a going concern may be parked in a separate subsidiary, and this subsidiary has its own creditors. If this subsidiary is also insolvent, then in a regime of relative priority the parent (and, indirectly, creditors of the parent) has only a call option on the key asset. It has no

[135] The hold-out value that the junior investors receive can never be greater than the value of the exit option of the senior investors. See Alberto Dalmazzo, Outside Options in Bargaining Model with Decay in the Size of Cake, 40 Econ. Letters 417, 417 (1992) (modelling two-party bargaining with exit options). For a formal application of this principle to bankruptcy, see Douglas G. Baird & Randal C. Picker, A Simple Noncooperative Bargaining Model of Corporate Reorganizations, 20 J. Legal Stud. 311, 328–40 (1991).

[136] The secured claim includes "interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement." 11 U.S.C. §506(b). For a discussion, see Am. Bankr. Institute, supra note 3, at 223.

[137] Interest rate battles are a major point of conflict in modern reorganizations. See In re MPM Silicones, LLC, 2015 WL 2330761, at *8–9 (S.D.N.Y. 2015). The treatment of "make-whole" provisions is similarly a fiercely contested issue in modern reorganizations. In re School Specialty, Inc., 2013 WL 1838513 (Bankr. D. Del. 2013); In re Trico Marine Services, Inc., 450 Bankr. 474 (Bankr. D. Del. 2011).

[138] For a discussion of corporate structure and the implications for bankruptcy, see Anthony J. Casey, The New Corporate Web: Tailored Entity Partitions and Creditors' Selective Enforcement, 124 Yale L.J. 2680 (2015).

ability to direct how it is used. If this asset is essential to the operation of the firm as a whole, those running the parent need to control it. Merely having a call option without any control rights is not enough.

It is possible, in principle, to value both the asset in the subsidiary and the value of the option that the parents have in it and cash out the creditors of the subsidiary accordingly, but the need for such a valuation is a serious weakness. Indeed, some of the most expensive valuation battles in large Chapter 11s involve creditors with rights against different members of a corporate group. Creditors with rights against a subsidiary square off against creditors of the parent or another subsidiary.[139] If relative priority requires a valuation, it may trigger the same costly litigation and bargaining that absolute priority brings with it when a corporate group is involved.

One might argue that these complications that arise from structural priority make any return to relative priority a pipe dream. As long as one respects corporate form, any institutional investor who wants to opt out of relative priority can readily do so merely by insisting that the firm's assets be dropped into an operating subsidiary and requiring all other institutional debt be at the parent level.

But it is also possible to turn this argument on its head. To the extent that one believes that relative priority is in fact the regime that would naturally emerge from the creditors' bargain, the ability of creditors to opt out of the regime is not a problem. If relative priority is in fact desirable, they will not want to opt out. The opting out that exists today may be a consequence of the high costs of a reorganization regime committed to absolute priority.

The case for relative priority rests on the idea that it serves the interests of investors as a group. There is no reason to force it on investors in a particular firm if, under the circumstances in which they find themselves, they do not want it. Indeed, a regime that implements relative priority while at the same time respecting structural priority may provide the best of both worlds. Most institutional investors might prefer relative priority, while other investors want the ability to opt out of bankruptcy entirely. Structural priority, when it is respected, provides one set

[139] In re Adelphia Communications Corp., 368 Bankr. 140, 159 (Bankr. S.D.N.Y. 2007) (value divided among 250 corporate entities and various creditor groups so at loggerheads that a sale everyone thought optimal was almost derailed).

of investors with a strong form of absolute priority that may come with lower costs than under existing law. It gives creditors of a separate legal entity the ability to exit the bankruptcy process entirely.[140]

Capital structures are themselves endogenous to the priority regime that the law provides.[141] The capital structures that we see today, ones in which corporate groups are the norm,[142] may be a product of a reorganization regime that imposes absolute priority and the costs associated with it.

IV. Bargaining in the Shadow of Absolute Priority

Parties have the ability to avoid the costs of a full-blown judicial valuation through negotiations. Indeed, much of the reorganization process consists of these negotiations. But these negotiations are themselves costly. Moreover, bargaining in anticipation of a judicial valuation itself introduces distortions. The fog and uncertainty of financial distress allows some creditors to manipulate the process to capture value from others.

