THE UNEASY CASE FOR THE PRIORITY OF SECURED CLAIMS IN BANKRUPTCY: FURTHER THOUGHTS AND A REPLY TO CRITICS

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INTRODUCTION

A longstanding and basic principle of U.S. bankruptcy law is that a secured creditor is entitled to receive the entire amount of its secured claim—the portion of its bankruptcy claim that is backed by collateral—before any unsecured claims are paid.[1] This principle of full priority[2] is generally reflected in the provisions of the U.S. Bankruptcy Code,[3] although, as is widely recognized, there are a number of rules, doctrines, and practices that have the effect of eroding the priority of secured claims in bankruptcy.[4] Until recently, there has been a general consensus among economists and legal scholars that secured claims should be given full priority in bankruptcy because full priority promotes desirable contracting between borrowers and their creditors.[5] As a result, the rules, doctrines, and practices that cause

[1] We follow the U.S. Bankruptcy Code in using the term "secured claim" to refer to the portion of a creditor's bankruptcy claim that is fully backed by collateral, and the term "unsecured claim" to refer to the portion of a creditor's claim that is not backed by any collateral. 11 U.S.C. § 506(a) (1994).

[2] This Article uses the term "full priority" to mean that, in bankruptcy, a secured creditor has 100% priority in its collateral over the claims of unsecured creditors. The term "unsecured creditors" refers to unsecured creditors that have not explicitly consented to subordination.

[3] The principle that secured claims are to be paid in full before any unsecured claims are paid is embodied in the "adequate protection" provisions of the U.S. Bankruptcy Code. 11 U.S.C. §§ 362-364. The principle of full priority is also reflected in the bankruptcy systems of many other countries. *See generally* DENNIS CAMPBELL, INTERNATIONAL CORPORATE INSOLVENCY LAW (1992) (surveying national insolvency and bankruptcy laws of more than twenty countries). However, an increasing number of foreign bankruptcy systems provide secured creditors with only partial priority in their collateral over the claims of unsecured creditors. *See infra* note 39 and accompanying text.

[4] *See infra* Part I.D.

[5] Those writing from an economic perspective have generally operated under the premise that full priority yields efficiency benefits and should be respected in bankruptcy. Much of the scholarly work has focused on what those efficiency benefits might be. Contributions to this literature include Barry E. Adler, *An Equity-Agency Solution to the Bankruptcy-Priority Puzzle*, 22 J. LEGAL STUD. 73 (1993); F.H. Buckley, *The Bankruptcy Priority Puzzle*, 72 VA. L. REV. 1393 (1986); David Gray Carlson, *On the Efficiency of Secured Lending*, 80 VA. L. REV. 2179 (1994); Jochen Drukarczyk, *Secured Debt, Bankruptcy, and the Creditors' Bargain*

deviations from full priority in bankruptcy have come under considerable criticism.[6]

In an article published last year in the *Yale Law Journal* entitled *The Uneasy Case for the Priority of Secured Claims in Bankruptcy* ("*The Uneasy Case*"),[7] we presented a detailed analysis of the economic costs that arise from according full priority to secured claims in bankruptcy.[8] One of the main contributions of the article was to show that full priority could give rise to inefficient contracting[9] between a bor-

Model, 11 INT'L REV. L. & ECON. 203 (1991); Thomas H. Jackson & Anthony T. Kronman, *Secured Financing and Priority Among Creditors*, 88 YALE L.J. 1143 (1979); Alex M. Johnson, Jr., *Adding Another Piece to the Financing Puzzle: The Role of Real Property Secured Debt*, 24 LOY. L.A. L. REV. 335 (1991); Hideki Kanda & Saul Levmore, *Explaining Creditor Priorities*, 80 VA. L. REV. 2103 (1994); Saul Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 YALE L.J. 49 (1982); Randal C. Picker, *Security Interests, Misbehavior, and Common Pools*, 59 U. CHI. L. REV. 645 (1992); Alan Schwartz, *A Theory of Loan Priorities*, 18 J. LEGAL STUD. 209 (1989) [hereinafter Schwartz *(1989)*]; Alan Schwartz, *Security Interests and Bankruptcy Priorities: A Review of Current Theories*, 10 J. LEGAL STUD. 1 (1981); Alan Schwartz, *Taking the Analysis of Security Seriously*, 80 VA. L. REV. 2073 (1994) [hereinafter Schwartz, *(1994)*]; Alan Schwartz, *The Continuing Puzzle of Secured Debt*, 37 VAND. L. REV. 1051 (1984); Robert E. Scott, *A Relational Theory of Secured Financing*, 86 COLUM. L. REV. 901 (1986); Paul M. Shupack, *Solving the Puzzle of Secured Transactions*, 41 RUTGERS L. REV. 1067 (1989); Clifford W. Smith & Jerold B. Warner, *Bankruptcy, Secured Debt, and Optimal Capital Structure: Comment*, 34 J. FIN. 247 (1979); René M. Stulz & Herb Johnson, *An Analysis of Secured Debt*, 14 J. FIN. ECON. 501 (1985); George G. Triantis, *Secured Debt Under Conditions of Imperfect Information*, 21 J. LEGAL STUD. 225 (1992); Lawrence A. Weiss, *Bankruptcy Resolution: Direct Costs and Violation of Priority of Claims*, 27 J. FIN. ECON. 285 (1990); James J. White, *Efficiency Justifications for Personal Property Security*, 37 VAND. L. REV. 473 (1984) [hereinafter White, *Efficiency*]. For a good recent survey of the law-and-economics literature, see Barry E. Adler, *Secured Credit Contracts, in* THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW (forthcoming 1997). The view that full priority is socially desirable is shared by many commentators writing outside of the law-and-economics literature. *See, e.g.*, Steven L. Harris & Charles W. Mooney, Jr., *A Property-Based Theory of Security Interests: Taking Debtors' Choices Seriously*, 80 VA. L. REV. 2021 (1994) (claiming that full priority is required by freedom-of-contract and property-rights principles); Homer Kripke, *Law and Economics: Measuring the Economic Efficiency of Commercial Law in a Vacuum of Fact*, 133 U. PA. L. REV. 929 (1985) (arguing that full priority increases supply of credit); James J. White, *Work and Play in Revising Article 9*, 80 VA. L. REV. 2089 (1994) (asserting that widespread and longstanding use of security interests demonstrates their social desirability).

[6] *See, e.g.*, Jeffrey S. Turner, *The Broad Scope of Revised Article 9 Is Justified*, 50 CONSUMER FIN. L.Q. REP. 328 (1996); Weiss, *supra* note 5, at 299-300 (discussing effects of violation of priority); James J. White, *The Recent Erosion of the Secured Creditor's Rights Through Cases, Rules and Statutory Changes in Bankruptcy Law*, 53 MISS. L.J. 384 (1983).

[7] Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857 (1996).

[8] For a more informal discussion of the costs of full priority, see Jesse M. Fried, *Taking the Economic Costs of Priority Seriously*, 51 CONSUMER FIN. L.Q. REP. (forthcoming Fall 1997).

[9] In *The Uneasy Case* and this Article, we use the standard Kaldor-Hicks definition of economic efficiency. Bebchuk & Fried, *supra* note 7, at 863-64. Under this definition, an arrangement, activity, or rule is efficient to the extent that it maximizes total social wealth (even if the arrangement, activity, or rule reduces the wealth of some parties). *See* Jules L. Coleman, *Efficiency, Utility, and Wealth Maximization*, 8 HOFSTRA L. REV. 509, 513-14 (1980). An "efficiency benefit" increases total social wealth while an "efficiency cost" decreases total social wealth.

rower and its creditors, and to several types of efficiency costs, even in a world where all of the borrower's creditors are voluntary and sophisticated. We also presented two partial-priority rules that could reduce the inefficiencies we identified (one of which could, in principle, eliminate them).[10] We suggested that the two rules of partial priority be considered as possible alternatives to the principle of full priority and the ad hoc system of partial priority that currently governs the treatment of secured claims in bankruptcy.

In writing this Article we have two aims. First, our analysis in *The Uneasy Case* has attracted various reactions from the contributors to this Symposium and others,[11] and we wish to address the objections that have been raised. Second, we wish in the Article to develop further some of the main elements of the analysis in *The Uneasy Case*.

The four main arguments that have been raised against our analysis—and to which we respond in this Article—appear to be as follows: (1) that full priority is required by fundamental principles of contract and property law (and therefore, a rule of partial priority would be inconsistent with these principles); (2) that the economic costs of full priority are lower than we suggest; (3) that even if the economic costs of full priority are high, the costs associated with a partial-priority rule, such as the ones we consider, would be even higher (in particular, a partial-priority rule would reduce financing for desirable activities, resulting in an economic cost that would far outweigh any benefits); and (4) that parties could circumvent the partial-priority rules we put forward, and, therefore, that adoption of these rules would have little beneficial effect. Critics suggest two ways in which borrowers and their lenders could circumvent a rule of partial priority in bankruptcy: (a) through the use of arrangements that have the same effect as a security interest under full priority but which would be beyond the reach of a partial-priority rule; and (b) by the secured creditor recovering its collateral outside of, or prior to, bankruptcy.

The analysis of this Article is organized as follows. We begin in Part I by explaining why the issue of priority should be considered with an open mind. To that end, Part I first offers a set of intuitions as to why, in contrast to the views expressed by our critics, full priority is

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[10] Bebchuk & Fried, *supra* note 7, at 904-11.

[11] *See, e.g.*, Steven L. Harris & Charles W. Mooney, Jr., *Measuring the Social Costs and Benefits and Identifying the Victims of Subordinating Security Interests in Bankruptcy*, 82 CORNELL L. REV. 1349, 1353-54, 1361-64, 1369 (1997); Lynn M. LoPucki, *Should the Secured Credit Carve Out Apply Only in Bankruptcy? A Systems/Strategic Analysis*, 82 CORNELL L. REV. 1483, 1495-1509 (1997); Ronald J. Mann, *The First Shall Be Last: A Contextual Argument for Abandoning Temporal Rules of Lien Priority*, 75 TEX. L. REV. 11, 45-49 (1996). Steven L. Schwarcz is currently in the process of writing an extensive critique of *The Uneasy Case*. Steven L. Schwarcz, *The Easy Case for the Priority of Secured Claims in Bankruptcy*, 47 DUKE L.J. (forthcoming Dec. 1997). Because Schwarcz's article will be finalized only after publication of this Symposium issue, we must defer a full response to some future occasion.

not required by (and in some cases is inconsistent with) important principles of contract, property, and insolvency law. Part I then discusses two important implications of the fact that the current system is one of de facto partial priority. The first is that a formal rule of partial priority would not necessarily be a radical change. The second is that those who defend full priority by arguing that the existing system works well are, in fact, providing evidence in support of partial priority.

Parts II and III further develop our claim that full priority can produce significant efficiency costs and respond in detail to criticisms of this claim. Part II focuses on the excessive use of security interests that results from full priority, and Part III describes the other types of efficiency costs associated with full priority.

Part IV describes three partial-priority rules that should be considered as alternatives to full priority and the current system of de facto partial priority. In addition to the two partial-priority rules that we considered in *The Uneasy Case*, we offer a third partial-priority rule for consideration: giving a secured creditor priority in its collateral in bankruptcy only over the claims of unsecured creditors that have explicitly consented to be subordinated.

After describing how partial priority might be implemented, we turn to the third and fourth objections that critics of our analysis have raised. Part V addresses the objection that partial-priority rules such as the ones we present would reduce the availability of financing for desirable investments. Part VI addresses the objection that creditors can circumvent a partial-priority rule (a) by the use of alternative arrangements which operate like security interests under full priority but which would be beyond the reach of the rule; and (b) by secured creditors recovering their collateral outside of, or prior to, bankruptcy.

Finally, before concluding, Part VII remarks on how our analysis relates to the current controversies over the revision of Article 9 and the "Carve-Out proposal."[12]

I
PRELIMINARY OBSERVATIONS AND INITIAL INTUITIONS

There is a commonly held view, expressed by some participants at the Symposium, that full priority is required by freedom-of-contract and property-rights considerations. Indeed, many people think of a "security interest" as a device that, *by definition*, gives the secured

[12] *See* Memorandum from Elizabeth Warren to the Council of the American Law Institute (Apr. 25, 1996) (on file with the authors) (proposing Article 9 set aside for unsecured creditors).

lender full priority in the collateral over the claims of all third parties, including unsecured creditors.[13] To people accustomed to this way of thinking, the notion of a rule that gives secured creditors only partial priority over the claims of unsecured creditors in bankruptcy may initially appear puzzling. Therefore, we wish to start our analysis by offering a set of intuitive reasons why the issue of priority should be approached with an open mind.[14]

A "security interest" is simply a legal arrangement that gives the borrower, the lender, and third parties certain rights which are specified by law. And although historically those rights in the United States generally have included the secured lender's right to full priority in the underlying collateral, we explain below that no legal principle requires secured lenders to have full priority over unsecured creditors' claims in bankruptcy. Nor is full priority required by economic considerations: in practice, secured creditors in the United States already do not have full priority in bankruptcy, and many other countries have adopted rules that explicitly give secured creditors only partial priority in bankruptcy.[15] Indeed, the next two Parts explain why it might be economically desirable to deny secured creditors full priority in their collateral in bankruptcy.

Section A explains that, notwithstanding its long history, full priority is actually inconsistent with an important general principle of commercial law: that a borrower may not subordinate one creditor's claim to that of another without the consent of the subordinated creditor. Section B explains why full priority is not required by freedom-of-contract considerations. Section C explains in turn why full priority is not required by property-rights considerations. Section D points out that our system is already one of de facto partial priority, which has two important implications. First, adopting a formal rule of partial priority would not necessarily be such a radical change. Second, claims that the existing system works well actually support the case for partial priority, not full priority. Section E summarizes the arguments for why the issue of priority should be approached with an open mind.

A. Full Priority Is Inconsistent with the General Principle Against Nonconsensual Subordination

Because most firms entering bankruptcy are insolvent, the value available is generally insufficient to pay every claim in full. An impor-

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[13] *See* William J. Woodward, Jr., *The Realist and Secured Credit: Grant Gilmore, Common-Law Courts, and the Article 9 Reform Process*, 82 CORNELL L. REV. 1511, 1511 (1997) (observing that "[o]ne of the central, defining features of secured debt is its priority").

[14] The discussion draws on, and further develops, material in Bebchuk & Fried, *supra* note 7, at 868-72, 931-34.

[15] *See infra* note 39 and accompanying text.

tant purpose of the bankruptcy system is to determine the proper distribution of that value. Under the bankruptcy systems of the United States and many other countries, pro rata sharing is the general rule.[16] That is, any value that remains after secured claims have been paid in full is divided pro rata among those with unsecured claims.[17] In the absence of secured claims, all of the value of the bankruptcy estate is distributed on a pro rata basis.

A fundamental principle of bankruptcy law is that, once a statutorily-created scheme for allocating a debtor's bankruptcy value among its creditors is in place, the borrower may not circumvent that scheme by transferring one creditor's bankruptcy allocation to another party without the former's consent. For example, unsecured creditor *C1* may not contract with the borrower for its claim to have priority in bankruptcy over that of another unsecured creditor *C2*.[18] The law also does not allow the borrower to contract with unsecured creditor *C1* to provide it with preferential payments on the eve of bankruptcy.[19] Were the borrower to contract with creditor *C1* for priority over creditor *C2* in bankruptcy, or for preferential payments outside of bankruptcy, the contract would be completely disregarded if the borrower ever entered bankruptcy.[20] Indeed, the only way for creditor *C1* to subordinate creditor *C2*'s claim is by negotiating a subordination agreement with creditor *C2* under which creditor *C2* promises to pay creditor *C1* as much of what creditor *C2* receives in bankruptcy as is necessary to make creditor *C1* whole. Such arrangements are often observed. Presumably, the creditor consenting to subordination receives a higher interest rate from the borrower or compensation directly from the subordinating creditor.

There is, however, one exception to the general principle that subordination must be consensual: the borrower may use a security interest, under the rule of full priority, to subordinate creditor *C2*'s

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16 *See generally* CAMPBELL, *supra* note 3 (surveying bankruptcy systems of a number of countries). For another possible method of allocating bankruptcy value, see Schwartz *(1989)*, *supra* note 5, at 210-12 (suggesting that earlier creditors should have priority over later creditors).

17 Under U.S. bankruptcy law and the laws of most other countries, certain preferred classes of unsecured claims (the claims of certain government units, certain wage claims, *inter alia*) are paid in full before other "ordinary" or "general" unsecured creditors. *See* 11 U.S.C. § 507 (1994). For ease of exposition, we assume throughout that all unsecured creditors are treated equally in bankruptcy. This assumption is not critical to any of the analysis.

18 *See* James Steven Rogers, *The Impairment of Secured Creditors' Rights in Reorganization: A Study of the Relationship Between the Fifth Amendment and the Bankruptcy Clause*, 96 HARV. L. REV. 973, 994-95 (1983).

19 *See* 11 U.S.C. § 547 (1994).

20 *See* Rogers, *supra* note 18, at 994-95. Similarly, the law does not permit a borrower to sell options on its bankruptcy value to noncreditors. *See* Buckley, *supra* note 5, at 1456 & n.139.

claim to creditor *C1*'s claim. Thus, while the borrower may not otherwise subordinate the claim of unsecured creditor *C2* to that of creditor *C1* without creditor *C2*'s consent, the borrower can achieve the identical result under the rule of full priority by giving creditor *C1* a security interest. Given the general rule that the borrower may not give creditor *C1*'s claim priority over that of a single other creditor, it would appear peculiar that by complying with a few mechanical procedures, the borrower and creditor *C1* can arrange to give creditor *C1*'s claim priority over the claims of all unsecured creditors without obtaining those unsecured creditors' consent. One could argue that, although subordination through the use of a security interest under full priority does deviate from the general norm that explicit consent is required, unsecured creditors implicitly consent to subordination. The following discussion identifies two possible implicit consent arguments and explains why neither has much force.

The first implicit-consent argument in defense of full priority is that there is implicit consent to the creation of each security interest.[21] In most cases, a security interest created by the borrower gives creditor *C1*'s claim full priority over that of creditor *C2* only if creditor *C1* perfects the security interest by recording it in a public registry. Because the security interest is publicly registered, potential creditors whose bankruptcy allocations would be reduced by the creation of the security interest are able to adjust their terms or can refuse to lend in the first instance. Consequently, by entering into a transaction with the borrower, these creditors implicitly consent to having their fractional share of the borrower's bankruptcy assets reduced.

However, a substantial number of creditors can neither consent to nor be assumed to implicitly agree to, let alone know about, the creation of every security interest that subordinates their claims.[22] Tort creditors, for example, are unlikely to implicitly agree to have their claims subordinated by a security interest giving the secured lender full priority.[23] Indeed, under current law, a security interest could be used to subordinate the claim of an unsecured creditor that had explicitly refused to subordinate its claim. Consider a borrower's agreement with creditor *C2* that creditor *C2*'s claim would not be subordinated to that of any other creditor. Borrowers and creditors widely use such agreements.[24] However, under full priority, a security interest created by the borrower in violation of the borrower's non-

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[21] *See* Bebchuk & Fried, *supra* note 7, at 869-70.

[22] *See id.* at 869.

[23] We are not claiming that a creditor with a tort claim would *never* benefit from the creation of a security interest subordinating its claim. In certain cases, the granting of a security interest giving a lender full priority could make a tort creditor (as well as other nonadjusting unsecured creditors) better off. *See infra* Part II.B.1.

[24] *See infra* Part II.C.2.

subordination agreement with creditor *C2* will give the secured creditor priority in the collateral over the claim of creditor *C2*.[25] Thus, in the case of any given security interest, there is not necessarily implicit consent.