Whatever benefits absolute priority brings as a matter of theory may be lost in a regime that implements absolute priority with a judicial valuation. Modern Chapter 11's commitment to bargaining in the shadow of a nonmarket valuation is, at some level, inconsistent with its commitment to absolute priority. Bargaining that is done in the shadow of a judicial process committed to absolute priority results in systematic departures from absolute priority, even if judges are themselves unbiased and completely committed to respecting it.

A. Valuation Variance, Nonmarket Valuations, and Absolute Priority

The first obstacle to implementing absolute priority in a nonmarket environment arises from the asymmetrical positions of senior and junior lenders. Assume that a senior investor is owed \$100 and the firm is worth exactly \$100. Both the senior and junior investors have this information, but the judge does not. The judge will make an unbiased val-

140 See Douglas G. Baird & Anthony J. Casey, No Exit? Withdrawal Rights and the Law of Corporate Reorganizations, 113 Colum. L. Rev. 1, 29 (2013).

141 See Casey, supra note 138, at 2683 (firms tailor legal partition to create a precise structure).

142 See Casey, supra note 138, at 2682 ("firms regularly separate assets and place them in different legal entities to create value").

uation, but her valuation will have greater variance than that of the parties themselves. Half the time, she will find the firm is worth $110; half the time, she will find it is worth $90.

Under the absolute priority rule, the senior creditor is entitled to the entire firm. Absolute priority requires that the senior creditor receives in expectation $100. But bargaining in the shadow of an unbiased, but uncertain judicial valuation does not produce this result. When the senior lender and junior lender strike a bargain with each other, the senior lender will likely be willing to take less than $100.

If the judge finds that the firm is worth $90, which she will do half the time, she will give the entire firm to the senior lender. The judge has made an error, but no one is worse off. The senior lender will still receive what she would receive if absolute priority were implemented perfectly (something worth $100) and the junior creditor will still receive nothing. But errors in the other direction are not equally benign. Half the time the judge will find that the firm is worth $110. When this happens, the judge's error will lead her to award the junior creditor something and the senior creditor will end up with less than $100. This benefit the junior creditor enjoys when the judge overvalues the firm is not offset by any corresponding loss when she undervalues it.

This phenomenon of valuation variance is pervasive. Bargaining in Chapter 11 generates relative priority outcomes, even in the face of a judge's unflinching commitment to absolute priority. Junior investors are likely to enjoy option value from the variance associated with the valuation.[143] The uncertainty associated with the valuation leads senior lenders to accept less than what they would receive if the firm could be sold at the valuation that the parties themselves expect the court to place on the firm.[144]

[143] Junior creditors, however, do not always benefit from valuation variance. As Bo Huang shows, if the bankruptcy judge overvalues the firm and the junior investor receives a stake in the firm instead of cash, the junior investor is being paid in a diluted currency. It is even possible that in some cases the dilution effect dominates. Valuation variance, at least in theory, might favor senior creditors. See Huang, Bo, Absolute Priority Rule and Option Theory (Sept. 19 2011), available at http://dx.doi.org/10.2139/ssrn.1930404.

[144] This idea of valuation variance is explored in Baird & Bernstein, supra note 14, at 1955–57 (2006).

Both junior and senior creditors will take account of this departure from absolute priority in their negotiations. Valuation variance itself creates option value, and this option value will be cashed out in any deal they strike. Moreover, there are ways to correct for this bias. The junior creditor can be forced to give the senior creditor a put option, for example.[145] But such complications come at significant cost.

As it stands, Chapter 11 captures whatever ex ante benefits absolute priority brings only to the extent that what the senior creditor loses under relative priority is systematically greater than what she loses under absolute priority by virtue of valuation variance. The magnitude of this difference under existing law is not clear.[146] It is not self-evident that the former is even greater than the latter.[147] Valuation variance limits the ex-ante efficiency benefits of absolute priority over relative priority.[148]

145 Bo Huang was the first to show how put options can correct the distortion to absolute priority brought about by bargaining in the shadow of a judicial valuation. He also provides a formal proof. See Huang, supra note 143.

146 See Huang, supra note 143.

147 The variance that produces option value in a regime of relative priority is different from the variance that produces the option value when parties bargain in the shadow of absolute priority. In the case of relative priority, option value reflects the variance in expected future cashflows of the firm. In the second, it is variance in the judicial valuation. The two are not necessarily the same.

Assume that the senior creditor is owed $100 and Firm's only asset is a lottery ticket with a one-in-ten chance of paying $1,000 when the drawing takes place next year. The option value of the junior creditor's interest by virtue of its stake in Firm is worth $90 (reflecting a one-in-ten chance of the ticket proving a winner and leaving $900 after the senior creditor is paid). But there is no valuation variance. The ticket has a market value of $100, and this information is readily accessible to the judge.

In contrast, assume that the senior creditor is owed $100 and that Firm consists of a black box filled with $100 in cash. The investors know this amount, but the judge does not. Because the judge is as likely to find Firm is worth more than $100 as she is to find it is worth less, the junior creditor can strike a settlement for a positive amount, even though she and the senior creditor both know her junior stake in Firm has no option value. See Baird & Bernstein, supra note 14, at 1957–58.

148 See Douglas G. Baird & Anthony J. Casey, Bankruptcy Step Zero, 2012 S. Ct. Rev. 203, 214 (2013) (valuation variance alone may give the debtor an ability to capture value).

B. Nonmarket Valuations and Strategic Behavior

Rules are needed to police the strategic behavior that arises from the ability of parties to exploit information that they possess, but that the judge does not. These rules are themselves costly to implement and lead to reorganization plans that are themselves inefficient. Moreover, a rule designed to ensure that absolute priority is observed with respect to one party may increase the risk of undercutting the priority right of someone else.

Many of Chapter 11's most complicated rules are designed to prevent junior investors from exploiting the judge's inability to value the firm with precision.[149] For example, the plan must give senior creditors senior securities.[150] A plan cannot be confirmed over a senior creditor's objection if it gives the senior creditor unsecured notes or equity.[151] By giving the old senior creditor senior securities, it will be entitled to be paid first. This offers some protection when the firm is undervalued because the value of the firm flows in the first instance to the senior creditor. This protection for the senior creditor comes at a cost, however. By insisting that senior creditors receive senior debt, the Bankruptcy Code induces reorganized firms to leave Chapter 11 with too much debt in their capital structure. This in turn increases the chance that the firm will fail again and there will be another costly reorganization.[152]

Let us assume that the firm is worth \$100 and the senior creditor is owed \$100, but the bankruptcy judge erroneously thinks the firm is worth \$120. The senior creditor will receive a note for \$100. The note

[149] This observation that many of Chapter 11's rules are designed to prevent the undervaluation of secured claims is explored in Anthony Sexton, Indubitably Uncertain: *Philadelphia Newspapers* and the Role of Valuation Uncertainty in Attempted Cramdown of All-Equity Plans, 28 Emory Bankr. Dev. J. 55, 55 (2011).

[150] See Consol. Rock Prods. v. Du Bois, 312 U.S. 510, 528–29 (1941).

[151] 11 U.S.C. §1129(b)(2)(A).

[152] This phenomenon of "Chapter 22s" is a familiar one. Recent examples include Patriot Coal and Revel Casinos. Many of these arise because of the capital structure the firm has on exiting the first Chapter 11. See Edward I. Altman, Revisiting the Recidivism-Chapter 22 Phenomenon in the U.S. Bankruptcy System, 8 Brook. J. Corp. Fin. & Com. L. 253 (2014) (large proportion of debtors filing a subsequent bankruptcy petition had a significantly worse financial profile upon emergence from the initial filing than those emerging as going concerns and not filing again).

will not be worth $100. It will come with an artificially low interest rate. The judge's erroneous belief that there is a $20 equity cushion will lead her to set an artificially low interest rate. Nevertheless, the note should still be worth more than $80, which is value of the equity that the senior lender would receive if she lacked the right to demand a senior security.[153]

Many of Chapter 11's other rules are similarly designed to prevent junior investors from low-balling senior investors. Secured creditors are able to waive their deficiency claims and insist on a stream of payments equal, in nominal terms, to the face amount of the debt.[154] Secured creditors are entitled to press deficiency claims even if, outside of bankruptcy, they are nonrecourse creditors.[155] But this expansion of the secured creditor's rights protects against undercompensation only by introducing the risk of overcompensation.