The second possible implicit-consent argument is that all unsecured creditors are better off if the borrower has the ability to subordinate their claims without obtaining their explicit consent, and therefore, all unsecured creditors would prefer a rule of full priority to one in which explicit consent would be required to create a security interest subordinating their claims. If so, full priority would efficiently provide a subordination regime to which all unsecured creditors would agree (at least *ex ante*). But for this implicit consent-argument to succeed, those advancing it must show that all unsecured creditors would be better off under full priority than under any feasible alternative. The analysis we offer in the next two Parts suggests that some unsecured creditors would be worse off under full priority than under a rule of partial priority. These unsecured creditors could not be presumed to implicitly consent to full priority.

Finally, even if one could show that there is implicit consent to subordination, the rule of full priority is still inconsistent with the general requirement that consent to subordination be *explicit*. Thus, those in favor of full priority must explain why subordination through the use of a security interest under full priority should not, like all other means of subordination, require the explicit consent of the subordinated party.

B. Is Full Priority Required by Freedom-of-Contract Principles?

Many commentators share the sentiment, which was also expressed during the Symposium, that freedom-of-contract principles require a rule of full priority.[26] To illustrate this view, suppose that creditor *C1* offers a borrower a choice between (1) an unsecured loan to the borrower in exchange for interest payments totalling $15 (plus repayment of principal) and (2) a secured loan in exchange for interest payments of only $10 (plus repayment of principal) that, if the borrower becomes insolvent, gives creditor *C1* a larger fraction of the borrower's assets (and creditor *C2*, borrower's other creditor, a smaller fraction). The freedom-of-contract argument asserts that the borrower and creditor *C1* should be free to choose either arrangement (1) or arrangement (2).

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25 *See* Equitable Trust Co. v. Imbesi, 412 A.2d 96 (Md. 1980) (holding that mortgagee had priority in property encumbered by borrower in violation of covenant); *see also infra* Part II.C.2 (discussing the uses of negative pledge covenants).

26 *See* Harris & Mooney, *supra* note 5, at 2049-51; Turner, *supra* note 6, at 329-31.

In general, if an arrangement would have no detrimental effect on third parties, freedom-of-contract principles would suggest permitting the borrower and creditor *C1* to enter into the arrangement if they so choose.[27] However, freedom-of-contract arguments are not applicable when the arrangement contemplated by the borrower and creditor *C1* is at the expense of another party. In this case, since arrangement (2) is at the expense of creditor *C2*, freedom of contract does not require that the borrower and creditor *C1* be permitted to enter that arrangement.[28]

To be sure, it might be argued that arrangement (2) only *appears* to be at the expense of creditor *C2* because while arrangement (2) reduces creditor *C2*'s fractional share of the borrower's bankruptcy assets *ex post*, relative to arrangement (1), arrangement (2) could actually make creditor *C2* better off than arrangement (1) *ex ante* by lowering the borrower's interest burden, thereby reducing the probability that the borrower will go bankrupt in the first instance.[29] But the fact that arrangement (2) could, in theory, benefit creditor *C2 ex ante* (relative to arrangement (1)) does not mean that freedom of contract requires that the borrower and creditor *C1* be permitted to enter into that arrangement. To see why this is the case, consider two other arrangements that have the same *ex ante* and *ex post* effects on creditor *C2* as arrangement (2) but which are legally unenforceable.

First, suppose that creditor *C1* offers the borrower an unsecured loan under the same terms as arrangement (1) except that borrower need pay only $10 in interest payments if it accepts the following provision: should the borrower go bankrupt, creditor *C1* would have an option to buy its bankruptcy assets up to the value of the balance on the loan, at a strike price of $0. Should the option be exercised, it would be at the expense of creditor *C2*. Most people would agree that freedom of contract does not require the law to respect such an arrangement and, in fact, the law does not.[30]

Second, suppose that creditor *C1* offers the borrower an unsecured loan under the same terms as arrangement (1) except that the borrower need pay only $10 in interest payments if the borrower agrees that before bankruptcy, it must first pay creditor *C1* in full, effectively reducing the pro rata amount available to creditor *C2*.

[27] Interestingly, Article 9 itself places restrictions on the types of arrangements that borrowers and lenders can enter into, even if no other parties are involved. *See, e.g.*, U.C.C. § 9-502(2) (1994) (requiring secured lender to return surplus from sale to borrower, notwithstanding an agreement to the contrary).

[28] *Cf.* Schwartz *(1994)*, *supra* note 5, at 2082 (stating that "society commonly does and should respect voluntary transactions less" when such transactions may harm third parties).

[29] This point is discussed further *infra* Part II.B.1.

[30] *Cf.* Buckley, *supra* note 5, at 1456-60 (discussing prohibition on issuance of bankruptcy rights to noncreditors and shareholders in particular).

Again, most people would agree that freedom of contract does not require the law to enforce such an arrangement, and in fact, such an arrangement is legally unenforceable.[31]

It is easy to see that the option and preference arrangements described above have the same *ex ante* effect on creditor *C2* as the creation of a security interest under full priority. Each of the arrangements could benefit creditor *C2 ex ante* relative to an ordinary unsecured loan by reducing the probability of the borrower's bankruptcy. But we do not consider the option and preference arrangements required by freedom-of-contract principles. And if these arrangements are not mandated by freedom of contract, then freedom of contract does not require that the borrower and creditor *C1* be permitted to enter into an almost identical arrangement through the creation of a security interest giving creditor *C1* full priority in the borrower's bankruptcy assets.

C. Is Full Priority Required by Principles of Property Law?

Two types of property-rights arguments have been raised in favor of full priority, and against partial priority. One focuses on the secured lender's property rights and the other focuses on the borrower's property rights.

The lender-based argument is that a partial-priority rule would take from the secured creditor something for which it paid. However, the lender-based argument carries no weight if the partial-priority rule under consideration applies only to security interests created after its adoption. In this case, secured creditors will enter into the arrangement knowing that they will receive partial priority, and partial priority will not defeat their expectations.[32]

The borrower-based argument is that the borrower has the right to alienate its interest in its property in any way it sees fit.[33] However, in granting a security interest in collateral under the rule of full priority, the borrower is alienating an interest not only in its own property, but also in the property of the bankruptcy estate, which the law considers to belong to the borrower's creditors as a group (and not to the borrower). Because the law does not permit a borrower to otherwise transfer or allocate its insolvency assets to third parties or to prefer certain creditors, the law is not required to permit the borrower to do so through the use of a security interest giving the secured creditor

[31] *See* 11 U.S.C. § 547 (1994).

[32] For a more detailed discussion of this argument, see Bebchuk & Fried, *supra* note 7, at 931-32; *see also* Kenneth N. Klee, *Barbarians at the Trough: Riposte in Defense of the Warren Carve-Out Proposal*, 82 CORNELL L. REV. 1466, 1476-77 (1997) (arguing that prospective application of partial priority would not constitute an illegal taking).

[33] *See* Harris & Mooney, *supra* note 5, at 2047-53; Turner, *supra* note 6, at 328-29.

full priority. Of course, one is free to take the position that the assets of the bankruptcy estate belong to the borrower and that the borrower should have the right to allocate them however it likes. But this would imply that fraudulent conveyance law, preference law, and the rule of mandatory pro rata sharing all violate the borrower's property rights.

D. What Lessons Can We Learn from the World Around Us?

In this Symposium and elsewhere, Steve Harris and others have argued that a partial-priority rule would require radically changing a system that, in their estimation, works well.[34] One implication of this argument is that the adoption of a partial-priority rule is unlikely to offer much improvement while creating a significant degree of risk. Another is that advocates of a partial-priority rule bear the burden of proof in this debate.[35]

To begin, participants on both sides of the priority debate recognize that we are already operating under a system of de facto partial priority.[36] In particular, there are a number of doctrines, practices, and rules that tend to erode secured creditors' priority in bankruptcy,[37] some of which we briefly discussed in *The Uneasy Case*.[38] For example, because a secured creditor usually cannot seize its collateral once a firm has filed for bankruptcy, the creditor is subject to the risk that the value of the collateral will fall during the course of a multi-year Chapter 11 proceeding. Other countries have gone further, imposing formal rules of partial priority in bankruptcy.[39]

The fact that we are already living in a world of partial priority has two very important implications. First, the adoption of a formal rule of partial priority would not necessarily be a radical change.

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[34] *See, e.g.*, Harris & Mooney, *supra* note 5.

[35] *See, e.g.*, Turner, *supra* note 6, at 329.

[36] *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*, 51 U. CHI. L. REV. 97, 112-14 (1984); Lawrence A. Weiss, *The Bankruptcy Code and Violations of Absolute Priority*, 4 J. APPLIED CORP. FIN. 71 (1991); White, *supra* note 6, at 392-94; Woodward, *supra* note 13, at 1516-20.

[37] The priority of secured claims is also eroded by state and federal law outside of bankruptcy. *See* Klee, *supra* note 32, at 1474-75 & n.35 (citing state statutes that give environmental creditors priority over mortgagees); William J. Woodward, Jr., *The Carve-Out Proposal and its Critics: A Response*, 30 UCC L.J. 32, 34 (1997) (describing the judicial tendency to undermine priority of secured creditors); Woodward, *supra* note 13, at 1520 (noting that state legislatures have dramatically increased the number of statutory lienholders with priority over secured creditors).

[38] Bebchuk & Fried, *supra* note 7, at 911-13.

[39] *See id.* at 872 n.42; Theodore Eisenberg & Stefan Sundgren, *Is Chapter 11 Too Favorable to Debtors? Evidence from Abroad*, 82 CORNELL L. REV. 1532 (1997) (discussing Finnish reorganizations); Klee, *supra* note 32, at 1477-78 (describing partial-priority rule recently adopted in Germany).

Whether the rule would represent a radical change would depend on the degree of priority the rule accords secured claims in bankruptcy. For example, suppose that the aggregate effect of the erosion of priority currently is, on average, to reduce priority to 90%.[40] In that case, a regime which imposes a formal partial-priority rule of 90% and eliminates the ad hoc erosion would not significantly differ from the current system.[41] Indeed, the adoption of such a rule might represent a less radical change than moving from the current system of de facto partial priority to a system of de facto 100% priority. Thus, advocates of partial priority do not necessarily bear a greater burden of proof than those favoring full priority.[42]

The second important implication of the fact that we are living in a partial-priority world is that those who criticize our analysis by pointing to evidence that the existing system works perfectly well are, in fact, supporting our claim that partial priority is likely to be superior to full priority. The question, however, is whether changing the degree of priority accorded to secured claims in bankruptcy (and the way in which the priority system is implemented) would make the system work even better. To rephrase the question, if currently secured creditors receive, on average, 90% of the value of their collateral, would we be better off under a regime under which that percentage is lower (e.g., 80%) or even higher (e.g., 100%—full priority)? And if some degree of partial priority is desirable, should we implement it in the current ad hoc manner, or should there be, as there is in a growing number of other countries,[43] an explicit partial-priority rule?

E. Considering the Issue of Priority with an Open Mind

In the previous sections, we have tried to show that the principle of full priority is not required by fundamental principles of contract or property law; is actually inconsistent with important principles of insolvency law; and therefore is not logically, legally, morally, or otherwise compelling. We have also explained that, as a practical matter, we are not living under a regime of full priority, but rather under one of partial priority, which means that adoption of a formal partial-prior-

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[40] Of course, the actual degree of erosion might be greater or less than 10%.

[41] In fact, adoption of a formal partial-priority rule of 90% (with no further erosion of priority) would clearly be superior to an ad hoc system of partial priority that cuts back priority by an average of 10% because there would be less uncertainty. *See* Bebchuk & Fried, *supra* note 7, at 912. In practice, of course, it might be difficult to eliminate all of the state and federal rules that operate to erode the priority of secured claims. However, adoption of a formal rule of partial priority might eliminate one source of this erosion by making courts that have traditionally been hostile to secured creditors on distributional grounds more inclined to respect security interests. *See* Woodward, *supra* note 13, at 1516-17.

[42] *See* Fried, *supra* note 8 (manuscript at 5-7); Klee, *supra* note 32, at 1468.

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

ity rule would not necessarily entail a radical change. In short, one should approach the question of whether we should have a rule of partial priority with an open mind.

II
On the Excessive Use of Security Interests Under Full Priority

Those who have expressed concern about full priority in the past have generally done so on fairness and distributional grounds.[44] In contrast, our analysis in *The Uneasy Case* has focused on the efficiency costs of according full priority to secured claims. Our view is that, even assuming that efficiency is the sole criterion for assessing the desirability of full priority,[45] full priority would still be problematic.[46] This Part develops and defends our claim that, under full priority, security interests will be used excessively. What we mean by excessive use of security interests is as follows: in a loan transaction that will go forward *whether or not a security interest is used*, full priority may cause the parties to incorporate an inefficient security interest into the arrangement, a security interest whose use in the arrangement reduces the total value available to all parties affected.[47]

The analysis of the problem of excessive use proceeds as follows. Under full priority, the use of a security interest can effect a transfer of bankruptcy value from nonadjusting creditors—creditors that do

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44 Commentators critical of full priority on fairness grounds have included Vern Countryman, *Code Security Interests in Bankruptcy*, 75 Com. L.J. 269, 280 (1970); Grant Gilmore, *The Good Faith Purchase Idea and the Uniform Commercial Code: Confessions of a Repentant Draftsman*, 15 Ga. L. Rev. 605, 620-28 (1981); R.M. Goode, *Is the Law Too Favorable to Secured Creditors?*, 8 Can. Bus. L.J. 53, 71-73 (1983-84), and more recently, Klee, *supra* note 32, at 1469-71; LoPucki, *supra* note 11, at 1500-02; Elizabeth Warren, *Making Policy With Imperfect Information: The Article 9 Full Priority Debates*, 82 Cornell L. Rev. 1373, 1388-92, (1997); Woodward, *supra* note 37, at 37-38; Woodward, *supra* note 13, at 1525-31.

45 We agree with Bill Woodward that a determination of the optimal priority rule will also depend on distributional considerations. *See* Woodward, *supra* note 13, at 1529-30. Unfortunately, determining the distributional effects of any given rule in bankruptcy is likely to be difficult. *See* Douglas G. Baird, *The Importance of Priority*, 82 Cornell L. Rev. 1420, 1427-29 (1997).

46 *The Uneasy Case* provided what we believe is the first comprehensive analysis of how full priority can distort a debtor's arrangements with its creditors. Bebchuk & Fried, *supra* note 7. Other contributions in this area include John Hudson, *The Case Against Secured Lending*, 15 Int'l Rev. L. & Econ. 47 (1995); Thomas H. Jackson & Robert E. Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain*, 75 Va. L. Rev. 155 (1989); Michelle J. White, *Public Policy Toward Bankruptcy: Me-First and Other Priority Rules*, 11 Bell J. Econ. 550 (1980). For a brief discussion of this literature, see Bebchuk & Fried, *supra* note 7, at 865 n.27.

47 In the subsequent Part, we will explain the efficiency costs of full priority in the context of loan transactions in which a security interest would be used whether or not secured claims are accorded full priority in bankruptcy, and in the context in which the loan transaction would not go through without the use of a security interest giving the creditor full priority in the collateral.

not adjust the terms of their loan to reflect the effect on them of the creation of security interests which, under full priority, completely subordinate the nonadjusting creditors' claims in bankruptcy. This transfer of value effectively acts as a "subsidy" for the use of a security interest by reducing the apparent cost (or increasing the apparent benefit) to the borrower and the secured creditor of using a security interest. This "subsidy," in turn, can lead to the use of inefficient security interests.

The problem of excessive use would not arise if incorporating a security interest into a loan arrangement always adds value to the transaction (which, we are assuming for now, would go forward in any event). There are, in fact, a number of ways in which the incorporation of a security interest into a loan contract can add value to such a transaction. Most of the ways in which the incorporation of a security interest can add value are "priority-independent." That is, they do not depend on the security interest giving the creditor full priority over unsecured claims in bankruptcy. Rather, they depend on the rights the security interest gives the secured creditor against the borrower and other third parties (e.g., subsequent secured creditors, transferees, and nonordinary-course purchasers).[48] For example, a security interest may enable the lender to prevent the borrower from selling the collateral to another party and inefficiently squandering the proceeds.[49]

However, incorporating a security interest into a loan agreement can also give rise to various costs. Some of these costs are priority-independent, while others are priority-dependent, meaning that they arise only to the extent that secured claims are given priority over unsecured claims in bankruptcy.[50] The priority-independent costs of including a security interest in a transaction that will go forward in any event include what we have labelled "contracting costs"—the costs of

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[48] For a description of the possible "priority-independent" benefits of incorporating a security interest into a loan arrangement that will go forward in any event, see Bebchuk & Fried, *supra* note 7, at 875-76. For empirical studies confirming the existence of some of these benefits, see Ronald J. Mann, *Explaining the Pattern of Secured Credit*, 110 HARV. L. REV. 625 (1997) [hereinafter Mann, *Explaining the Pattern*]; Ronald J. Mann, *The Role of Secured Credit in Small-Business Lending*, 86 GEO. L.J. (forthcoming Nov. 1997) [hereinafter Mann, *Small-Business Lending*]; Scott, *supra* note 5, at 933-52. There are also potential priority-dependent benefits of incorporating a security interest into a loan arrangement that will go forward in any event (benefits which can arise only to the extent secured claims are accorded priority in bankruptcy), although we argue that they are of limited importance. Bebchuk & Fried, *supra* note 7, at 913-21.

[49] *See* Baird, *supra* note 45, at 1422-23 (explaining how reducing secured creditors' priority rights over unsecured creditors still leaves secured creditors with many useful rights).

[50] The priority-dependent costs of security interests are discussed in Bebchuk & Fried, *supra* note 7, at 897-903, and *infra* Parts III.A-B.

creating the security interest;[51] "enforcement costs"—the costs of monitoring the collateral;[52] and "opportunity costs"—the potentially adverse effects of the security interest on the borrower's investment and financing flexibility in the future.[53] When the costs of incorporating a security interest into a loan arrangement exceed the benefits, the incorporation of the security interest into the loan agreement would be value-wasting. In this situation, the problem of excessive use can arise.[54]

The rest of this Part provides a detailed analysis of the problem of excessive use. Section A reintroduces the concept of "nonadjusting" creditors—creditors that cannot or do not adjust the size of their claims against a borrower to reflect the borrower's arrangements with other creditors, including arrangements creating security interests that subordinate the nonadjusting creditors' claims. Section B then explains why the existence of such creditors can lead to the excessive use of security interests. In Section C, we explain why the empirical evidence shows that the use of a security interest would often be value-wasting.

A. The Concept of "Nonadjusting" Creditors

In *The Uneasy Case*, we introduced the concept of "nonadjusting" creditors.[55] A "nonadjusting" creditor is a creditor that, for one reason or another, cannot or does not adjust the terms of its loan to reflect the effect on its loan of all the arrangements the borrower enters into with other creditors, including the creation of security interests which, under full priority, completely subordinate the

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[51] Bebchuk & Fried, *supra* note 7, at 877 & nn.69-70. Contracting costs may be significant for some (but not all) secured transactions. *See* Mann, *Explaining the Pattern, supra* note 48, at 659-62; Mann, *Small-Business Lending, supra* note 48, (manuscript at 30-31).

[52] Bebchuk & Fried, *supra* note 7, at 877-78.

[53] *Id.* & n.72. Opportunity costs can arise whenever a firm enters into a loan agreement restricting its future course of action, but the use of the security interest in the arrangement can make these costs higher. *See* Mann, *Explaining the Pattern, supra* note 48, at 664-67.

[54] Some commentators have charged that our analysis either assumes or implies that the use of secured debt is ordinarily motivated by the desire to limit the assets available to pay unsecured creditors, and not by the efficiency benefits offered by security interests. *See* Harris & Mooney, *supra* note 11, at 1354 (citing an unpublished manuscript by David Carlson arguing that we "posit[] secured credit as a zero-sum game"); Mann, *Explaining the Pattern, supra* note 48, at 683. But as we emphasized in *The Uneasy Case* (and do so again here), our analysis assumes that there are both efficient security interests (security interests whose efficiency benefits are greater than their efficiency costs) and inefficient security interests (security interests whose efficiency costs are greater than their efficiency benefits). Bebchuk & Fried, *supra* note 7, at 872-73, 878. Our point has been that the ability of security interests under full priority to transfer bankruptcy value from nonadjusting creditors can cause a borrower and a lender to adopt an inefficient security interest. Bebchuk & Fried, *supra* note 7, at 896-97.

[55] Bebchuk & Fried, *supra* note 7, at 864-65, 882-91.

nonadjusting creditor's claim in bankruptcy.[56] Because this concept is critical for understanding the problems with full priority, we want to make clear the identities of these creditors.

Before proceeding, we wish to emphasize the following. Our point is *not* that some nonadjusting creditors are "victimized" by priority. As we will see, some nonadjusting creditors will be hurt under priority and others will not. Our point is simply this: the existence of nonadjusting creditors means that, at the moment a borrower is considering creating a security interest giving a lender priority in the underlying collateral, the borrower knows that the interest rate charged by nonadjusting creditors will be the same whether or not the borrower incorporates the security interest into the loan arrangement. This means that the borrower is able to "sell" the nonadjusting creditors' share of bankruptcy value to the secured lender in exchange for a lower interest rate, without paying any *additional* interest to the nonadjusting creditors. As we explained in *The Uneasy Case*, the ability to sell nonadjusting creditors' share of bankruptcy value (whether those nonadjusting creditors are large banks, small trade suppliers, or tort creditors) creates a "subsidy" for the use of security interests and can cause a borrower, under full priority, to incorporate a security interest into its loan arrangements even though the security interest is value-wasting.[57] Our analysis would apply even if all nonadjusting creditors receive an interest rate that compensates them, on an expected value basis, for the increased risk of loss associated with the possibility of subordination. For example, our analysis would apply even in a world where the only nonadjusting creditors are sophisticated financial institutions that charge interest rates fully compensating them for the additional risk of loss associated with subordination.[58] The fact that, in the real world, many nonadjusting creditors are not compensated for the possibility of subordination is completely irrelevant for purposes of our analysis.[59]

1. *Involuntary Creditors*

The classic example of a nonadjusting creditor is a party that has been injured by the borrower and that is unable to recover fully from the borrower's insurance carrier.[60] Although uninsured tort claims

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56 *See id.*

57 *Id.* at 865, 891-95.

58 For an extended example demonstrating this point, see *id.* at 891-95.

59 *See id.* at 865.

60 Although most firms purchase insurance, *see* David Mayers & Clifford W. Smith, Jr., *On the Corporate Demand for Insurance*, 55 J. BUS. 281 (1982), the insurance they purchase may not cover all tort claims. Insurance companies typically impose limits on the scope and amount of coverage under their policies. *See* Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879, 1889 (1991);

do not often surface in bankruptcy, those that do turn up can be substantial.[61] Because the claims are fixed by a court without regard to the borrower's financial structure, the claims of these tort creditors cannot be adjusted to reflect the existence of a security interest. Therefore, the size of the tort claims will neither take into account the extent to which the borrower has already encumbered its assets, nor be subject to adjustment if the borrower subsequently subordinates the tort claims by issuing a security interest. Thus, in considering whether to create a security interest in a loan transaction, a borrower can "sell" some of what involuntary creditors would receive in bankruptcy by creating a security interest giving the secured lender priority.

Some commentators have urged that tort creditors should receive full compensation when the corporate tortfeasor goes bankrupt, either through a program of mandatory insurance or through the imposition of shareholder liability for corporate torts.[62] Others have suggested that the law give tort creditors priority over secured claims ("superpriority") in bankruptcy.[63] To the extent that any of these reform proposals are adopted, the parties could not use security interests to transfer bankruptcy value from tort claimants, and the problem of tort creditor nonadjustment would be eliminated.[64] But as long as

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Lynn M. LoPucki, *The Unsecured Creditor's Bargain*, 80 VA. L. REV. 1887, 1907 (1994). In addition, shareholders have an incentive to underinsure because they do not reap all of the benefits of the insurance they purchase. *See* Hansmann & Kraakman, *supra*, at 1889. Consequently, firms generally choose low insurance coverage limits and are often not insured for certain types of risks. *See id.* When private tort claims against the firm do arise, there is thus the possibility that they will become unsecured claims against the firm in bankruptcy.

[61] In two of forty-three large reorganizations studied by Lynn LoPucki and William Whitford, tort claims—in one case for personal injury, and in the other for patent infringement—amounted to more than two-thirds of the unsecured claims against the bankrupt company. *See* LoPucki, *supra* note 60, at 1896 n.41 (citing Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. PA. L. REV. 669, 738 & nn.226-27 (1993)), 1906 n.81 (describing other cases in which the tort liability of bankrupt firms was far in excess of the applicable insurance coverage).

[62] *See, e.g.*, Hansmann & Kraakman, *supra* note 60, at 1887-90 (proposing unlimited shareholder liability for corporate torts); S. Shavell, *The Judgment Proof Problem*, 6 INT'L REV. L. & ECON. 45 (1986) (proposing mandatory insurance).

[63] *See, e.g.*, Kathryn R. Heidt, *Cleaning Up Your Act: Efficiency Considerations in the Battle for the Debtor's Assets in Toxic Waste Bankruptcies*, 40 RUTGERS L. REV. 819, 851-62 (1988); David W. Leebron, *Limited Liability, Tort Victims, and Creditors*, 91 COLUM. L. REV. 1565, 1643-49 (1991); Christopher M.E. Painter, Note, *Tort Creditor Priority in the Secured Credit System: Asbestos Times, the Worst of Times*, 36 STAN. L. REV. 1045, 1080-82 (1984).

[64] However, as we explained in *The Uneasy Case*, a mandatory insurance system that permitted the insurer to reach the bankruptcy assets of the tortfeasor firm as an unsecured creditor in order to recover payments made to the firm's tort victims would not eliminate the problem of nonadjustment. In such a case, mandatory insurance would simply substitute one set of nonadjusting creditors (insurers) for another (tort creditors). *See* Bebchuk & Fried, *supra* note 7, at 883 n.94. While such a substitution might be desirable for risk-

tort creditors are (1) not fully paid when a tortfeasor firm goes bankrupt and (2) not given superpriority over secured claims, a borrower will be able to "sell" some of the bankruptcy value that tort creditors would otherwise receive by creating a security interest that, under full priority, completely subordinates their claims.

2. *Government Tax and Regulatory Claims*

Although tort claims against a bankrupt firm may in some cases be substantial,[65] in most cases they are not as significant as the claims of the second group of involuntary creditors—federal, state, and local government agencies.

At any given point in time, firms will typically owe payments to federal, state, and local governments for corporate income taxes, withholding taxes on employees' salaries, social security contributions, sales taxes, property taxes, excise taxes, and customs duties.[66] When the bankruptcy petition is filed, at least some of these taxing authorities will be creditors of the firm for unpaid taxes. In fact, tax claims against bankrupt firms are usually substantial, especially in the case of closely-held firms.[67] The government may also have environmental, pension-related, and other nontax claims against a bankrupt firm. Although these claims will not, unlike tax claims, be present in many bankruptcies, they may be substantial when they do arise.[68]

The size of the government's claims against a firm is set by statute without regard to the firm's capital structure and, in particular, without regard to any security interests the firm may have created that subordinate the government's claims to those of secured creditors. Thus, the government is nonadjusting with respect to the creation of security interests by the firm. That is, when a borrower and a creditor must decide whether to create a security interest, the borrower will treat its obligations to the government—like its obligations to tort creditors—as fixed, and knows that it can "sell" bankruptcy value that would otherwise go to pay government claims to the creditor in exchange for a lower interest rate.

During the Symposium, Steve Harris and Alan Schwartz argued that the government should not be considered nonadjusting because it has the power not only to change the tax laws so that its claims are "adjusted" for the creation of security interests, but also to change bankruptcy law so that its claims take priority over those of any other

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spreading reasons, it would not reduce the problem of excessive use of security interests under full priority.

65 *See supra* note 61.

66 *See* 11 U.S.C. § 507(a)(8) (1994).

67 *See* Douglas G. Baird, *The Reorganization of Closely Held Firms and the "Opt Out" Problem*, 72 WASH. U. L.Q. 913, 915 (1994).

68 *See* LoPucki, *supra* note 60, at 1896-97.

creditor. However, the ability (in principle) of the government to become an adjusting creditor is irrelevant.[69] We are not arguing that government claims are inherently nonadjusting. Nor are we arguing that the government is victimized because it does not adjust.

Rather, we are simply pointing out that the government currently does not adjust its claims to take into account the effect on those claims of the creation of security interests which, under full priority, have the effect of subordinating those claims. Thus, when a borrower is considering the creation of a security interest giving the secured creditor priority, it knows that it can lower its overall interest burden by "selling" some of the bankruptcy value that would otherwise go to the government in exchange for lower interest payments.

3. *Voluntary Creditors with Small Claims*

Involuntary creditors—tort creditors and government agencies—are not able to adjust the size of their claims against a borrower when it creates a security interest in favor of another creditor, because their claims are fixed by law. But the fact that a creditor voluntarily contracts with a firm does not necessarily make that creditor adjusting with respect to a particular security interest which the firm has created. Many of a firm's voluntary creditors are customers,[70] employees,[71] and trade creditors that have relatively small claims against the firm. Even though these creditors can, in principle, take the existence of a security interest into account in contracting with the firm, the small size of their claims will generally make it rational for them not to do so.[72] Even trade suppliers, which are more commercially sophisti-

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69 *See* Bebchuk & Fried, *supra* note 7, at 884 n.95.

70 Customers may be owed money for payments made toward purchases of goods or services. For example, ticketholders had substantial unsecured claims against Braniff Airlines when it went bankrupt. *See* LoPucki, *supra* note 60, at 1896 n.41.

71 *See* 11 U.S.C. § 507(a)(4), (b) (1994).

72 As we explained in *The Uneasy Case*, the cost to any creditor of adjusting its terms with a firm to reflect accurately its risk of loss in connection with lending to that particular firm is substantial, while the benefit of such an adjustment is minimal. Bebchuk & Fried, *supra* note 7, at 885-86. Determining the extent of a firm's secured debt will be quite difficult. For example, although public registries identify the class of assets subject to a security interest, they do not indicate the size of the loan secured by the collateral. *See* Douglas G. Baird, *Notice Filing and the Problem of Ostensible Ownership*, 12 J. LEGAL STUD. 53, 54-55 (1983) (describing lack of information conveyed by the Article 9 notice filing system). Even if a creditor with a small claim could costlessly acquire information about the firm's secured debt, the creditor would still be required to estimate the firm's likelihood of insolvency, its insolvency value, and the extent of its unsecured debt in order to estimate its risk of loss. Finally, a creditor which had undertaken such an investigation would face the additional cost of contracting specialized terms with the firm. However, the amount owed to each of these creditors individually—and thus the expected loss faced by each creditor—is typically small. Thus, the benefit to these creditors of acquiring information and negotiating special terms with the firm each time they extend credit will be minimal. *See* Bebchuk & Fried, *supra* note 7, at 885-86.

cated than employees and customers, are believed to have neither the time nor the expertise to evaluate individual firm risk.[73] Indeed, trade creditors generally charge uniform interest rates to all customers that are allowed to purchase on credit,[74] indicating that those creditors do not set the interest rate to take into account the particular risk of loss associated with lending to each customer.

The failure of creditors with small claims to take into account a borrower's arrangements with other creditors does not imply that these creditors are systematically undercompensated for bearing the risk that other creditors of the borrower will have priority claims in bankruptcy. Experienced trade creditors probably set terms that compensate them for the average risk of loss they face in lending to all of their customers. However, whether or not these creditors are adequately compensated for their risk of loss is not relevant to our analysis. The point is simply that, when deciding whether to create a security interest giving a lender priority in the underlying collateral, the borrower knows that the decision will not affect the interest rate charged by creditors with small claims. Thus, the borrower can obtain a lower interest rate by selling the bankruptcy value to which these creditors would otherwise be entitled.[75]

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73 *See* Hudson, *supra* note 46, at 56; Mark J. Roe, *Commentary on "On the Nature of Bankruptcy": Bankruptcy, Priority, and Economics*, 75 VA. L. REV. 219, 225 (1989) (commenting on Thomas H. Jackson & Robert E. Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain*, 75 VA. L. REV. 155 (1989)).

74 *See* Mitchell A. Petersen & Raghuram G. Rajan, *The Benefits of Lending Relationships: Evidence from Small Business Data*, 49 J. FIN. 3, 23-25, 32 (1994).

75 For an extended example, showing why it might be rational for creditors lending relatively small amounts to ignore the capital structure of their borrowers in fixing their interest rates, giving some borrowers an incentive to create value-wasting security interests, see Bebchuk & Fried, *supra* note 7, at 886-87. In his Symposium article, Alan Schwartz criticizes our example. He appears to make three arguments. First, Schwartz charges that our example assumes, but does not show, that there are creditors that will charge the same interest rate to all of their borrowers. Alan Schwartz, *Priority Contracts and Priority in Bankruptcy*, 82 CORNELL L. REV. 1396, 1415 (1997). However, there is uncontested empirical evidence that trade creditors do in fact charge borrowers to which they extend credit the same interest rate, suggesting that they are unable (or unwilling) to differentiate among these borrowers. *See supra* note 74 and accompanying text. Our example is designed to explain why it might be rational for trade creditors to behave this way, and why the observed failure of trade creditors to charge different rates of interest to different borrowers can cause some borrowers to create inefficient security interests.

Second, Schwartz argues that our example fails to explain why lenders would not eventually learn which types of borrowers issue secured debt and which ones do not, and then set their interest rates accordingly. Schwartz, *supra*, at 1415. The explanation is that whether or not a particular borrower creates a security interest may depend not just on the borrower's industry (e.g., retail, manufacturing), but also on the particular situation of the borrower at the time it must decide whether to borrow on a secured or unsecured basis, including, among other things, its pre-existing capital structure and the availability of assets that can serve as collateral. Thus, at any given time, there is likely to be variation in the use of security interests within an industry, and over time there is likely to be variation in the use of security interests by a single firm. A creditor lending a small amount of money

4. *Prior Voluntary Creditors*

We have just seen that involuntary creditors cannot adjust and that voluntary creditors with small claims generally do not adjust to the security interests created by a borrower (although some voluntary creditors with small claims may charge an interest rate that compensates them *ex ante* for the risk of subordination in bankruptcy). In contrast, voluntary creditors with larger claims may find it worthwhile to adjust the interest rate they charge to take into account the existence of a security interest which, in the event of bankruptcy, would give the secured creditor priority over their claims. However, a sophisticated unsecured creditor with a large claim can adjust only to security interests which the borrower has already created. Thus, even voluntary creditors with large claims will be nonadjusting with respect to subsequently created security interests. Again, the point is not that the voluntary creditor is "hurt" by the subsequent creation of a security interest giving another creditor priority; the voluntary creditor with a large claim would be expected to take into account the possibility of the subsequent creation of a security interest in setting its interest rate. The point is that, when the borrower is deciding whether or not to create a security interest in favor of a lender, it knows that the decision will not affect the interest rate charged by pre-existing unsecured creditors lending at fixed rates.

One might ask why a voluntary creditor with a large claim would ever allow itself to become a nonadjusting creditor. That is, why would the creditor fail to simply require that the borrower covenant not to grant security interests during the term of the loan? Indeed, as discussed below, sophisticated creditors frequently negotiate a negative pledge covenant restricting their borrowers' ability to issue secured debt.[76] The question then is why sophisticated creditors do not *always* use such covenants when extending a large amount of credit to a borrower. We can offer three reasons for this phenomenon.[77]

First, a negative pledge covenant may be inefficiently broad. Consider the case of an unsecured creditor lending to a borrower that anticipates issuing both efficient and inefficient security interests. If (a) the aggregate efficiency loss from preventing the creation of efficient security interests would be greater than the aggregate efficiency benefit from preventing the creation of inefficient security interests;

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would not find it worthwhile to investigate the particular circumstances of each firm every time it extends credit.

Third, Schwartz argues that borrowers with little or no secured debt would have an incentive to signal this fact to prospective lenders. Schwartz, *supra*, at 1415-16. We respond to this argument *infra* Part II.B.3.

76 *See infra* Part II.C.2.

77 For a more detailed discussion, see Bebchuk & Fried, *supra* note 7, at 888-91.

and (b) the creditor and the borrower would bear all of the costs and enjoy all of the benefits of a negative pledge covenant, then the parties will not find it worthwhile to adopt a negative pledge covenant, even though the borrower may later create an inefficient security interest subordinating the unsecured lender's claim.

Second, even when a negative pledge covenant would not be too broad, the unsecured lender and the borrower will not use it if they cannot capture enough of the benefit that would be generated by the covenant. To the extent that the borrower has other (nonadjusting) unsecured creditors, some of the benefit of the arrangement will be captured by these other creditors.[78] If the borrower and the unsecured creditor contemplating the use of a negative pledge covenant do not capture enough of the benefit to outweigh the costs they must bear, they will not adopt it even if it would create value.[79]

Third, even if a negative pledge covenant (a) would create value and (b) would (if enforceable) privately benefit the borrower and the unsecured lender, the parties may not use it if—as is often the case—the lender believes that such a provision would be difficult to enforce.[80] Under current law, the claim of an unsecured creditor that has bargained for a negative pledge covenant would be subordinated by a security interest created in violation of a negative pledge covenant.[81] In many cases, the lender would have difficulty preventing the borrower from creating such a security interest and then determining that such a security interest had been created.[82]

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78 Because these other creditors are nonadjusting, the adoption of a negative pledge covenant in the loan arrangement will not cause them to lower the interest rates they charge the borrower. As a result, the borrower will not capture any of the benefit that would accrue to these creditors.

79 Thus, the failure of a borrower and an unsecured creditor to negotiate a negative pledge covenant, the failure of a negative pledge covenant to ban all types of secured debt, or the willingness of an unsecured creditor to waive a negative pledge covenant does not, unlike some commentators have argued, prove that the parties expect that it will be efficient for the borrower to create the security interests that the unsecured creditor fails to prohibit. *See* Schwartz, *supra* note 75, at 1397. For further discussion of the inferences that one can draw from negative pledge covenants, see Bebchuk & Fried, *supra* note 7, at 922-23; *infra* Part II.C.2.

80 *See* Bebchuk & Fried, *supra* note 7, at 888.

81 *See id.* at 889 n.116 (citing Equitable Trust Co. v. Imbresi, 412 A.2d 96 (Md. 1980) (holding that mortgagee had priority in property encumbered by borrower in violation of covenant)); Mann, *Explaining the Pattern*, *supra* note 48, at 643. One commentator has proposed making recorded negative pledge covenants enforceable against third parties. *See* Carl S. Bjerre, Secured Transactions Inside Out: Reflections on Making Negative Pledge Covenants Perfectible 56-57 (Aug. 8, 1997) (unpublished manuscript, on file with authors). We think that his proposal deserves serious consideration.

82 *See* Bebchuk & Fried, *supra* note 7, at 888-90. The creation of a security interest will be undetectable for as long as the security interest is not perfected (recorded). In many cases, it will also be difficult to detect a recorded security interest. *See* Mann, *Explaining the Pattern*, *supra* note 48, at 643.

A negative pledge covenant is not the only method that an unsecured creditor could use to ensure that it does not become nonadjusting with respect to a subsequently created security interest. For example, sophisticated unsecured creditors could build an adjustment mechanism into their contracts with borrowers which allows them to reset the interest rate if a borrower subsequently creates a security interest. Unlike a negative pledge covenant, an adjustment mechanism negotiated between an unsecured lender and a borrower does not prevent the borrower from creating a value-creating security interest: it merely increases the cost of doing so. As long as the cost is not so high that it precludes the creation of the security interest, the adjustment mechanism, unlike a negative pledge covenant, would not be overbroad. Nor would such a mechanism confer a benefit on any other creditors. Thus, the parties would be more likely to adopt an efficient adjustment mechanism than a negative pledge covenant.