Other rules aimed at protecting senior creditors invite strategic behavior on the part of junior investors. For example, at least one impaired class must accept the plan.[156] This rule induces plan proponents to manipulate classes to pass this hurdle.[157] These manipulations both generate costly litigation and lead to distortions of their own. (For example, the plan proponent must ensure that enough is given to the gerrymandered class of junior creditors so that they support the plan. This itself introduces the risk of overcompensating them.)

[153] The judge believes the firm is worth $120 and the senior creditor is owed $100. Hence, she would award the senior creditor 80 percent of the equity. Because the firm is worth only $100, the senior creditor's share would trade for $80. It is possible to come up with hypotheticals in which the equity would be more valuable than the senior security. They crucially depend upon the judge overestimating the value of the firm and the likelihood of default. One would, for example, rather have 80 percent of the value of the firm rather than a note that paid $100 if the bankruptcy judge mistakenly thought that the note would be paid with certainty when the firm's only asset were a lottery ticket that paid $1000 one time in ten. Eighty percent of the equity is still worth $80, but the note is worth only $10. (Because the bankruptcy judge believes the firm to be riskless, the senior creditor would not be given any risk premium.)

[154] This is the combined effect of the §1111(b) election and the treatment of a dissenting class of secured creditors under §1129(b)(2)(A).

[155] 11 U.S.C. §1111(b).

[156] 11 U.S.C. §1129(a)(10).

[157] See In re Village at Camp Bowie, 710 F.3d 239 (5th Cir. 2013).

C. Upward Departures from Absolute Priority

It is commonly thought that Chapter 11's nonmarket valuation mechanism systematically undercompensates senior creditors.[158] Academics typically assume deviations from absolute priority run in only one direction.[159] In modern practice, however, overcompensation of senior creditors is the bigger problem. Chapter 11 provides few rules to protect junior investors against attempts by senior creditors to capture more than that to which the absolute priority rule entitles them. The drafters thought such protections unnecessary as they did not envision that the senior creditor would gain control of the case, as they have in recent years.[160] The Bankruptcy Code does not even explicitly prohibit plans that pay senior creditors more than 100 cents on the dollar.[161]

Rules aimed at protecting senior creditors often provide a channel that allows senior creditors to take control of the process. For example, to ensure that junior creditors do not gamble with the senior creditor's money, the Bankruptcy Code provides that the nonbankruptcy rights of the senior creditor must be "adequately protected."[162] It also imposes strong limits on the ability of the debtor to borrow and give new lenders security interests that prime the senior lender.[163]

The effect of these two provisions ensures that, as a practical matter, the senior lender is often the only viable source of financing during the case.[164] Hence, she is free to insist on control rights as a condition of

[158] See, e.g., Arturo Bris, Alan Schwartz, & Ivo Welch, Who Should Pay for Bankruptcy Costs, 34 J. Leg. Stud. 295, 296 (2005) (suggesting junior creditors spend resources capturing value from seniors in violation of absolute priority).

[159] See id.

[160] See Miller, supra note 36, at 385 (Chapter 11 process, as contemplated in 1978, has been overwhelmed by marginalization of the debtor-in-possession and expansion of secured creditor control).

[161] See 11 U.S.C. §1129(b)(2).

[162] See 11 U.S.C. §362(d)(1) (providing the absence of adequate protection is grounds for lifting the automatic stay).

[163] See 11 U.S.C. §364.

[164] Kenneth N. Klee & Richard Levin, Rethinking Chapter 11, 21 Norton J. Bankr. L. & Prac. 5 (2012) ("Due to the prevalence of companies granting lenders blanket liens over all their assets, prepetition secured lenders more often than not end up being the only lenders willing to provide postpetition financing to debtors. Postpetition financing proposals often come with onerous terms that result in the debtor losing the ability to control the course of the

providing the financing.[165] These control rights include milestones that the debtor must meet in order to maintain its credit line. A milestone might require the debtor to confirm a plan or consummate a sale within a prescribed period of time. A failure to meet a milestone is a default that allows the senior lender to seize the firm's assets. The senior lender can waive these milestones if they are not met, but their presence allows the senior lender to dictate how the reorganization process unfolds and the sorts of plans that are introduced.[166]

Bankruptcy judges will not approve plans that give senior creditors more cash than they are owed, but there are many ways secured creditors can persuade the debtor to overcompensate them that are hard to detect. If the plan undervalues the firm and puts its value at less than what the senior creditors are owed, the senior creditors can capture the entire value of the firm even when it is worth more than they are owed. Similarly, senior creditors can settle challenges to their liens for less than their expected value.