Although sophisticated creditors with large claims might find such mechanisms worthwhile in principle, adjustment mechanisms are generally considered to be impractical.[83] Given that the appropriate adjustment factor for each security interest would depend on numerous parameters—such as the likelihood of the borrower's insolvency—that would be realized only at the time the security interest is created, it would be extremely difficult to specify the appropriate schedule of interest rate adjustments in advance.[84] Moreover, such a contractual provision—like a negative pledge covenant—might be difficult to enforce against smaller companies that can easily conceal a financing transaction and that may lack the funds to pay the adjustment once the transaction is discovered. Thus, even if an appropriate adjustment schedule could be specified in advance at no cost, there might be situations in which a sophisticated creditor would not reduce

Because an unperfected security interest would not give the secured lender priority over the negative pledge lender (once the lender obtains a judgment lien), some readers questioned our claim that an "'informal creditor' [e.g., a friend or family member of the business owner] need not perfect its security interest for its claim to have priority over that of the [negative pledge] unsecured lender." Bebchuk & Fried, *supra* note 7, at 888. We made this claim because between the time that (1) the negative pledge lender discovers the security interest and (2) the negative pledge lender obtains a court judgment against the borrower (which might be months, or longer), the secured creditor would have time to perfect the security interest (giving it priority over the negative pledge lender) or simply to seize the collateral (making it unavailable to the negative pledge lender). Thus, our claim is that the "informal" creditor need not perfect its security interest for its claim to have *effective* priority over that of the unsecured lender.

83 *See, e.g.*, Kanda & Levmore, *supra* note 5, at 2112 (observing that variable interest rate arrangements impose high transaction costs).

84 Although the parties could instead renegotiate the terms of the loan contract following the creation of each security interest, it would be costly for the parties to verify the appropriate parameters and bargain over the adjustment every time after the creation of a security interest. Such a scheme would therefore also not be practical.

the interest rate it charged a borrower in exchange for an adjustment mechanism.

In any event, even if some prior sophisticated creditors with sufficiently large claims did adopt such an interest rate adjustment mechanism, other prior creditors would be nonadjusting with respect to the subsequent creation of security interests by the borrower. Thus, the borrower would still have an incentive—albeit a reduced one—to create security interests in order to transfer value from prior nonadjusting creditors.

We again want to emphasize that, while prior voluntary creditors might not be able to adjust to the creation of a security interest by a borrower, we are not assuming that they are exploited by the borrower. In fact, we are willing to assume that prior creditors anticipate the risk that subsequent security interests will subordinate their claims in bankruptcy and set their interest rates accordingly. The only assumption on which our analysis depends is that the terms negotiated by almost all prior creditors, however set, are fixed by the time the borrower and a potentially secured creditor negotiate their loan transaction. Thus, when the borrower and the potentially secured creditor shape their arrangement, the use of a security interest giving the creditor a secured claim with full priority—compared to an arrangement without such a security interest—can make the borrower better off by allowing it to "sell" to the creditor bankruptcy value that would otherwise be enjoyed by these prior nonadjusting creditors.

B. Nonadjusting Creditors and the Use of Inefficient Security Interests

1. *The Problem*

We are now ready to consider how full priority and the presence of nonadjusting creditors affect the incentives of a borrower and a creditor contemplating the use of a security interest in connection with a loan transaction that will proceed whether or not a security interest is used. Recall that the steps in the analysis are as follows: (1) under full priority, the use of a security interest can effect a transfer of bankruptcy value from nonadjusting creditors; (2) this transfer of value acts as a subsidy for the use of a security interest by reducing the apparent cost (or increasing the apparent benefit) of using a security interest to the borrower and the secured creditor; and (3) this "subsidy" can lead to the use of inefficient security interests. Below, we provide a simple example to illustrate these points.[85]

To begin, suppose that a borrower and creditor *C1* are contemplating incorporating a security interest into their loan arrangement.

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[85] For a more extended treatment, see Bebchuk & Fried, *supra* note 7, at 891-95.

Under full priority, one effect of incorporating a security interest is that, everything else equal, in the event of bankruptcy, creditor *C1* will receive more than it would without the security interest, and other creditors will receive less. Everything else equal, creditor *C1* should therefore be willing to charge the borrower a lower interest rate. To the extent that the borrower's other creditors are adjusting, the borrower will be required to "pay" for transferring the bankruptcy value from these creditors to creditor *C1* through a higher interest rate charged by these other creditors. But at least some of the borrower's creditors will be nonadjusting.

Suppose that the presence of nonadjusting creditors means that, by creating a security interest in favor of creditor *C1*, the borrower can "sell" $10 of expected bankruptcy value to creditor *C1* in exchange for a lower interest rate without "paying" for the transfer through higher interest rates to nonadjusting creditors. The transfer of $10 in expected bankruptcy value to creditor *C1* should, everything else equal, cause creditor *C1* to reduce the interest it charges the borrower by the same amount—$10. From the borrower's point of view, this transfer reduces the apparent cost of creating the security interest by $10 (or, equivalently, increases the apparent benefit of creating the security interest by $10).

The fact that the security interest would transfer $10 from nonadjusting creditors to the borrower may, in turn, affect the borrower's decision whether to grant creditor *C1* a security interest. Suppose, for example, that the creation of the security interest would give rise to an efficiency cost of $15 and provide an efficiency benefit of $10 and that the borrower and creditor *C1* would bear all of the efficiency costs and capture all of the efficiency benefits. Such a security interest would be value-wasting. If all of the creditors were adjusting, the borrower and creditor *C1* would not have an incentive to adopt the security interest because, without the transfer, the security interest would impose a net cost of $5. However, if the effect of the security interest is to transfer $10 from nonadjusting creditors, the borrower and creditor *C1* will have an incentive to adopt the security interest. The reason is that the benefit to the borrower and creditor *C1* of adopting it appears to be $20 (rather than $10), an amount greater than the cost of $15 (or, equivalently, the cost appears to be only $5, less than the benefit of $15).

Before proceeding, we would like to emphasize two important points. First, we are not arguing that the incorporation of a security interest into a loan transaction (that will go forward in any event) will always have the effect of transferring value from nonadjusting creditors. The creation of a security interest giving the secured creditor bankruptcy priority will, *everything else equal,* transfer value from

nonadjusting creditors by reducing their *fractional share* of the bankruptcy pie. But, as we have emphasized, the incorporation of such a security interest into a loan agreement will also affect unsecured creditors in two other ways: (1) by affecting the *probability* that the borrower will fail and (2) by affecting the *amount* of assets that will be available in the event of bankruptcy. Depending on the circumstances, the use of a particular security could either increase or decrease the probability of failure, and either increase or decrease the amount of assets that will be available to creditors as a group.[86] Thus, the use of a security interest under full priority in connection with a loan transaction that will go forward in any event will make unsecured creditors better off overall if the subordination effect is outweighed by the other two effects.[87]

But by the same reasoning, unsecured creditors may be in an even worse position after the creation of a security interest than if the only effect of the security interest were to reduce their fractional share of the borrower's bankruptcy assets. In particular, and as we explain in the next Part, under full priority, the incorporation of a security interest not only subordinates the claims of unsecured creditors, but by reducing the incentive of the secured creditor to monitor the borrower, may also increase the probability of failure and reduce the amount of assets that are available to pay all claims in the event of default. That is, the incorporation of a security interest into a loan agreement may make unsecured creditors worse off in not one, but three ways: (1) by increasing the probability of the borrower's failure; (2) by reducing the amount of assets that will be available to all creditors in the event the borrower fails; and (3) by reducing unsecured creditors' fractional share of these assets.

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86 The use of a security interest will tend to increase the probability of failure and/or reduce the amount of assets that are available to creditors as a group, to the extent that the security interest imposes priority-independent costs on the borrower (including "opportunity costs"); *see* Bebchuk & Fried, *supra* note 7, at 872-73; *supra* notes 50-54 and accompanying text; and to the extent that the protection provided by the security interest reduces the lender's incentive to monitor the borrower. *See* Bebchuk & Fried, *supra* note 7, at 897-903; *infra* Part III.A. The use of a security interest will tend to decrease the probability of failure and/or increase the amount of assets that are available to creditors as a group, to the extent that it permits the lender to better control the actions of the borrower (e.g, prevent the borrower from selling the collateral and transferring the proceeds to its shareholders). *See* Bebchuk & Fried, *supra* note 7, at 876.

87 A related but distinct point is that the use of a security interest under full priority, in connection with a transaction that would *not* go forward under less than full priority can also make unsecured creditors better off. *See* Bebchuk & Fried, *supra* note 7, at 919-20. In Part V, we will address the efficiency effects of priority on transactions that will not go forward unless there is full priority, where we will point out that full priority can also make unsecured creditors worse off by enabling inefficient transactions to go forward. For now, however, we continue to focus only on transactions that would go forward whether or not a security interest is used.

The second point to be emphasized is that a particular security interest's potential, under full priority, to transfer value from nonadjusting creditors does not mean that the borrower and a potentially secured creditor would always have an incentive to use the security interest. The borrower and the potentially secured creditor would have an incentive to use the security interest only if the efficiency benefits they capture from the security interest, plus the (expected) transfer of value from nonadjusting creditors, is greater than the efficiency costs they will bear from the use of the security interest. Thus, the fact that a security interest under full priority can transfer value from nonadjusting creditors does not imply that lenders and borrowers would always use security interests in their loan arrangements.[88]

2. *Excessive Use Can Occur Without Involuntary Creditors*

The presence of nonadjusting creditors can lead to the use of value-wasting security interests, whether or not nonadjusting creditors are hurt.[89] To see why value-wasting security interests might be used under full priority, even though no involuntary nonadjusting creditors are hurt, suppose that, in the example above, all of the nonadjusting creditors are voluntary.

Suppose, for example, that all of the nonadjusting creditors are large unsecured lenders that have lent at fixed interest rates before the borrower faces the decision of whether to create a security interest as part of its loan arrangement with creditor *C1*. Suppose further that the security interest will have the effect of, among other things, increasing the expected value of creditor *C1*'s bankruptcy claim by $10, and reducing that of the nonadjusting creditors' bankruptcy claims by the same amount.

In principle, the creditors extending large loans to the borrower before the borrower enters into a transaction with creditor *C1* can compensate themselves *ex ante*, via a higher interest rate, for the possibility that, when the borrower and creditor *C1* negotiate their loan arrangement, the borrower will create a security interest that, everything else equal, reduces the expected value of their bankruptcy claims by $10. So while the incorporation of a security interest into the loan arrangement with creditor *C1* will, at that time, make these nonadjusting creditors worse off than if a security interest is not incorporated into the loan arrangement, they will not be worse off than they would have been in a world where there is no priority because

[88] Consequently, the failure of borrowers to secure all of their assets does not, as Alan Schwartz has argued, Schwartz, *supra* note 75, at 1410-11, prove that borrowers cannot use security interests to transfer value from unsecured creditors. For further discussion on the inferences that can be drawn from the use of unsecured debt, see *infra* Part II.C.1.

[89] *See* Bebchuk & Fried, *supra* note 7, at 891-95.

they will have been compensated for the risk of subordination by a higher interest rate. Nonetheless, because the terms of their loans will not be adjusted if creditor *C1* gets a security interest, there will still be a subsidy in favor of using a security interest, and this subsidy could lead to the use of a security interest even if it reduces the total value of the transaction.

3. *Can Disclosure by Borrowers Eliminate the Problem of Excessive Use?*

In his Symposium article, Alan Schwartz makes the point that although it may not be worthwhile for creditors with small claims to determine whether a borrower has created security interests that would subordinate their claims in the event of bankruptcy, the borrower could provide such information to these creditors at low cost.[90] Firms that have not created security interests would, Schwartz argues, have an incentive to bring this to the attention of creditors with small claims in order to induce the lenders to lower their interest rates.[91] This information would permit lenders with small claims to adjust their interest rates to reflect the existence (or non-existence) of particular security interests.[92] The implication of Schwartz's analysis appears to be twofold. First, to the extent that borrowers already provide this information to creditors with small claims, the amount of nonadjustment may not be as large as we suggest, at least with respect to creditors with small claims. Second, to the extent that borrowers do not find it worthwhile to provide this information, we can infer that the amount of nonadjustment by creditors with small claims is fairly small because, otherwise, borrowers with little secured debt in their financial structure would have an incentive to notify creditors of that fact.

Of course, Schwartz's point is applicable with respect to only one of the four groups of nonadjusting creditors—creditors with small claims. Clearly, notification would not cause involuntary, government, or prior creditors to become adjusting. The absence of borrower-notification would also not indicate that the amount of nonadjustment by these three other classes of nonadjusting creditors is insignificant.

Moreover, notification is unlikely to be able to cost-effectively reduce nonadjustment (and, therefore, the absence of notification is not likely to indicate that the magnitude of nonadjustment is small) for creditors with small claims that could in principle adjust the size of their claims to take into account the existence of previously-issued se-

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[90] Schwartz, *supra* note 75, at 1408, 1415-17.
[91] *Id.* at 1415.
[92] *See id.* at 1415-16.

cured debt in the borrower's financial structure. The cost of effectively communicating one's financial structure to these creditors may not be insignificant. First, the borrower will have an incentive to mislead because the borrower would face liability only in the event it cannot pay its creditors, at which point, any additional liability is of no consequence. Thus there must be a third party involved to provide verification.[93] Second, accuracy would require that disclosure be continuous; otherwise, lenders would suspect that, since the previous disclosure, the borrower had significantly changed its financial structure to their detriment. Third, and most importantly, even if the borrower could cheaply provide up-to-date accurate information about its financial structure, creditors with small claims would still bear the cost of assessing the information provided by the borrower and the cost of negotiating special rates. When the amount of the loan, and therefore the expected risk of loss, is relatively small, it will simply not be worthwhile for the creditor to incur these processing and negotiation costs. Moreover, even in the absence of those costs, many creditors with small claims—including the borrower's employees and customers—are not sophisticated enough to adjust the (implicit) rate they charge a borrower to take into account the existence or non-existence of secured debt in the borrower's financial structure.

In short, borrower disclosure is unlikely to convert creditors with small claims into adjusting creditors, and in any event could not cause the other three classes of nonadjusting creditors (tort creditors, the government, and creditors with prior claims) to become adjusting.

C. Empirical Evidence That Security Interests Are Often Inefficient

We have shown that borrowers and creditors might create security interests even if they are inefficient. The question remains whether there are many cases in which security interests actually are inefficient. In this Section, we present empirical evidence indicating that this is the case.

1. *The Persistence of Unsecured Debt*

Although there is very little data on the extent of secured lending in the U.S. economy, there is no question that it is an important form of financing for many companies. Almost 30% of the dollar volume of commercial bank loans is secured.[94] Of course, the same data also

[93] Much of this information is available through Dun & Bradstreet, UCC filings, and other sources. But often these sources are not accurate. *See* Bebchuk & Fried, *supra* note 7, at 885 n.103; Mann, *Explaining the Pattern*, *supra* note 48, at 643-44.

[94] *See* Allen N. Berger & Gregory F. Udell, *Collateral, Loan Quality, and Bank Risk*, 25 J. MONETARY ECON. 21, 31 (1990). Because non-bank loans are more frequently secured than

show that a substantial amount of debt (including 70% of the dollar volume of commercial bank loans) is not secured. Indeed, not only are many loans unsecured, but many companies borrow on an exclusively unsecured basis. It is well known, for example, that large companies rarely issue secured debt.[95] And, even among small businesses—the type of firm most likely to rely on secured financing—a substantial percentage borrow exclusively on an unsecured basis: almost 50% of small businesses that borrow from banks do not provide collateral for their loans.[96] Almost 40% of small companies do not rely on any secured credit financing.[97]

The failure of many loan transactions to incorporate security interests provides evidence that the use of security interests can entail significant costs. As we saw in Section B above, the use of a security interest allows a borrower to transfer bankruptcy value from nonadjusting creditors. Thus, the failure to use a security interest implies that the efficiency costs of the security interest that would be borne by the borrower and the potentially secured creditor are greater than the efficiency benefits that they would enjoy from the security interest *plus* the expected transfer of bankruptcy value made possible by the current priority regime.[98] This, in turn, suggests that the use of a security interest in these cases would be inefficient.

bank loans, the percentage of the total dollar volume of business lending that is secured is even higher. *See* John D. Leeth & Jonathan A. Scott, *The Incidence of Secured Debt: Evidence from the Small Business Community*, 24 J. FIN. & QUANTITATIVE ANALYSIS 379, 379 (1989) (citing studies from the early 1980s suggesting that nearly 80% of dollar volume of business loans was secured).

95 *See* James R. Booth, *Contract Costs, Bank Loans, and the Cross-Monitoring Hypothesis*, 31 J. FIN. ECON. 25, 40 n.10 (1992) (reporting that firms with public debt rarely borrow on a secured basis).

96 *See* Leeth & Scott, *supra* note 94, at 387.

97 *See Trends Tracked in Banking Practices of Small Businesses*, J. ACCT., Oct. 1987, at 36, 39.

98 Although the current system is one of de facto partial priority, *see supra* Part I.D, it still permits a borrower to transfer value from nonadjusting creditors by issuing a security interest. Of course, the expected value of this transfer will be low if there is little likelihood that the borrower will default. Thus, one might suggest that the borrowers from which sophisticated lenders do not take security interests are those that are unlikely to fail. However, the widespread use of negative pledge covenants, *see infra* Part II.C.2, indicates that sophisticated creditors believe that, even with respect to firms that borrow mostly on an unsecured basis, the risk of failure is sufficiently high to make it worth negotiating for a provision that ensures that their claims will not be subordinated in bankruptcy. Because the use of these provisions indicates creditors' concerns with their standing in bankruptcy, it stands to reason that these creditors would place at least some value on the bankruptcy priority accorded by a security interest. Thus the failure of a sophisticated creditor to use a security interest in any given case suggests that the efficiency cost of using a security interest might have been substantial. It is also worth noting that small firms, which have a much higher failure rate than larger firms, frequently borrow exclusively on an unsecured basis. *See supra* note 97 and accompanying text.

However, the failure of a lender to incorporate a security interest into its loan arrangement with a borrower does not prove that a security interest would have been value-wasting. The creation of a security interest, even under full priority, can, in principle, make nonadjusting creditors better off—meaning that the borrower and the secured lender do not capture all of the benefit.[99] Thus, a borrower and lender contemplating the use of a value-increasing security interest in their loan arrangement will choose not to incorporate the security interest into the loan arrangement if their share of the benefits is less than the costs they must bear.[100]

2. *Negative Pledge Covenants*

The widespread use of negative pledge covenants—provisions in loan agreements that severely restrict the borrower's ability to incur secured debt—provides evidence that the creation of a security interest can often make unsecured creditors worse off. Unsecured creditors would not seek these provisions if these provisions did not make them better off. These provisions would not make unsecured lenders better off unless the creation of the security interests prohibited by the provisions would make them worse off.

The fact that borrowers agree to these provisions provides additional information. Negative pledge covenants impose a substantial cost on borrowers by preventing borrowers from collateralizing future loans. The fact that a borrower agrees to such a covenant thus indicates not only that the creation of a security interest prohibited by the covenant would make the lender worse off, but also that the creation of the security interest would hurt the lender more than it would help the borrower. In other words, the provision increases the size of the pie that the two parties can share.

If the lender and the borrower were the only parties affected by the arrangement, the existence of a negative pledge covenant would

99 *See* Bebchuk & Fried, *supra* note 7, at 919-20; *supra* note 87 and accompanying text.

100 The fact that a borrower and a creditor contemplating taking a security interest in the borrower's property may choose to forego using a value-creating security interest because they do not capture a sufficient portion of the efficiency benefits raises an interesting point: full priority may reduce the insufficient use of value-creating security interests. Suppose that under partial priority, a borrower and a creditor do not find it worthwhile to use a value-creating security interest because the portion of the efficiency benefits they capture, plus the expected transfer of bankruptcy value under partial priority, is less than the portion of the efficiency costs that they bear. And suppose that under full priority, the borrower and the creditor would find it worthwhile to use that security interest because the portion of the efficiency benefit they capture, plus the expected transfer of bankruptcy value under full priority, is greater than the portion of the efficiency costs that they bear. In that case, full priority would confer an efficiency benefit by encouraging the use of a value-creating security interest that a borrower and a creditor would not otherwise use. However, the failure of advocates of full priority to make this argument may indicate that this benefit is likely to be insignificant.

suggest that the covenant is efficient, and therefore, that the creation of the security interests prohibited by it would be inefficient.[101] However, the two parties do not capture all of the net benefit created by the provision, as some of that net benefit flows to nonadjusting unsecured creditors. For example, the provision ensures that the loans of the borrower's other unsecured creditors are not subordinated during the term of the negative pledge lender's loan. Therefore, such restrictions mean that the negative pledge lender's *share* of the net benefits derived from not creating the security interest is greater than the *entire* cost borne by the borrower. In other words, the provision is so efficient (or, equivalently, the creation of the prohibited security interests would be so inefficient) that even though the negotiating creditor cannot capture all of the benefits from the provision, the two parties still find it worthwhile to include the provision in the loan agreement.

Of course, the fact that negative pledge clauses, when value-creating, confer a benefit on other creditors means that there are many times when they are not used by unsecured lenders even though they would be efficient.[102] There are also many times that negative pledge clauses are not used because the lender takes a less efficient security interest that is more privately beneficial to the borrower because of the resulting transfer of value.[103] Thus, the widespread use of negative pledge clauses understates the extent to which the creation of the security interests they prohibit would be inefficient.[104]

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[101] Alan Schwartz is correct to point out that the existence of a negative pledge covenant does not prove that "'it would be inefficient to create . . . security interests [that would be] prohibited by its terms.'" Schwartz, *supra* note 75, at 1417 n.62 (quoting Bebchuk & Fried, *supra* note 7, at 923). Like any covenant, the negative pledge covenant can be overbroad. Our claim is therefore that, at the time the covenant is written, the parties believe that there is a net efficiency gain to prohibiting a broad range of security interests (even though some of those security interests might add value to a future transaction, or permit an efficient transaction to go forward). However, Schwartz is incorrect to argue that the willingness of a negative pledge creditor to waive the restriction (in exchange for a higher interest rate, a security interest, or some other compensation) proves that the secured transaction thereby agreed to is efficient. One cannot draw the inference that a security interest created as the result of a waiver is efficient because the other parties affected do not receive the same compensation as the negative pledge creditor, and thus may be made worse off by the secured transaction. If the waiver and resulting secured transaction make the lender and the borrower better off, but make other (uncompensated) creditors worse off by a greater amount, then the secured transaction would be inefficient.

[102] *See* Bebchuk & Fried, *supra* note 7, at 889; *supra* notes 78-79 and accompanying text.

[103] For another reason why lenders would not use negative pledge clauses even when such a clause is efficient, see Bebchuk & Fried, *supra* note 7, at 888-89 (explaining that lenders may not use negative pledge covenants where the debtor's future borrowing is difficult to monitor, where the benefits may not flow to the creditor, and where a negative pledge covenant would be overbroad).

[104] To be sure, the widespread use of negative pledge covenants in the United States takes place under the current system of de facto partial priority. As we explained in *The Uneasy Case*, certain efficiency benefits of security interests are "priority-dependent."

D. Who Is Hurt by the Use of Security Interests Under Full Priority?

In Section A, we explained that there are four classes of nonadjusting creditors that cannot or do not adjust the size of their claims against the borrower to take into account the borrower's arrangements with other creditors, including the use of security interests that, under full priority, would have the effect of reducing the expected value of these nonadjusting creditors' bankruptcy claims. In Section B, we explained why the existence of these creditors could cause a borrower to incorporate a security interest into a loan arrangement even though the security interest would not add value to the arrangement. In Section C, we presented evidence that the use of security interests would, in fact, often be value-wasting. In this Section, we identify the parties that ultimately bear the efficiency costs associated with the creation of value-wasting security interests. As explained below, the cost is spread among many different parties, including borrowers.

Perhaps the easiest way to identify the parties hurt by the creation of value-wasting security interests is first to identify the two types of parties that, in aggregate, are not hurt. The two groups that do not bear the efficiency cost associated with the use of value-wasting security interests are (1) adjusting creditors and (2) nonadjusting creditors, including trade suppliers, commercial lenders, and others, that set an interest rate that, on average, compensates them for the risk of loss they face in extending credit. Every other party affected is hurt, in one way or another, by the creation of value-wasting security interests.

Consider first involuntary nonadjusting creditors such as tort creditors. Unlike other groups that might, in theory, be able to charge a price that compensates them for the increased risk of loss due to the use of a value-wasting security interest, involuntary creditors cannot. These nonadjusting creditors thus bear part of the costs arising from the use of value-wasting security interests.[105] Certain voluntary nonadjusting creditors that do not always deal with the borrower on terms that reflect their expected risk of loss due to the

Bebchuk & Fried, *supra* note 7, at 914-21. That is, these benefits arise only to the extent secured claims are accorded priority in bankruptcy. *See id.* Because these efficiency benefits would be greater under a true full-priority regime, one might argue that the existing behavior of sophisticated creditors and their borrowers fails to demonstrate that the use of security interests would often be inefficient under a true full-priority regime. However, we also explained in *The Uneasy Case* and in this Article as well that there are significant inefficiencies that arise when secured claims are accorded full priority in bankruptcy. Bebchuk & Fried, *supra* note 7, at 918-21; *infra* Part III. Under a true full-priority regime, these inefficiencies would be greater than they currently are. Thus, there might even be more use of negative pledge covenants under a full-priority regime.

105 Of course, these creditors will also bear some of the costs associated with the other inefficiencies arising out of full priority. *See infra* Part III.

borrower's use of a value-wasting security interest and that cannot diversify the risk (for example, the borrower's employees and customers) might also bear part of the cost.

Next, consider borrowers as a class. To the extent that adjusting and sophisticated nonadjusting creditors charge higher interest rates to reflect the risk of loss due to the creation of value-wasting security interests, borrowers' profits are reduced. Note that sophisticated nonadjusting creditors will charge a higher interest rate to *any* borrower that could potentially create value-wasting security interests subordinating their claims. If in the end, all borrowers do create value-wasting security interests, then each borrower will ultimately bear the cost, through higher interest rates, that would otherwise be imposed on adjusting and sophisticated nonadjusting creditors. However, if some borrowers create security interests and others do not, and nonadjusting creditors are unable to distinguish between these two types of borrowers, then both types of borrowers will pay higher interest rates for unsecured credit even though one type will create value-wasting security interests and the other will not. In essence, the higher interest rates paid by borrowers that do not create value-wasting security interests will subsidize the use of value-wasting security interests by other borrowers.[106] This cross-subsidization effect means that borrowers creating security interests do not necessarily internalize the full cost of the security interests that they create.

III
On the Other Efficiency Costs of Full Priority

In Part II, we examined one efficiency cost of full priority: in loan transactions that would go through whether or not the parties use a security interest, full priority may cause the borrower to create a security interest even though it does not add value to the transaction. This Part further develops and defends our claim that full priority produces at least three other efficiency costs: (1) in a loan transaction in which the parties will use a security interest whether or not secured claims receive full priority in bankruptcy, according full priority to secured claims may undesirably reduce the secured creditor's monitoring of the borrower; (2) the possibility of borrowing later on a secured basis under full priority may cause a borrower to make inefficient decisions with respect to potential tort liability; and (3) when a loan transaction will not go through unless the lender is given a security

106 For a simple example of this cross-subsidization effect, see Bebchuk & Fried, *supra* note 7, at 887.

interest providing it with full priority in the underlying collateral, full priority may permit the financing of undesirable activities.[107]

A. Reduced Monitoring by Secured Lenders Under Full Priority

A potentially large efficiency cost of according full priority to secured claims is that full priority reduces the incentive of the secured creditor to "monitor" the debtor, that is, attempt to prevent the debtor from engaging in value-wasting activities, known as "misbehavior."[108] The intuition here is simple: to the extent that the secured creditor is insulated from risk of loss because it has full priority in the collateral subject to the security interest, it has less incentive to monitor the borrower for misbehavior. Full priority is likely to have two distinct effects on a secured creditor's incentive to monitor the borrower: (1) full priority will reduce the secured creditor's incentive to incorporate into the loan agreement additional covenants aimed at preventing the borrower from engaging in certain types of undesirable behavior and (2) even if full priority does not reduce the secured creditor's incentive to incorporate additional covenants into the loan agreement, it will reduce the secured creditor's incentive to attempt to enforce the covenants it has incorporated into the loan agreement, as well as whatever creditor rights state debtor-creditor law provides.[109]

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[107] Our analysis below of these three costs draws on, and further develops, material in Bebchuk & Fried, *supra* note 7. There are other possible costs of full priority which we did not examine in *The Uneasy Case* and which we will not consider here, including the possible detrimental effect of full priority on the ability of firms to reorganize themselves in Chapter 11.

[108] *See* Bebchuk & Fried, *supra* note 7, at 897-903. One commentator, asserting that in *The Uneasy Case* we use the term "misbehavior" to describe conduct by a borrower that does not further the interests of the lender, argues that such a characterization is "erroneous because it ignores the fact that the borrower is just as independent an economic actor, and therefore just as entitled to pursue its own interests, as the lender." Mann, *Explaining the Pattern*, *supra* note 48, at 649 n.89. In *The Uneasy Case*, we indicated that we use the term "misbehavior" to mean "inefficient behavior." Bebchuk & Fried, *supra* note 7, at 872. The use of the term misbehavior is not meant to imply that inefficient behavior by the borrower is necessarily illegal, immoral, or otherwise blameworthy. And an efficient activity that runs counter to the interest of the lender would not be considered misbehavior, even if the activity would violate the loan agreement. (To the extent the borrower is unable to engage in an efficient activity because of the loan agreement, we would consider that result an "opportunity cost" of the loan arrangement. *See supra* note 53 and accompanying text.)

[109] For a discussion of how lenders monitor borrowers' behavior through various features of their loan agreements, see Raghuram Rajan & Andrew Winton, *Covenants and Collateral As Incentives to Monitor*, 50 J. FIN. 1113 (1995). There are a number of theories addressing how full priority could assist the monitoring of a borrower. We reviewed these theories in *The Uneasy Case*, and explained why we believe that full priority is unlikely to offer significant monitoring benefits. Bebchuk & Fried, *supra* note 7, at 913-17. During the Symposium, no one expressed support for full priority on these grounds, so we will not restate these theories and our analysis of them here.

1. *Reduced Use of Covenants*

When a borrower and a creditor have adopted a security interest, full priority makes it less likely that the two will include in their arrangement a set of covenants that would be efficient. This problem may arise even if the security interest giving the creditor full priority adds value to the arrangement. The point is that the arrangement would add *even more value* if it also included the covenants that, as a result of full priority, the arrangement does not incorporate.

In a perfect world in which the terms of other creditors' arrangements fully reflect the consequences to them of all of the elements of the arrangements into which the borrower enters, a borrower and a creditor would have an incentive to adopt any covenant that is efficient because they would capture all of the resulting benefits. In our world, however, nonadjusting creditors would capture part of the benefits and bear none of the costs of any covenants which the creditor and the borrower negotiate. Consequently, even if the set of covenants were efficient, it would not be privately beneficial for the borrower and creditor to adopt the covenants if the cost to the borrower outweighs the benefits accruing to the creditor (and any other adjusting creditors).

Although this problem—that a borrower and creditor will have an insufficient incentive to adopt efficient covenants—is generally true whenever there are creditors whose claims do not fully reflect the agreement between the borrower and creditor, the problem becomes even more severe if the two parties adopt a security interest under the rule of full priority. In such a case, the creditor's risk of loss will be reduced and, therefore, the benefit to the creditor of an additional set of covenants will be even smaller.[110] The creditor is thus even less likely under a rule of full priority to adopt a covenant that is highly efficient.[111]

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[110] If the creditor's loan is fully secured, and there is sufficient excess collateral to fully cover the creditor's collection costs and any unpaid interest, then its risk of loss will approach zero. *Cf.* Hudson, *supra* note 46, at 52 (observing that a bank with a secured loan will have no incentive to use its knowledge of the debtor optimally because it is fully protected from risk of loss).

[111] For an extended example, see Bebchuk & Fried, *supra* note 7, at 900-01. The point that a creditor taking security is less likely to "monitor" the debtor through other contractual restrictions is well understood in the literature. *See* Buckley, *supra* note 5, at 1440; Jackson & Kronman, *supra* note 5, at 1153; Triantis, *supra* note 5, at 244. For empirical evidence that secured lenders adopt fewer covenants, see Kenneth Lehn & Annette Poulsen, *Contractual Resolution of Bondholder-Stockholder Conflicts in Leveraged Buyouts*, 34 J.L. & ECON. 645, 660-68 (1991).

2. *Reduction in Monitoring*

We have just seen that, in the presence of nonadjusting creditors, the use of a security interest may cause a borrower and a creditor to forego the use of desirable covenants even if the security interest adds value to the arrangement. However, even if full priority has no effect on the use of covenants in the arrangement,[112] full priority can inefficiently reduce the creditor's incentive to enforce its loan contract with the borrower. In particular, full priority can give the creditor less incentive to enforce any loan contract covenants with the borrower or to force the borrower into bankruptcy when it would be socially desirable for the borrower to liquidate or reorganize.[113]

In discussing full priority's effect on the use of covenants in loan arrangements, we abstracted from the level of the creditor's enforcement efforts—the activities the creditor undertakes to ascertain that the borrower is complying with its contractual commitments. However, a borrower's incentive to comply with the covenants it has issued may depend on the extent of the creditor's enforcement efforts. That is, the less the creditor monitors the borrower's compliance with these commitments, the less likely it is to detect a breach. Hence, it will be more likely that the borrower will find the expected cost of breach to be less than the expected benefit of breach, and therefore will violate the covenants. To the extent that the covenants bar the borrower from engaging in inefficient activities, the level of the creditor's enforcement efforts will therefore have efficiency implications.

Even in the absence of priority, the creditor will engage in less than the optimal amount of enforcement activity because some of the benefit of this activity will flow to other creditors, yet it (and the borrower) will bear all of the costs. However, the creditor will have even less of an incentive to engage in enforcement activities to the extent that a security interest giving the creditor's claim full priority in bankruptcy protects the creditor from risk of loss, just as it will have less incentive to adopt even highly efficient covenants. As a result, the borrower may be more likely to violate a covenant and act inefficiently under a rule of full priority if the creditor has a security interest. Thus, even if full priority does not lead to the adoption of fewer covenants, it may well degrade the effectiveness of the covenants they do adopt and lead to efficiency problems by reducing the creditor's in-

[112] One can imagine a number of cases in which the priority rule does not affect a creditor's use of covenants. For example, a bank may use the same standardized loan contract whenever it extends credit to a particular class of borrowers whether or not it also takes a security interest. *See* Bebchuk & Fried, *supra* note 7, at 902 n.150. Another example might be financing sellers, which may or may not take a security interest when they extend credit, but rarely employ covenants in either case.

[113] *See* Bebchuk & Fried, *supra* note 7, at 902-03; Woodward, *supra* note 37, at 35-37.

centive to monitor the borrower's compliance with those covenants.[114]

Under the rule of full priority, a secured creditor that is well protected by collateral does not have sufficient incentive to call a default (or cut off funding) when the borrower's owners attempt to continue operating inefficiently in the hope of saving the business.[115] Because in many cases a borrower's unsecured creditors will have neither the information nor the sophistication to force the borrower into bankruptcy,[116] there will be an efficiency loss until the secured creditor forces the borrower to cease operating.[117] Thus, even if the creditor and borrower did not include any covenants in the loan agreement other than a default clause, full priority, by tending to insulate the creditor from the effects of the borrower's collapse, does not provide the creditor with the proper incentive to terminate its relationship with the borrower.[118]

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114 Even those who support the rule of full priority recognize the problem that a fully secured creditor will suboptimally monitor the borrower. *See, e.g.*, Buckley, *supra* note 5, at 1440-41. Because all contracts between commercial borrowers and creditors implicitly incorporate the mandatory rules that govern the debtor and creditor relationship, such as fraudulent conveyance law and corporate law limitations on payments to shareholders, this problem will arise even if the two parties do not choose to adopt other covenants. *See* Bebchuk & Fried, *supra* note 7, at 903 n.151.

115 It is widely understood that under full priority a secured creditor with influence over a borrower may not act optimally on the eve of bankruptcy. *See* Hudson, *supra* note 46, at 49; Jackson & Scott, *supra* note 46, at 170-71; White, *supra* note 46, at 554-55.

116 *See* Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775, 794 (1987).

117 Some commentators have argued that monitoring is ineffective because the secured creditor will react to borrower misbehavior by seizing the collateral, leaving unsecured creditors with nothing. *See* Lisa M. Bossetti & Mette H. Kurth, *Professor Elizabeth Warren's Article 9 Carve-Out Proposal: A Strategic Analysis*, 30 UCC L.J. 3, 20-21 (1997). However, these commentators miss two important points. First, the threat of repossession deters borrowers from engaging in activities that would adversely affect unsecured creditors. Second, by shutting down a company that is operating inefficiently, a secured creditor prevents a borrower from incurring more debts to current and future unsecured creditors (including the government, employees, customers, and trade creditors) which it is unlikely to be able to repay.

118 Full priority can also give a secured creditor insufficient incentive to provide additional credit to a borrower when avoiding bankruptcy would be efficient. *See* Klee, *supra* note 32, at 1472-74. In *The Uneasy Case*, we cited Dean Scott's empirical study of borrower-lender relationships and an article by a senior bankruptcy judge to support our claim that a "bank will be able to exert a significant amount of influence over the borrower. Indeed, a bank will frequently determine whether or not a borrower files for bankruptcy and the timing of any filing. Thus, the bank is in a unique position to control a borrower's behavior." Bebchuk & Fried, *supra* note 7, at 903 (citing Samuel L. Bufford, *What Is Right About Bankruptcy Law and Wrong About Its Critics*, 72 WASH. U. L.Q. 829, 834-35 (1994); Scott, *supra* note 5, at 925-33). Some readers have interpreted this to mean that we believe the bank "controls" the business of the borrower. We are not claiming that the secured lender runs the borrower's business, which might expose it to lender liability. We are simply making the familiar point that, by threatening to call a default (or by calling a default), a bank has a tremendous amount of leverage over a financially-distressed borrower. *See* LoPucki, *supra* note 11, at 1492-93; Mann, *Explaining the Pattern*, *supra* note 48, at 646-48.

B. Inefficient Decisions with Respect to Potential Tort Liability

As we saw, full priority may affect a borrower's behavior following a loan transaction if the effect of full priority is to cause the creditor to fail to incorporate various covenants into the arrangement or enforce those that are incorporated. However, the borrower's ability to give the creditor a security interest that subordinates the claims of nonadjusting creditors may affect the borrower's behavior even before the creditor and the borrower negotiate their loan contract.

Consider the case where the borrower must decide, prior to contracting with the creditor, whether to take certain precautions that will make its products safer and reduce the number of future tort claims against the borrower. The borrower knows that when the creditor and the borrower later negotiate their loan contract, the creditor will take expected tort claims into account in setting its interest rate. If the creditor is unsecured, the creditor will charge the borrower a higher interest rate, to the extent it anticipates that future tort claims will reduce the value of its loan by diluting the creditor's share of the borrower's bankruptcy assets. By adjusting its interest rate to take into account the expected number of tort claims, the creditor will force the borrower to internalize more of the costs of the tort claims that are likely to arise if it fails to take these precautions. If the creditor is expected to be unsecured, the prospect of paying a higher interest rate to the creditor will increase the incentive for the borrower to take the precautions in the first place.