The bankruptcy judge, of course, tries to be on guard against plans that give senior creditors too large a share. In principle, she will not confirm a plan that gives all the equity of the firm to a senior creditor unless the firm is worth less than what the senior creditor is owed. But the judge needs sufficient information to do this. She depends upon other

chapter 11 case and providing lenders with benefits they would not otherwise be entitled to outside of chapter 11.").

165 See Harvey R. Miller, Shai Y. Waisman, Does Chapter 11 Reorganization Remain A Viable Option for Distressed Businesses for the Twenty-First Century?, 78 Am. Bankr. L.J. 153, 185 (2004) ("[S]uch provisions can permeate and control every facet of a debtor's operations.").

166 For example, in the Molycorp reorganization, the judge's decision granting a dip financing motion reduced the value of junior creditors in half, a drop in value of over $50 million. See Molycorp 10%s Test Single Digits as Mountain Pass Security Dwindles with Oaktree DIP, Reorg Research (July 6, 2015). In the abstract, it is not possible to tell whether the decision brings the parties closer to their substantive entitlements under the absolute priority rule, but it does underscore that a decision that nominally affects only the bankruptcy process and does not affect any substantive rights in fact can have substantial distributional consequences.

interested parties to ensure that she has the relevant information or that at least she is in a position to draw inferences from silence.[167]

Senior creditors have discovered ways to keep the bankruptcy judge in the dark. For example, the senior creditor can use its control rights to accelerate the process and limit the amount of information that flows to the judge.[168] Alternatively, she can bargain strategically with those (such as the existing managers) who might otherwise vindicate the rights of others.[169] Bankruptcy judges, of course, try to limit such misbehavior.[170] Indeed, controlling such misbehavior is a large part of what bankruptcy judges do in Chapter 11. But there are limits to the amount of control they can exercise over the process.[171]

V. The Evolution of Chapter 11

Over time, the dual commitment to absolute priority and nonmarket valuations has become harder to maintain. In the first two decades after the enactment of the Bankruptcy Code, well-established norms provided

167 See Paul Milgrom & John Roberts, Relying on the Information of Interested Parties, 17 Rand J. Econ. 18, 19 (1986).

168 See Jacoby & Janger, supra note 98, at 895 ("[B]ankruptcy court has no more information than the informationally disadvantaged claimants. Consequently, the melting ice cube argument places the estate at the mercy of the sale's advocates.").

169 The senior creditor can try to persuade the plan proponent through "gifting." The "gift" can be anything of value given to gain cooperation. For example, the secured creditor, in return for having a plan quickly approved to here liking, might agree to continue to employ the former CEO even though there is no expectation that the former CEO do any work. See, e.g., In re Bush Industries, Inc., 315 Bankr. 292, 305 (Bankr. W.D.N.Y. 2004) (court finds plan filed in bad faith because of employment contract with CEO who has already left the company and moved to Florida).

170 DISH Network Corp. v. DBSD North America, Inc., 634 F.3d 79, 100 (2d Cir. 2010) (prohibiting a plan that provides for a "gift" to a junior class because of possibility of "serious mischief between senior creditors and existing shareholders").

171 See, e.g., Official Committee of Unsecured Creditors v. CIT Group/Business Inc. (In re Jevic Holding Corp.), 787 F.3d 173, 177 (3d Cir. 2015) (allowing a "gift" that served to end the case on the ground that no other alternatives existed that would give value to anyone other than the senior creditors).

focal points for the bargaining.[172] Many possible deals might exist, but the players gravitated towards only a few.[173] But in recent years, the bargaining process became harder.

Dramatic changes in the reorganization landscape over the last two decades have made manifest the dangers of an unwavering commitment to absolute priority. A new set of players now occupies the bankruptcy stage, and they have brought increasingly expensive fights over priority that would be unnecessary under a relative priority regime. Trading in claims is now ubiquitous and many of the players in large reorganization today are professionals who specialize in trying to promote their positions at the expense of others.[174] Today their positions are large enough that they willingly and rationally spend millions or tens of millions to increase their share.[175] Different classes of creditors as well as those holding blocking positions within a class exploit weaknesses within existing rules to expand their shares at the expense of others.[176] Forming coalitions that avoid a full-blown cramdown hearing has become harder.[177] These changes compound the difficulties of strict adherence to absolute priority.