Under the rule of full priority, however, the borrower may give the creditor a security interest that protects the value of the creditor's loan from the dilutory effect of tort claims. Consequently, if the creditor is given a security interest, it may not charge a higher interest rate even if the borrower fails to take precautions, and there are more tort claims against the borrower. Because the borrower will not face the prospect of paying the creditor a higher interest rate if more tort claims against it are likely, the borrower will have less incentive to invest in precautions if it knows that it can grant the creditor a security interest giving the creditor's secured claim full priority.[119]

With respect to this particular efficiency cost of full priority, Harris and Mooney argue that tort liability generally has little to no effect on a borrower's behavior.[120] Therefore, the borrower's ability to reduce the effect of tort liability by issuing security interests under the rule of full priority should not, they argue, have much effect on the

[119] Both those favoring and those critical of the rule of full priority recognize the use of security interests to permit the borrower to bear less of the tort claims against it. *See* Buckley, *supra* note 5, at 1417; LoPucki, *supra* note 60, at 1898.

[120] Harris & Mooney, *supra* note 11, at 1361-70.

borrower's decisions whether to take precautions or to refrain from activities likely to generate tort claims.

We do not share the view that tort liability has little effect on firm behavior, for there is substantial evidence that tort liability does affect firm behavior. For example, firms invest in precautions that reduce their expected tort liability. Firms would not incur such expenses if they were indifferent to their expected tort liability.

Harris and Mooney argue in the alternative that even if tort liability does affect firm behavior, firms' ability to reduce the cost of tort liability by issuing secured debt under a rule of full priority is likely to have only a minimal effect on tort liability, and therefore, on firm behavior. Whether full priority has a small or large effect on tort liability is, of course, an empirical question to which we currently do not have an answer.[121] Nevertheless, it is worth emphasizing that even if full priority has only a limited effect on expected tort liability, and therefore on firm behavior, partial priority may still yield substantial benefits in terms of reducing expected tort liability. For example, a slight increase in expected tort liability might cause firms to adopt, at little expense, additional precautions that have a substantial effect on the amount of expected harm.

C. Funding of Marginal Activities

So far, we have discussed three efficiency costs of full priority: (1) in loan transactions that will go through in any event, full priority may cause a borrower to incorporate a security interest into the arrangement even though it is value-wasting; (2) in loan transactions that will use a security interest regardless of the priority rule in bankruptcy, full priority may undesirably reduce the secured creditor's incentive to monitor the borrower; and (3) the prospect of borrowing on a secured basis under full priority may cause a firm to undesirably reduce its investment in precautions or to undesirably engage in more activity likely to give rise to tort liability.

The fourth efficiency cost of full priority is that it may facilitate loan transactions that enable the borrower to fund inefficient investments. The intuition here is simple: when there are nonadjusting creditors, the creation of a security interest giving a lender full priority creates a subsidy not only for the use of the security interest in the arrangement, but also for the transaction itself. Thus, a transaction that would not go forward without such a subsidy might go forward with such a subsidy. We will defer further discussion of this efficiency cost of full priority until Part V, where we discuss the effect of partial

[121] *See id.* at 1370. It is easy, of course, to construct a numerical example showing that a particular rule has no effect on a firm's behavior. *See* Bossetti & Kurth, *supra* note 117, at 18-19.

priority on the financing of value-increasing and value-decreasing projects.

IV
On the Design of Partial-Priority Rules

We have seen that full priority can produce significant efficiency costs. However, it would not be desirable to adopt a rule of partial priority if either (a) the efficiency costs of such a rule would be even larger; or (b) such a rule could not be effectively implemented. Before considering these issues (as we do in Parts V and VI), it is necessary to explain how partial priority might be implemented. Therefore, this Part presents and discusses three possible partial-priority rules. We first restate the two partial-priority rules that we put forward and analyzed in *The Uneasy Case* (the "fixed-fraction priority rule" and the "adjustable-priority rule").[122] We then introduce a third possible rule (the "consensual-priority rule").

The three partial-priority rules can be summarized as follows. Under the "fixed-fraction priority rule," a fixed fraction of the collateral backing secured claims would be made available to pay the claims of unsecured creditors.[123] The "adjustable-priority rule" accords secured claims priority only over the claims of nonadjusting creditors.[124] Finally, under the "consensual-priority rule," secured claims would have priority only over the claims of creditors that had explicitly consented to subordination.

We wish to emphasize that none of these partial-priority rules would be superior in every respect to the rule of full priority. There would be efficiency costs associated with these rules or any rule of partial priority. Thus, although some commentators have read *The Uneasy Case* as advocating adoption of a partial-priority rule,[125] we tried to make clear in *The Uneasy Case* and will restate here that, at this point, we merely think that these rules should be considered with an open mind as alternatives to full priority.[126]

Before proceeding with descriptions of these rules, we also must emphasize three other points. First, as we have explained in *The Uneasy Case* and in this Article, the purpose of these rules is not to protect unsecured creditors, although all of these rules might have the effect of making certain groups of unsecured creditors, such as involuntary creditors and unsophisticated creditors that do not set their interest

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[122] Bebchuk & Fried, *supra* note 7, at 904-11.
[123] *See id.* at 909-11.
[124] *See id.* at 905-09.
[125] *See, e.g.*, LoPucki, *supra* note 11, at 1495; Mann, *Explaining the Pattern*, *supra* note 48, at 683 n.228.
[126] Bebchuk & Fried, *supra* note 7, at 904, 934.

rate to reflect the risk of loss from the borrower's failure and the subordination of their claims (e.g., customers and employees), better off.[127] The purpose of these rules is to reduce the efficiency costs associated with full priority.[128]

Second, although some commentators have characterized the two rules we put forward in *The Uneasy Case* as "a subordination scheme,"[129] none of these rules subordinates the claims of secured creditors to those of unsecured creditors: *under all three of the rules, secured creditors' claims would receive at least as much as unsecured creditors' claims.* Indeed, neither of the two rules we considered in *The Uneasy Case* would completely eliminate the priority accorded to secured claims in bankruptcy. Rather, these partial-priority rules would affect only the degree to which the secured creditor enjoys priority in its collateral over unsecured creditors when the debtor enters bankruptcy.[130] Furthermore, under all three of the partial-priority rules we consider, a secured creditor would continue to enjoy full priority in its collateral over the claims of subsequent secured creditors, transferees, nonordinary-course purchasers, and unsecured creditors that had consented to subordination.[131] Finally, none of these priority rules would have any effect on the secured creditor's rights outside of bankruptcy. That is, none of the rules would require modifying Article 9 of the UCC or the state laws governing transactions in real property.[132]

Third, there is no need to apply the same partial-priority rule in every context. Some Symposium participants expressed the concern that imposing a partial-priority rule in certain contexts (for example, securities loans among financial institutions) would produce little benefit and give rise to potentially large costs. To the extent that there are particular transactions that should not be subject to partial priority, they could be exempted.[133] In general, secured creditors could be given different degrees of priority in their collateral depend-

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[127] *Id.* at 904.

[128] In a world without priority but with nonadjusting creditors, the problems that we identify would continue to arise, albeit to a lesser degree. *See* Baird, *supra* note 45, at 1427-29.

[129] Harris & Mooney, *supra* note 11, at 1364.

[130] Under the third rule, a secured creditor would not enjoy any priority over the claim of an unsecured creditor that had not explicitly consented to subordination. Instead, the secured creditor and the unsecured creditor would both share pro rata in the collateral. *See infra* Part IV.C.

[131] Thus, any of the rules would be compatible with any system of priority among secured claims.

[132] Therefore, the adoption of any of the rules would not affect the priority-independent efficiency benefits connected with security interests. *See* Bebchuk & Fried, *supra* note 7, at 875-76.

[133] *See* Klee, *supra* note 32, at 1477-78.

ing on the type of collateral, the size of the loan, and the type of the lender or borrower.[134]

A. The Fixed-Fraction Priority Rule

Under the fixed-fraction priority rule, a secured creditor would receive full priority with respect to a certain percentage of its secured claim. The collateral backing the rest of the claim would be made available to pay unsecured claims (including that portion of the secured creditor's secured claim that was made unsecured by operation of the rule). Thus, under a rule giving secured creditors 75% of their secured claim, the other 25% of the collateral would be distributed to pay unsecured claims—including the unsecured claims of all secured creditors.[135] The fixed-fraction priority rule would always leave secured creditors partially unsecured, even if the value of the collateral exceeds the amount owed to them.[136]

To illustrate the operation of the fixed-fraction priority rule, we will consider the version in which the secured creditor receives priority with respect to 75% of its secured claim. Assume that when the borrower goes bankrupt, it has $1.2 million in assets and owes $1 million to each of three creditors: the secured creditor, an adjusting creditor, and a nonadjusting creditor. Assume that the secured creditor has a security interest with respect to all $1.2 million of the borrower's assets. Its secured claim—which is the lesser of the amount owed and the value of the collateral—would thus be $1 million. Under a 75% fixed-fraction priority rule, the secured creditor receives $750,000 of the encumbered assets. The remainder of its claim, $250,000, is made unsecured and pooled with those of the other two creditors. The

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[134] We agree with those who argue that in designing a bankruptcy system attention must be paid to underlying commercial practices. *See, e.g.*, Mann, *supra* note 11, at 48. However, commercial practices evolve rapidly and are in part shaped by the rules used to govern them. Thus it would be fruitless and perhaps counterproductive to try to fashion a different priority rule for each commercial context.

[135] In 1985, the German Commission on Bankruptcy Law proposed a variant of the fixed-fraction priority rule as a replacement for the rule of full priority in German bankruptcy law. *See* Drukarczyk, *supra* note 5, at 205 & n.8. The proposal recommended that secured creditors receive only 75% of the amount of their secured claims collateralized by personal property on the grounds that personal property liens in Germany are difficult to discover, and that, as we have argued, exposing secured creditors to increased risk of loss is likely to encourage more desirable monitoring of their borrowers. *See id.* at 205. Although this proposal was never adopted, the new German Insolvency Law, adopted in 1994, incorporates several new administrative fees that have the effect of reducing the payment to secured claims in bankruptcy by 9% of the value of personal property collateral. *See* Bebchuk & Fried, *supra* note 7, at 909-10; Klee, *supra* note 32, at 1477-78.

[136] Contrary to the claims of some commentators, the fixed-fraction rule would not "limit[ ] security interests to a percentage of a borrower's collateral." Bossetti & Kurth, *supra* note 117, at 4. Under the 75% fixed-fraction rule, a borrower could encumber all of its collateral. However, in bankruptcy, at least 25% of the encumbered collateral would be made available to pay the claims of unsecured creditors.

$450,000 in assets available to pay unsecured claims is then distributed to the three creditors in proportion to their unsecured claims so that the $2.25 million in unsecured claims ($2 million in claims by the adjusting and nonadjusting creditors and $0.25 million of the secured creditor's secured claim which is rendered unsecured by operation of the rule) are paid 20 cents on the dollar. Thus, the secured creditor receives $50,000 for its unsecured claim and the other creditors receive $200,000 each.[137]

As we explain in *The Uneasy Case*, the fixed-fraction priority rule would reduce the ability of creditors and their commercial borrowers to use security interests to transfer value from nonadjusting creditors by not allowing secured claims to fully subordinate nonadjusting claims in bankruptcy.[138] The fixed-fraction priority rule would thus also decrease the excessive use of security interests, the distortion in the monitoring arrangements of commercial borrowers and their creditors, and (as we will explore in more detail below) the funding of undesirable business activities. The reduction of these distortions would depend on the percentage of the secured claim that is treated as unsecured: the larger the percentage, the greater the reduction in the identified efficiency costs. In the extreme case where the entire secured claim is treated as unsecured, the parties could not use a security interest to transfer value in bankruptcy, and the inefficiencies that full priority causes would be completely eliminated.[139]

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[137] One person has suggested to us that the rule "double-compensates" adjusting creditors by giving them some of the secured creditors' collateral even though they had adjusted to the security interest by charging a higher interest rate. If a creditor is adjusting, however, it will charge a lower interest rate than it would under full priority to reflect the fact that it will receive a larger fraction of the borrower's bankruptcy estate. As a result, the fixed-fraction rule does not overcompensate adjusting creditors.

[138] Bebchuk & Fried, *supra* note 7, at 910.

[139] *See id.* Ronald Mann has argued that in the context of construction finance, his proposal to give the claims of contractors priority over the claims of (secured) construction lenders would be superior to a fixed-fraction rule which, in this context, would give secured construction lenders partial priority over contractors. Mann, *supra* note 11, at 46-48. Although his carefully-researched proposal may well be worth adopting, his claim that a contractor-first rule gives construction lenders more incentive to control risk than a fixed-fraction rule is not necessarily correct. Relative to a fixed-fraction rule, a contractor-first rule would force construction lenders to internalize more of the costs that would otherwise fall on contractors, giving construction lenders more of an incentive to reduce the risk of loss faced by this class of creditors. However, unlike a fixed-fraction rule, a contractor-first rule would not force construction lenders to internalize any of the costs imposed on other creditors, including tort creditors, the government, and other nonadjusting creditors of the property owner, thereby giving construction lenders less incentive to reduce the risk of loss faced by these classes of creditors. Depending on the fraction of secured claims that the fixed-fraction rule would treat as unsecured, and the size of these other creditors' claims relative to the claims of contractors, a fixed-fraction rule might provide construction lenders with more of an incentive to reduce the risk of loss faced by other creditors.

In any event, the purpose of our rules is to reduce the efficiency costs that arise from priority, not to solve all of the possible problems that can arise in contracting between

B. The Adjustable-Priority Rule

The other partial-priority rule we put forward in *The Uneasy Case* is the adjustable-priority rule.[140] Under the adjustable-priority rule, claims of nonadjusting creditors would not be subordinated to secured claims with respect to which they were nonadjusting. In other words, a nonadjusting creditor's share of bankruptcy value would be calculated by (1) assuming that the secured claims with respect to which the creditor was nonadjusting were actually unsecured claims, and (2) applying the rule of full priority. The difference between what the nonadjusting creditor would receive under the rule of full priority and what it receives under the adjustable-priority rule would come at the expense of the secured claims with respect to which it was nonadjusting. Adjusting creditors would receive what they would have received under the rule of full priority.

One might question whether a bankruptcy court could, in fact, identify those creditors that were nonadjusting with respect to a particular security interest in order to enforce such a rule. In *The Uneasy Case*, we address the feasibility of implementing the adjustable-priority rule, and will not do so again here.[141] Below, we will simply assume that the court is able to identify a debtor's nonadjusting creditors to show how the rule would work under ideal conditions.

Suppose again that a borrower goes into bankruptcy with $1.2 million in assets and outstanding liabilities of $3 million, of which $1 million is owed to the secured creditor, $1 million is owed to an adjusting unsecured creditor, and $1 million is owed to a nonadjusting creditor. Again, assume that all $1.2 million of the assets are subject to a security interest held by the secured creditor.

In the absence of any priority, the $1.2 million in assets would be divided on a pro rata basis with each creditor receiving $400,000. Under the rule of full priority, assuming that all unsecured creditors share pro rata in the remaining assets, the secured creditor receives $1 million and the remaining $200,000 in assets is divided equally between the other two creditors. The result under full priority is that $300,000 of bankruptcy value is transferred from each unsecured creditor to the secured creditor. The secured creditor thus benefits under the full-priority rule at the equal expense of both the adjusting and the nonadjusting creditor.

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borrowers and creditors. *See* Bebchuk & Fried, *supra* note 7, at 904 n.158. A rule such as Mann's that gives superpriority to a limited class of nonadjusting creditors (while reducing the inefficiencies that result from the presence of those nonadjusting creditors) will not reduce the efficiency problems arising from priority to the extent that they are caused by the presence of involuntary creditors and other voluntary nonadjusting creditors. *See id.* at 907-08.

140 *Id.* at 905.

141 *Id.* at 908-09.

Under the adjustable-priority rule, the secured creditor's claim is treated as unsecured for the purpose of determining the nonadjusting creditor's share. As a result, the nonadjusting creditor in this example is entitled to receive $400,000. The $300,000 difference between what the nonadjusting creditor receives under the rule of full priority—$100,000—and what it receives under the adjustable-priority rule—$400,000—comes at the expense of the creditor's secured claim. The adjusting creditor would receive what it would have obtained under full priority, $100,000, and the secured creditor would thus receive $700,000.

Because the use of the security interest would not affect the nonadjusting creditor's share of bankruptcy value, the adjustable-priority rule would ensure that the security interest could not be used to transfer bankruptcy value from nonadjusting creditors. Thus, if such a rule could be fully implemented, it would eliminate the inefficiencies we identified—the use of inefficient security interests, the monitoring distortions, and the funding of undesirable projects—to the extent they arise out of full priority.

It is worth emphasizing that an adjustable-priority rule is not the same as a rule that would give certain creditors *superpriority* over secured creditors' claims. For example, a growing number of commentators have proposed that tort or other claims receive superpriority over secured claims (or certain secured claims) in bankruptcy.[142] The goal of these proposals has been to increase firms' incentives to reduce harmful externalities on third parties. As we explained in Part III, the borrower's ability to subordinate unsecured creditors' claims by issuing security interests, giving the secured lender priority, enables the borrower to internalize less of the cost it imposes on these parties than it would under a rule of pro rata sharing in bankruptcy (or under the adjustable-priority rule). Superpriority would thus force borrowers to internalize even more of these costs than pro rata sharing, and presumably would lead borrowers to take even better precautions and choose even better projects than under a pro rata rule. However, superpriority for tort claimants would, at best, somewhat reduce, and certainly not eliminate, the efficiency problems that full priority causes. As explained, the efficiency costs of according full priority to secured claims arise because of the existence of nonadjusting creditors, most of which are voluntary creditors or government agencies. Thus, giving superpriority to tort claims would immunize tort creditors against the effect of priority, thereby reducing the effi-

[142] For recommendations that tort creditors receive priority over the claims of other creditors, see Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 STAN. L. REV. 311, 340 (1993); Leebron, *supra* note 63, at 1650; LoPucki, *supra* note 60, at 1907-08; Roe, *supra* note 73, at 227; Painter, *supra* note 63, at 1088-81.

ciency costs to the extent that they are due to the presence of tort creditors. However, such a scheme would not, unlike the adjustable-priority rule, reduce the distortions and efficiency costs resulting from the presence of contractual nonadjusting creditors and government claims.

C. A Consensual-Priority Rule

In *The Uneasy Case* and this Article, we have argued that full priority is inconsistent with the general commercial law principle against nonconsensual subordination.[143] The fixed-fraction priority rule would also allow nonconsensual subordination, although to a lesser degree than full priority. Similarly, the adjustable-priority rule—even if it could be implemented so that secured creditors receive priority only over the claims of adjusting creditors—would not require adjusting creditors' explicit consent for subordination. Thus, both rules would be at least somewhat inconsistent with the general principle that a borrower cannot subordinate the claims of particular creditors without their explicit consent.

The third rule we put forward—the consensual-priority rule—would harmonize the priority system with the general principle against nonconsensual subordination by giving a secured creditor priority in its collateral only over the claims of creditors that had explicitly consented to subordination. (The explicit consent might be with respect to a particular security interest or all security interests which the borrower creates.)

A borrower would be able to obtain creditors' consent to subordination. Thus, such a rule would not prevent the borrower and its creditors from contracting for full priority.[144] However, a creditor that had not explicitly consented to subordination would receive a bankruptcy share equal to that which it would have received if all of the creditors were unsecured and shared pro rata in the bankruptcy assets.

D. Why Not Partial Priority Outside of Bankruptcy?

The rules we describe would apply in bankruptcy. However, it is important to emphasize that we are not advocating, as others have suggested,[145] that partial priority apply only in bankruptcy. If partial priority is superior to full priority, we think that this distributional

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143 Bebchuk & Fried, *supra* note 7, at 868-70.

144 Under the other two partial-priority rules, a borrower and its contractual creditors could also, by contract, subordinate the claims of particular creditors to the claims of others.

145 *See, e.g.*, LoPucki, *supra* note 11, at 1488.

principle should apply to any liquidation or reorganization of an insolvent firm, either inside or outside of bankruptcy.

As a practical matter, however, it makes sense to consider first rules that would apply only in bankruptcy.[146] First, it would be simpler to make changes to bankruptcy laws than it would be to make uniform changes to the various state laws that govern priority in personal property and real property.[147] Second, there is no need to apply partial priority to solvent firms (and there may well be costs to doing so). A bankruptcy-only rule ensures that the rule would apply only to firms in financial distress.

Of course, a bankruptcy-only rule would not be as effective as a more widely implemented rule.[148] However, as we will explain below, we think that a bankruptcy-only partial-priority rule could still be quite effective.[149]

V
On the Cost and Availability of Financing Under Partial Priority

Various Symposium participants and others have expressed concern that a partial-priority rule would have an adverse effect on the financing of business activity.[150] That is, partial priority might make it more difficult for businesses to finance desirable (value-increasing) projects.

Before we analyze this claim in more detail, three points are worth noting up front. First, in a world where not all business projects are value-increasing, the desirability of a partial-priority rule's effect on firms' ability to finance their projects will depend not only on whether partial priority prevents some desirable projects from going forward, but also on whether it prevents some undesirable projects from going forward. Specifically, a partial-priority rule's effect on firms' ability to finance their projects would be desirable (relative to an alternative rule) if the economic cost avoided when value-decreasing projects do not go forward is greater than the economic benefit lost when desirable projects do not go forward.

Second, the magnitude of the effect of a partial-priority rule on the financing of projects will depend on the degree to which the rule continues to respect priority. Suppose that under our current ad hoc

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146 Many others apparently share the view that if partial priority is to be adopted, it should be adopted only in bankruptcy. *See* LoPucki, *supra* note 11, at 1483-84 & n.5 (citing those advocating a bankruptcy-only approach).

147 *See* Klee, *supra* note 32, at 1478; LoPucki, *supra* note 11, at 1485 n.12.

148 *See* LoPucki, *supra* note 11, at 1503-04, 1509-10.

149 *See infra* Part VI.

150 *See, e.g.*, Harris & Mooney, *supra* note 11, at 1356-64; Klee, *supra* note 32, at 1472-74; Turner, *supra* note 6, at 328-29.

system of partial priority, secured claims are paid, on average, 90 cents on the dollar. If that is the case, replacing the current system with a 90% fixed-fraction priority rule is likely to have little effect on the financing of business activity, for better or for worse. A partial-priority rule of 50% would, of course, have a larger effect, and so on.

Third, even if a partial-priority rule's net effect on the financing of projects is undesirable (for example, the economic cost arising from the failure of value-increasing projects to be financed is greater than the economic benefit arising from the failure of value-decreasing projects to be financed), the overall economic effect of partial priority may still be desirable because partial priority will provide other benefits that could offset the negative net effect on project financing. In particular, a partial-priority rule might reduce the excessive use of security interests, lead to better monitoring of firms that do receive financing, and give firms more incentive to avoid externalizing harms on third parties. Thus, even if one believes that a particular partial-priority rule's net effect on financing projects would be negative, one should still be open-minded as to whether the rule is worth adopting.

A. Some Preliminary Points

To begin, we want to make some general points on the cost and availability of credit under partial priority. Our claim is that, on an aggregate basis, the availability and cost of credit need not change substantially under a rule of partial priority.

1. *The Availability of Secured Credit Under Partial Priority*

One argument against partial priority is that certain lenders will not lend at any interest rate unless they have full priority in the collateral that is subject to the security interest.[151] The evidence adduced in support of this claim is that currently there are lenders that will not lend unless they receive a security interest. Supporters of full priority argue that under partial priority these lenders simply will not lend money to borrowers at any interest rate and, therefore, that partial priority will reduce the amount of credit these lenders extend. (Presumably, those who make this argument would also claim that borrowers would have no other sources of credit, so that the total supply of credit would be reduced.[152])

Let us assume *arguendo* that currently, certain lenders will not lend without getting a security interest. Even if this assertion were

[151] *See* Harris & Mooney, *supra* note 5, at 2030-35; Kripke, *supra* note 5, at 954-55 & n.95.

[152] There is, however, evidence to the contrary. *See* Mann, *Small-Business Lending*, *supra* note 48, (manuscript at 12-15) (reporting that small commercial borrowers have alternatives to secured credit).

true, it certainly does not prove that these lenders will not lend under a rule of partial priority. After all, these lenders are currently operating under a system of de facto partial priority.[153] The assertion proves only that under the current priority regime, certain lenders require a security interest.

The question, then, is whether reducing the degree of priority in bankruptcy will cause these lenders to restrict credit. This, in turn, will depend on why these lenders do not lend without a security interest. For our purposes, there are two possible reasons why currently certain lenders will not lend without a security interest: (1) because the security interest gives the lender priority over the claims of unsecured creditors in bankruptcy, or (2) because the security interest gives the lender priority-independent rights (for example, priority over the claims of transferees or subsequent secured creditors) that are unrelated to the lender's priority in bankruptcy over the claims of unsecured creditors.

Suppose that the reason that certain lenders will not lend without a security interest is that security interests afford the lender priority in bankruptcy over the claims of unsecured creditors. Currently, secured claims do not get full priority in bankruptcy.[154] Thus, these lenders are clearly willing to lend under partial priority. The question, then, is how much priority is necessary to induce these lenders to lend? Ninety percent? Eighty percent? And how much priority would a secured lender require if the borrower's owners guarantee the loan?[155]

Now suppose that the reason why certain lenders will not lend without a security interest is that the security interest gives lenders many other rights which are connected not to the priority accorded to secured claims in bankruptcy, but rather to something else. For example, it is possible that many lenders will not lend without a security interest because they have no other means of preventing the borrower, should it be on the verge of failing, from liquidating its assets and distributing the proceeds to related parties. To the extent certain lenders insist on a security interest for this reason, a partial-priority rule in bankruptcy will not cause these lenders to lend any less. In short, we are skeptical of the claim that if priority is further reduced, the supply of secured credit will materially decrease.[156]

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[153] *See supra* Part I.D.

[154] *See supra* Part I.D.

[155] A separate question—which we address *infra* Parts V.B-C—is if lenders do not lend with, say, 80% priority, are the projects that would go unfunded generally value-increasing projects or value-reducing projects?

[156] To support the claim that it is necessary to give secured creditors full priority over the claims of unsecured creditors in bankruptcy, some commentators point to evidence that there is inadequate lending in third-world countries without functional security sys-

2. *The Aggregate Cost of Credit Under Partial Priority*

We just explained that the adoption of a partial-priority rule need not reduce the aggregate supply of secured credit in the economy. Let us now consider how a partial-priority rule would affect the aggregate cost of secured and unsecured credit, assuming, for purposes of the analysis, that the availability of secured and unsecured credit remains the same. As we will see, a partial-priority rule could either increase or decrease the aggregate cost of credit in the economy.

To begin, let us assume that partial priority has no direct effect on borrowers other than on the distribution of the borrower's assets in bankruptcy, which, in turn, affects the cost of both secured and unsecured credit.[157] To the extent that a partial-priority rule reduces the expected value of secured creditors' share of bankruptcy value, secured creditors will charge more under such a rule than under a rule of full priority. However, voluntary unsecured creditors, in aggregate, should be willing to charge less interest under a partial-priority rule than under full priority.[158] In a world where (1) the priority rule's only effect is to change the distribution of assets in bankruptcy, and (2) all of the unsecured creditors are voluntary and set their interest rates to reflect their risk of loss, the total cost of credit should remain unchanged.

Now, let us assume (as we have argued is likely to be the case) that partial priority not only affects the distribution of value in bankruptcy, but also causes borrowers and their secured creditors to enter into more efficient arrangements than under full priority.[159] In a world where partial priority has these two effects and all unsecured creditors set their interest rates to reflect their expected risk of loss,

tems. *See* Harris & Mooney, *supra* note 11, at 1358 n.39; Turner, *supra* note 6, at 329. For two reasons this evidence fails to support their claim. First, creditors in these countries might restrict their lending not because they lack priority in their collateral over the claims of unsecured creditors in bankruptcy, but because in the absence of a functional security system, they cannot prevent a borrower on the verge of failure from liquidating its assets and transferring the proceeds to its owners or related parties (or transferring the collateral directly to these parties). We suspect that the primary reason that lenders in these countries are reluctant to lend is their inability to prevent such fraudulent transfers. Bebchuk & Fried, *supra* note 7, at 874. Second, even if the lenders' main concern is not controlling the borrower's behavior, but rather their priority position in bankruptcy, the fact that these lenders are reluctant to lend when they have 0% priority in bankruptcy (i.e., they share pro rata with other unsecured creditors) does not prove that they would be reluctant to lend if they had, say, 80% priority. Put simply, the behavior of lenders in countries where there is no functional system of security can shed little light on how U.S. lenders would behave if security interests would give them partial priority over the claims of unsecured creditors in bankruptcy and full priority against the claims of all other parties.

157 Below, we will relax this assumption and examine the case in which partial priority causes borrowers and their lenders to act more efficiently.

158 For evidence that lenders take priority rules into account in determining their lending policy, see Klee, *supra* note 32, at 1472.

159 *See* Bebchuk & Fried, *supra* note 7, at 870-71; *supra* Parts III, IV.

the total cost of credit will actually be lower than under full priority, because the risk of loss that unsecured and partially secured creditors face will be lower in a world where borrowers and their lenders act more efficiently.

Finally, let us make the assumptions more realistic by assuming that there are many unsecured creditors that are not voluntary and, therefore, cannot set the interest rate to reflect their expected risk of loss. These creditors will not charge less interest under partial priority than under full priority. Thus, the reduction in interest that unsecured creditors charge will not be as great as in a world where all of the unsecured creditors are voluntary. But the reduction in interest charged by voluntary unsecured creditors might still be greater than the increase in interest charged by secured creditors, in which case, the total cost of credit will be lower under partial priority than under full priority. Otherwise, the total cost of credit will be higher under partial priority.

However, if the total cost of credit is higher under partial priority than under full priority, it is only because involuntary creditors receive more in bankruptcy under partial priority. Presumably, we would prefer that tort and government claims be paid more in bankruptcy, even if this raises the total cost of credit. Put differently, few would argue that we should attempt to reduce the total cost of credit by making it more difficult for tort and government claims to be paid in bankruptcy.[160]

B. The Financing of Value-Increasing and Value-Decreasing Projects

In Section A, we explained why the adoption of a partial-priority rule need not reduce the availability of secured credit or increase the overall cost of credit. However, the aggregate amount and cost of credit in the economy is not as important as the uses to which the credit is put. If the effect of the availability of low-cost credit is to allow inefficient projects to go forward, while not facilitating the financing of good projects, then the availability of low-cost credit would clearly be undesirable. We now turn to the effect of the priority rule on the financing of different types of projects.

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[160] One who believes that tort judgments are too high may favor reducing the payout to tort claims in bankruptcy. *See* Harris & Mooney, *supra* note 11, at 1366-67 n.80. However, if tort judgments are too high, the solution would not be to distort the entire commercial lending system, but rather to reform the tort system or, perhaps, to subordinate tort claims in bankruptcy to the claims of other unsecured creditors.

1. *The Question*

Let us now move to the central question: how does partial priority (relative to full priority) affect firms' ability to undertake given projects? From the perspective of economic efficiency, we want firms to undertake all projects that are value-increasing and undertake no projects that are value-decreasing. If borrower *F* and creditor *C1* would capture all of the benefits of a project and bear all of the costs, the two would have an incentive to finance and pursue a project if and only if it were value-creating. The problem is that, when there are nonadjusting creditors, borrower *F* and creditor *C1* will not necessarily capture all of the benefits and bear all of the costs of a project. Some of the benefits and costs will accrue to nonadjusting creditors (unless there is further renegotiation).[161] This can distort the agreement between borrower *F* and creditor *C1* to finance a particular project, as we explain below.

2. *The Effect of Partial Priority on the Financing of Value-Increasing Projects*

Let us now consider the circumstances under which partial priority would prevent the financing of value-increasing projects that full priority would facilitate. Suppose that, under a rule of partial priority, borrower *F* is considering financing a project with a loan from creditor *C1*. Suppose that the project would be value-increasing, but that borrower *F* and creditor *C1* cannot capture enough of the gain under partial priority to make it worthwhile for them to pursue the project. Specifically, suppose that the project would generate a surplus of $100 but would confer a positive externality on nonadjusting creditors of $120 (and the nonadjusting creditors are unwilling to reduce the size of their claims in order to reduce the size of the externality). Thus, the project would make borrower *F* and creditor *C1* worse off by $20 even though it would produce a net surplus of $100.

Full priority would facilitate such a project if the additional transfer of expected bankruptcy value as a result of the project is at least $20. Suppose that the additional transfer of expected bankruptcy value is $30. In that case, the project would make nonadjusting creditors better off by only $90, leaving $10 of surplus available to be shared between borrower *F* and creditor *C1*. As a result, the two will have an incentive to pursue the project.

[161] *See infra* Part V.B.4. In principle, an efficient project should always go forward because there are ways to share the gain to make all parties better off. *See* Fried, *supra* note 8 (manuscript at 17); Robert E. Scott, *The Truth About Secured Financing*, 82 CORNELL L. REV. 1436, 1440-41 (1997). In the real world, however, it is often difficult to reach this result. *See* Fried, *supra* note 8 (manuscript at 7-9).

More generally, full priority would facilitate the financing of value-creating projects that would not go forward under partial priority whenever both of the following conditions exist: (1) under partial priority, the value-creating project will confer a positive externality on nonadjusting creditors that is bigger than the surplus it would create (and the parties are unable to renegotiate to reduce this externality), and (2) under full priority, the positive externality is reduced sufficiently so that it becomes smaller than the surplus that would be created.

3. *The Effect of Partial Priority on the Financing of Value-Decreasing Projects*

Next, consider the circumstances under which partial priority would prevent the financing of value-decreasing projects that full priority would facilitate.[162] Suppose that, under a rule of partial priority, borrower *F* is considering financing a project with a loan from creditor *C1*. Suppose that the project would be value-decreasing, and that borrower *F* and creditor *C1* would not transfer enough bankruptcy value from nonadjusting creditors to make it worthwhile for them to pursue the project. Specifically, suppose that the project would generate a loss of $100 and would make borrower *F* and creditor *C1* worse off by $20.

Full priority would facilitate such a project if the additional transfer of expected bankruptcy value is at least $20. Suppose that the additional transfer of expected bankruptcy value is $30. In that case, the project would make nonadjusting creditors worse off by $110, leaving $10 available to be shared between borrower *F* and creditor *C1*. As a result, the two will have an incentive to pursue the project.

More generally, full priority will facilitate the financing of value-decreasing projects that would not go forward under partial priority whenever both of the following conditions occur: (1) under partial priority, the value-reducing project will not transfer sufficient value from nonadjusting creditors to make it worthwhile, and (2) under full priority, sufficient value is transferred from nonadjusting creditors so that it makes the project worthwhile.

4. *Assessing the Overall Effect of Partial Priority on Financing*

One cannot determine the overall effect of partial priority on the financing of value-increasing and value-decreasing projects on *a priori* theoretical grounds. The net effect may also depend on the extent of the reduction in priority. For example, on the margin, reducing pri-

[162] For a discussion of why secured lenders might find it worthwhile to fund undesirable activities, see Klee, *supra* note 32, at 1479-81.

ority from 100% to 90% may create a desirable net effect, but moving from 90% to 80% may create an undesirable net effect. Therefore, we would need evidence to make the determination as to what level of priority yields the optimal mix of projects.

Even so, there are some general reasons to think that partial priority is not as likely to prevent the financing of value-increasing projects as it is likely to prevent the financing of value-decreasing projects. When an efficient activity would otherwise not take place under partial priority because it would confer too great a benefit on nonadjusting creditors, those creditors may find it in their interest to modify their contractual rights to reduce the size of the positive externality, and permit the activity to take place. That is, when nonadjusting creditors would gain from certain activities that will not be financed under partial priority because the equityholders would capture too little of the activities' benefit, the nonadjusting creditors might agree to reduce their claims (by, for example, forgiving part of their loans) in order to induce the equityholders to undertake the project. The nonadjusting creditors will be better off receiving full payment on their reduced claims than receiving little or no payment on their full claims. Indeed, lenders in workouts commonly agree to reduce the size of their claims, presumably in order to increase the likelihood of eventually receiving payment on the remainder of their claims.[163]

C. The Effect of Partial Priority on the Financing of Post-Bankruptcy Projects

A partial-priority rule will affect not only the financing of projects outside of bankruptcy, but also the financing of projects in Chapter 11. Dean Baird has suggested two ways in which a partial-priority rule may have detrimental effects in bankruptcy.[164]

The first is that partial priority would simply provide more money for lawyers to spend on reorganization and would therefore waste resources that would otherwise be allocated to more productive uses.[165] To begin, it is not clear that providing more resources for funding reorganizations would be undesirable. It is possible, as Dean Baird recognizes,[166] that there are currently insufficient assets to finance the reorganization of businesses that should continue to operate. However, assuming *arguendo* that a partial-priority rule would, in the con-

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163 *See* Stuart C. Gilson et al., *Troubled Debt Restructurings: An Empirical Study of Private Reorganization of Firms in Default*, 27 J. FIN. ECON. 315, 318, 322 (1990).

164 Baird, *supra* note 45, at 1433-34.

165 *See id.*; *see also* Bossetti & Kurth, *supra* note 117, at 28 (noting that proposed revisions expanding Article 9 will reduce the assets available to administer the bankruptcy estate).

166 Baird, *supra* note 45, at 1434.

text of the current bankruptcy system, lead to wasteful attempts at reorganization, one could simply modify bankruptcy rules to ensure that the value transferred from secured creditors is not used to pay administrative expenses. For example, value could be transferred from secured to unsecured creditors (according to the fixed-fraction or any other partial-priority rule) only at the very end of the proceeding.

Dean Baird also argues that partial priority may make it more difficult to create the financial structure of the emerging company because some parties will prefer full priority.[167] However, this argument is simply the bankruptcy analogue to the argument discussed above, that full priority is necessary to obtain desirable financing outside of bankruptcy. If partial priority yields a better mix of projects outside of bankruptcy, then it should also yield a better mix of projects in companies emerging from bankruptcy. Of course, if Dean Baird is right that full priority is necessary to achieve the optimal mix of projects in firms coming out of bankruptcy, then this should be true outside of bankruptcy as well.

VI
On the Enforcement of Partial Priority

This Part addresses the circumvention objection that has been raised against our partial-priority rules—that borrowers and creditors could easily avoid the effect of partial priority in bankruptcy. Two circumvention strategies have been considered. The first is that, regardless of how partial priority is implemented, creditors could structure their transactions in a way that would be economically equivalent or similar to a secured loan, but formally would not fall under the partial-priority rule.[168] The second is that secured creditors seizing their collateral outside of, or prior to, the debtor's bankruptcy filing can circumvent a partial-priority rule implemented only in bankruptcy.[169] The analysis of this Part suggests that neither one of these circumvention strategies is likely to materially undermine the effectiveness of a partial-priority rule in bankruptcy. Before elaborating however, it is worth pointing out that there is a tension between the argument that creditors can easily circumvent a rule of partial priority and the argument that a rule of partial priority would substantially reduce the financing of value-increasing projects.

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167 *Id.*

168 *See, e.g.*, Turner, *supra* note 6, at 331; White, *Efficiency, supra* note 5, at 502-08.

169 *See, e.g.*, LoPucki, *supra* note 11, at 1493-94.