Proposing sensible reforms in this environment best begins by recognizing that religious adherence to any particular system of priority is a mistake. It costs too much and compromises other values. The debate should shift from the question of how to find a bankruptcy mechanism that best vindicates the absolute priority rule to the question of identify-

[172] See Huebner & Tisdell, supra note 41, at 78.

[173] Many years ago there was a particular creditor's lawyer in the garment trade who always stood on principle—and his principle was 50 cents on the dollar.

[174] See Miller, supra note 36, at 394 (hedge funds described as often destructive and instigators of litigation). One should be careful however, there is some empirical evidence that the presence of an activist hedge fund is utility-enhancing. See Wei Jiang, Kai Li & Wei Wang, Hedge Funds in Chapter 11, 67 J. Fin. 513, 540 (2012).

[175] See Bishop, supra note 86 (fees of a second-lien holder in a single case exceed $100 million).

[176] See Baird & Rasmussen, supra note 40, at 691.

[177] See Harvey R. Miller & Shai Y. Waisman, Does Chapter 11 Reorganization Remain a Viable Option for Distressed Businesses for the Twenty-First Century?, 78 Am. Bankr. L.J. 153, 181 (2004).

ing the priority rule that minimizes the costs of bankruptcy itself.[178] Whether a priority rule helps to implement a successful plan at reasonable cost is a better point of focus than debating which priority rule provides the best set of ex ante incentives.

We have long become accustomed to thinking that our bankruptcy regime has rejected relative priority.[179] But this has not been true on the ground. The Bankruptcy Code itself recognizes the option value of junior creditors if their options come into the money by the time the plan of reorganization is confirmed.[180] The time of confirmation, not the time the petition is filed, is the moment of reckoning in Chapter 11.

Out-of-the-money junior creditors often receive some form of rain check, at least if they agree to support a plan of reorganization.[181] Giving options to junior out-of-the-money creditors is a common way to resolve the tensions that absolute priority brings.[182] Junior creditors end up enjoying a payoff for the option value of their claim in part because of the valuation variance that arises from the uncertainty of a judicial valuation.[183] In all events, the idea that junior creditors end up with options is not at all alien to modern practice.[184]

178 See, e.g., Anthony J. Casey & Edward R. Morrison, Beyond Options (2015) (unpublished manuscript).

179 See, e.g., Bris, Schwartz & Welch, supra note 158, at 300 n.6.

180 See 11 U.S.C. §1129(b)(2) (requiring valuations at the time of the reorganization, rather than at the time the petition is filed).

181 It is common, however, for plans to provide for worse treatment if junior creditors as a group reject the plan. There was such a "death trap" in *ResCap*. The junior noteholders rejected a plan that, had they accepted it, would have paid them the principal amount of their claim in full. Because they rejected the plan, they receive a note in lieu of cash at a rate that was substantially below market. They chose to risk receiving less because of the prospect of persuading the bankruptcy judge to reject the plan on the ground that they were entitled to interest as well as principal. They spent tens of millions in pursuit of this goal and failed.

182 Warrants are a common feature of securities issued in large Chapter 11 reorganizations. See Eric Nierenberg, Stock Warrants and Bankruptcy Restructuring Efficiency (Nov. 11, 2005) (unpublished manuscript).

183 See Bernstein & Baird, supra note 144.

184 See, e.g., In re Young Broadcasting, Inc, 430 Bankr. 99, 109 (Bankr. S.D.N.Y. 2010) (approval of a plan in which junior creditors receive warrants). Casey provides additional examples of junior investors receiving options. See Casey, supra note 3, at 803.

The existing priority system is an uneasy compromise between absolute and relative priority. Senior lenders, in return for enjoying a continuing stake in the firm rather than the proceeds of a foreclosure sale, recognize the option rights of the junior investors until the reorganization is over. Recent calls for bankruptcy reform, both from the academy and practitioners, reflect the tug of relative priority.[185] The time to confront the huge costs of implementing absolute priority is long overdue.

[185] See, e.g., Casey, supra note 3; Commission Report, supra note 3, at 207–24.