A. A Preliminary Note: The Tension Between the Circumvention and Credit Availability Objections to Partial Priority

If one believes that borrowers and creditors can easily circumvent a rule of partial priority, then one cannot simultaneously argue that adoption of such a rule would substantially reduce the availability of financing for good projects. (Of course, if one believes that a creditor could circumvent a formal partial-priority rule, but only at some expense, one could object to such a rule on the ground that such a rule might produce undesirable transaction costs.) Likewise, those who argue that a partial-priority rule would reduce the financing available for good projects are implicitly assuming that creditors could not easily circumvent such a rule.

B. Circumvention Through Alternative Forms of Financing

1. *The Severity of the General Problem*

As Symposium participants and others have pointed out, there are many arrangements that accomplish a result similar to a secured loan but which would receive more favorable treatment in bankruptcy under a partial-priority rule.[170] Borrowers and creditors facing a rule of partial priority may seek to avoid its effects by using such arrangements. Although there are many ways to accomplish a result similar to a secured loan, all of the arrangements have one thing in common: they put ownership of the assets that would have served as collateral for a secured loan in the hands of another (perhaps related) party, in an attempt to make those assets unavailable to the borrower's unsecured creditors in bankruptcy.

In our view, the problem of circumvention through the use of economically similar but legally different arrangements would not be as severe as others believe. Application of the partial-priority rule to arrangements similar to secured loans, but that would otherwise remain outside its reach, could substantially reduce circumvention.[171] In general, courts pay attention to substance over form. For example, if the parties characterize an arrangement as a lease, but it is in fact economically equivalent to a secured loan, a bankruptcy court will treat it as a secured loan.

Thus, two parties that would otherwise have used a secured loan could avoid a partial-priority rule only by using an arrangement that is substantially different from a secured loan in an economic sense. However, using an economically different arrangement will often impose costs on the parties that a secured loan would not impose. Parties would bear these costs whether or not either party enters

[170] *See, e.g.*, Baird, *supra* note 45, at 1423-24; Klee, *supra* note 32, at 1474-75.

[171] For further support for this view, see Klee, *supra* note 32, at 1474-75.

bankruptcy. In contrast, a partial-priority rule would impose costs on the parties only if one of the parties enters bankruptcy. Thus, the expected cost of partial priority would have to be quite high (or the cost of substituting an alternative arrangement would have to be quite low) for the use of alternatives to secured loans to be worthwhile.

We now turn to briefly examine specific types of alternative financing arrangements: (1) the use of leases rather than secured loans; (2) the use of subsidiary financing; and (3) the use of "special purpose" or "bankruptcy-remote" vehicles to isolate liquid assets (typically receivables) from creditors in bankruptcy.

2. *The Use of Lease Arrangements*

Under a rule of partial priority, secured creditors might consider using leases. Leases can be functionally similar to secured loans, although bankruptcy courts will generally not treat them as secured loans.[172] Under current bankruptcy law, leased assets are not the debtor's property and, therefore, do not enter the bankruptcy estate.[173] As a result, their value is not available for distribution to creditors. Instead, the bankrupt firm must either cure any existing defaults and then either assume the lease (or assign it to another party) or reject the lease and return the assets to the lessor.[174] As a result, the lessor is assured of receiving either the assets or the contracted-for payments after the lessee enters bankruptcy. If a rule of partial priority were in effect, a secured creditor would receive only a portion of the value of the assets serving as collateral for its loan. Thus, firms and their sophisticated creditors would have an incentive to structure secured transactions as leases to avoid the effect of a rule of partial priority. But, as we explained, current law makes it somewhat difficult for an arrangement that is like a secured loan to be treated as a lease in bankruptcy. That is, even if the parties label an arrangement a "lease," a bankruptcy court may consider it a secured loan for bankruptcy purposes.[175] There must be a real economic difference between the lease arrangement and a secured loan for bankruptcy law to recognize the arrangement as a lease.[176] For a bankruptcy court to

172 *See, e.g.*, White, *Efficiency, supra* note 5, at 504. In a sale-leaseback transaction, a firm sells assets to another party which then leases them back. A standard lease agreement requires the firm to make periodic payments on the lease to the lessor, and gives the lessor the right to repossess the assets in the event of the firm's default. At the termination of the typical lease, the lessee may either return the assets or purchase them. Depending on its terms, the lease may very closely resemble a secured transaction. In both cases, the firm has use of an asset, agrees to make a stream of payments to another party, and must relinquish possession of the asset if it fails to make these payments.

173 *See* 11 U.S.C. § 541(b)(2) (1994).

174 *See* 11 U.S.C. § 365(a)-(d).

175 *See* Klee, *supra* note 32, at 1475.

176 *See* U.C.C. § 1-201(37) (1994); White, *supra* note 6, at 420.

treat the arrangement as a lease, the arrangement must, for example, not make the lessee bear the cost of depreciation and must terminate before the end of the asset's life.[177]

To the extent the lease is functionally different from a secured loan, it is likely to impose costs on the parties that a secured loan would not impose. For example, because the lessee would not bear the risk that the leased assets will fall in value by the end of the lease term, it would have less incentive to properly use and maintain them. The lessor must thus impose restrictions on the assets' use and monitor the lessee's compliance, a costly arrangement for both parties.[178] If these costs, which the parties would bear whether or not the lessee goes bankrupt, exceed the lessor's expected costs of acting as a secured lender under partial priority, then the parties would not substitute a lease for a secured loan under full priority.[179]

Even if current law permitted leases structured very similarly to secured loans to receive lease treatment in bankruptcy, courts could easily enforce the partial-priority rule by modifying the treatment of leases in bankruptcy to conform it to that accorded to secured loans. To the extent leases are similar to secured loans, no economic or other justification exists for treating the arrangements differently in bankruptcy. Thus, there is no reason why lessors could not receive less favorable treatment in bankruptcy than they currently enjoy if that treatment were necessary to enforce a partial-priority rule.[180]

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177 *See* White, *supra* note 6, at 420.

178 *See generally* Clifford W. Smith, Jr. & L. MacDonald Wakeman, *Determinants of Corporate Leasing Policy*, 40 J. FIN. 895 (1985) (discussing incentives that influence the decision to enter a lease).

179 *See* Bossetti & Kurth, *supra* note 117, at 17. There are other costs to leasing. For example, if the marginal tax rate of the lessee is higher than that of the lessor, so that the depreciation is worth more if the lessee owns the property, there will be a tax disadvantage to leasing. *See* Smith & Wakeman, *supra* note 178, at 897. Furthermore, the bankruptcy treatment of leases is not entirely favorable. If the debtor decides to breach the lease, any damage claim by the lessor will be treated as an unsecured general claim that arose before bankruptcy. In addition, the bankrupt firm may assign the lease to another party, notwithstanding any anti-assignment provisions in the lease contract. Thus, the lessor may find itself in a contractual relationship into which it otherwise would not have chosen to enter.

180 Indeed, according the lessor less favorable treatment in bankruptcy—such as by allowing the bankruptcy estate to reduce their payment obligations under lease contracts—should yield efficiency benefits. As we pointed out in *The Uneasy Case*, to the extent that leases and secured loans are substitutes, they are likely to give rise to the same types of efficiency problems. Bebchuk & Fried, *supra* note 7, at 926-29. In fact, covenants that public companies issue typically place similar restrictions on borrowers with respect to both security interests and leases. *See* Morey W. McDaniel, *Are Negative Pledge Clauses in Public Debt Issues Obsolete?*, 38 BUS. LAW. 867, 868 (1983). Indeed, the only restrictions found in the debentures of companies rated A or better are sale-leaseback restrictions and negative pledge covenants, *see id.*, suggesting that the two arrangements can have similarly undesirable efficiency consequences. Thus, even in a world without secured lending, there might be efficiency benefits to giving lessors less favorable treatment in bankruptcy than they currently enjoy. For example, giving less favorable treatment may reduce the use of ineffi-

3. *The Use of Subsidiaries*

One way firms might attempt to achieve the effect of full priority under a rule of partial priority is to put in a subsidiary the assets serving as collateral for a secured loan.[181] The unsecured creditors of the parent would not be able to reach the assets if the parent goes bankrupt, because, in principle, their claims would have no more priority in the assets of the subsidiary than the claims of the parent, the subsidiary's shareholder. The creditor whose loan the subsidiary's assets secured would thus effectively have full priority in the assets.

There are a number of reasons why this strategy is unlikely to substantially undermine a partial-priority rule in bankruptcy. First, the creation of a subsidiary and the maintenance of corporate formalities involves costs which are borne whether or not either the subsidiary or the parent goes bankrupt. These costs, in turn, would discourage many (but not all) firms from pursuing this approach. Second, this strategy is not without risk. In particular, the subsidiary's activities (including, perhaps, the ownership and lease or operation of the assets transferred to it by the parent) may give rise to unsecured claims—government claims, tort claims, or even trade claims—against the subsidiary that erode the priority of the secured creditor whose loan is secured by the subsidiary's assets. These unsecured claims will also have full priority over any unsecured claims against the parent. Thus, to the extent the parent itself borrows from sophisticated unsecured creditors, the parent will pay a higher interest rate on these loans. Third, if it turns out that creditors widely use this strategy and effectively undermine the partial-priority rule in bankruptcy, bankruptcy courts could consolidate the assets of, and claims against, subsidiaries and parents to render the strategy ineffective.[182]

4. *"Special Purpose" or "Bankruptcy Remote" Vehicles*

An increasing number of firms, most of them large, publicly-traded companies, have created so-called "special purpose vehicles" ("SPVs"), also known as "bankruptcy-remote vehicles."[183] An SPV is a

cient lease arrangements which are used to give the lessor a better position in bankruptcy. Another possible benefit is that it might reduce the problem of inefficient rejection of leases. *See* Jesse M. Fried, *Executory Contracts and Performance Decisions in Bankruptcy*, 46 DUKE L.J. 517, 545-66 (1996) (explaining how adjusting the price of an executory contract against the nonbankrupt party can reduce the problem of excessive rejection in bankruptcy).

[181] *See* Bossetti & Kurth, *supra* note 117, at 16.

[182] Consolidation is still the exception rather than the rule. However, given bankruptcy judges' sympathy for unsecured creditors and their considerable discretion, they might become less reluctant to consolidate if they came to believe that debtors were establishing subsidiaries primarily to avoid their liability to unsecured creditors.

[183] *See generally* Claire A. Hill, *Securitization: A Low-Cost Sweetener for Lemons*, 74 WASH. U. L.Q. 1061, 1062, 1076 (1996) (discussing the costs and benefits of securitization).

separate legal entity, typically a trust, that purchases the borrower's receivables with funds borrowed from public or private investors. The flow of income from the receivables repays the investors. If the firm fails, the SPV, an independent entity, is unlikely to be forced into the bankruptcy proceeding (where, because of the *de facto* partial-priority system, the receivables backing the SPV's obligations to its creditors could be compromised). If secured creditors were to be given even less priority in bankruptcy, then SPVs would become even more attractive.

Nevertheless, the possibility of using SPVs is unlikely to undermine a partial-priority rule in bankruptcy. First, at present, firms use SPVs only to isolate non-operating assets, such as receivables.[184] Second, it is expensive to set up an SPV. Steven Schwarcz estimates that a publicly-traded SPV must issue at least $50 million of public debt because of the high transaction costs, effectively making this means of financing unavailable to small and medium-sized companies, the primary issuers of secured debt.[185] Third, SPVs may reduce, but do not eliminate, bankruptcy risk. As Steven Schwarcz observes, risk-averse investors are unwilling to lend funds to SPVs whose originating companies are at risk of bankruptcy, indicating that there is still a material risk that SPV investors will be drawn into a bankruptcy proceeding should the parent file for bankruptcy.[186]

C. Liquidation of Collateral Outside of Bankruptcy

Secured creditors might try to circumvent partial priority in bankruptcy by seizing collateral outside of bankruptcy in two ways. The first is to ensure that the borrower never enters bankruptcy, but rather liquidates outside of bankruptcy. The second is to seize the collateral *before* the borrower enters bankruptcy.

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[184] When receivables capitalize the SPV, the arrangement is equivalent to factoring. *See* Paul M. Shupack, *On Boundaries and Definitions: A Commentary on Dean Baird*, 80 VA. L. REV. 2273, 2291 (1994). When the SPV is capitalized with operating assets that the corporation must use, the arrangement will involve a lease of those assets to the corporation, with all of the risks and problems that leasing entails. *See supra* Part VI.B.2.

[185] Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J.L. BUS. & FIN. 133, 138-39 (1994). In a conversation with one of the authors, Schwarcz reported that an SPV structure can be created for deals as small as $5 million (and perhaps less) if the funding is obtained through bank debt or private placement. While the use of private debt would lower the costs of creating an SPV, many small and medium-sized companies will still not have a sufficient amount of receivables to make an SPV worthwhile. *Cf.* Allen N. Berger & Gregory F. Udell, *Relationship Lending and Lines of Credit in Small Firm Finance*, 68 J. BUS. 351 (1995) (reporting that half of 3400 small businesses (including businesses with as much as $219 million in assets) surveyed in 1988-89 by the Federal Reserve Board and the Small Business Administration had assets of $500,000 or less).

[186] Schwarcz, *supra* note 185, at 137.

1. *Firms That Liquidate Outside of Bankruptcy*

Suppose that the secured creditor believes (correctly) that a defaulting borrower has nothing to gain from entering bankruptcy, and various transaction costs and information problems prevent unsecured creditors from filing an involuntary bankruptcy petition. In such a case, the secured creditor might repossess the collateral while the borrower liquidates its business outside of bankruptcy, escaping the effect of a partial-priority rule in bankruptcy.

To eliminate this problem, the law could require that liquidating companies report all of their transactions within the previous year and submit a list of unsecured creditors to a bankruptcy clearinghouse. The clearinghouse would pass the information on to the unsecured creditors and "bounty hunters" who would receive a percentage of the assets recovered from the secured creditor.[187] To enforce the mandatory bankruptcy filing requirement, the government could condition limited liability for the firm's owners on such a filing.[188]

However, even if the law did not change to make these types of liquidations more difficult or impossible, liquidations outside of bankruptcy that give secured creditors full priority in their collateral and leave unsecured creditors' claims unpaid are unlikely to significantly reduce a partial-priority rule's effectiveness. First, cases in which neither unsecured creditors nor the borrower has anything to gain from bankruptcy are likely to involve small amounts of assets and claims. More importantly, when a secured creditor extends credit, it will not know if it can avoid being subject to a partial-priority rule in bankruptcy. Thus, in negotiating its loan contract with a borrower, it will act as if there is some possibility that it will lose some of its priority in bankruptcy.[189]

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[187] There are other possibilities. *See* LoPucki, *supra* note 11, at 1503-05.

[188] In his Symposium article, Lynn LoPucki suggests that implementing a mandatory bankruptcy filing requirement would require specifying the circumstances under which criminal liability (for failure to file) is imposed. *Id.* at 1505-06. But we doubt that criminal enforcement would be necessary if, as we suggest, owners (or, if appropriate, managers) of a borrower that has not yet filed for bankruptcy can be held liable for the borrower's debts by the borrower's creditors. In such a case, those controlling the borrower would have an incentive to file for bankruptcy as soon as they are sued by an unsecured creditor.

[189] In his Symposium article, Lynn LoPucki argues that a secured creditor would attempt to avoid the reach of a partial-priority rule in bankruptcy by including provisions in the loan arrangement that give the debtor an incentive to participate voluntarily in an out-of-bankruptcy liquidation that benefits the secured creditor. *Id.* at 1498-99. In particular, a secured creditor might demand that the owners personally guarantee the debtor's obligation to the secured creditor. Such a guarantee would give the owners an incentive to maximize the secured creditors' recovery in the event of the debtor's failure.

While personal guarantees might be used as part of a strategy to avoid partial priority in bankruptcy, their use would achieve directly one of the results that partial priority is intended to achieve indirectly: namely, to reduce the debtor's incentive and ability to engage in excessively risky activities. Partial priority achieves this indirectly by giving secured

2. *Firms That Give Secured Creditors Their Collateral Prior to Bankruptcy*

The secured creditor may expect that the borrower or unsecured creditors (which would have an interest, under a partial-priority rule in bankruptcy, to see the borrower enter bankruptcy) would eventually file a bankruptcy petition. As we explain below, the secured creditor's ability to "opt out" of partial priority by seizing its collateral before bankruptcy would likely be very limited.

Consider first a debtor that intends to resist repossession. The secured creditor would be unable to repossess unless the contract gives it the right to declare a default and seize the collateral. Even if the creditor has the right to declare a default under the loan contract, its ability to seize the collateral will usually be very restricted. In particular, the secured creditor may not seize the collateral if, by doing so, it would breach the peace.[190] Since most commercial collateral is located on the borrower's property and is thus difficult to access without the borrower's cooperation, this breach-of-the-peace restriction makes it virtually impossible for secured creditors to engage in "self-help" repossession. As a result, the secured creditor would almost always need to enlist the judicial system's help in recovering the collateral, providing the borrower with ample time to file for bankruptcy and invoke the automatic stay.

Next, consider a debtor that would not resist, and may even assist in, repossession.[191] Under a rule of partial priority, a repossession (within a statutorily defined period, usually 90 days) would violate the

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creditors an incentive to monitor debtors; a guarantee does so directly by increasing the cost to the debtor's owners of failure. In effect, a personal guarantee is equivalent to a partial waiver of limited liability. Because limited liability is what gives rise to inefficient borrower behavior in the first instance, *see* Bebchuk & Fried, *supra* note 7, at 873-75, a partial waiver of limited liability is likely to be desirable.

LoPucki suggests that the secured creditor might also negotiate for provisions that enable the secured creditor to assume control of the debtor should it suffer financial distress. LoPucki, *supra* note 11, at 1499. We suspect that in many cases these provisions will not be effective. First, lender liability law and the possibility of equitable subordination in bankruptcy might deter a secured creditor from attempting to take control of a debtor and liquidating its assets. Second, in those cases where a secured creditor nevertheless attempts to take control of the debtor in order to liquidate it—and the owners did not personally guarantee the debtor's loans—the owners would have an incentive to resist the takeover by filing for bankruptcy.

However, to the extent such arrangements are effective, they would increase the potential cost of financial distress to the owners of the debtor by putting their ownership and control at greater risk. This, in turn, would reduce owners' incentives to engage in undesirably risky activities. Therefore, such arrangements (if effective) would have the same desirable *ex ante* effects on the debtors as personal guarantees from the owners, albeit to a lesser degree because, unlike personal guarantees, such arrangements would not expose all of the owner's wealth to risk of loss.

190 *See* U.C.C. § 9-503 (1994).

191 *See* LoPucki, *supra* note 11, at 1498-99.

preference rules (Section 547 of the Bankruptcy Code) by enabling the repossessing secured creditor to obtain more than it would in bankruptcy. Section 547 would thus permit the bankruptcy trustee to undo such a transfer. Thus, the secured creditor's repossession might cause sophisticated unsecured creditors to force the borrower into bankruptcy before the preference period had expired so that the collateral could be recovered and its value could, at least in part, be used to satisfy their claims.[192] In fact, under current law, unsecured creditors often force a firm into bankruptcy after the firm grants a security interest to another creditor, so that they can attack the transfer of the security interest under Section 547,[193] even though the law makes it both difficult and risky for unsecured creditors to initiate involuntary bankruptcy filings.[194] Thus, even if a secured creditor could physically repossess its collateral, it might be reluctant to incur the cost of repossession, knowing that unsecured creditors would be likely to simply undo the repossession by filing a bankruptcy petition and attacking the transfer under Section 547.[195]

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192 In his Symposium article, Lynn LoPucki describes a strategy secured creditors could, in principle, use to defeat the preference rules: a single-purpose entity is created to lend money to, and take a security interest in, the property of a borrower. Should the borrower default, the entity seizes the collateral, sells it at foreclosure for a fraction of its value to a related party, and then distributes the proceeds of the sale to the owners of the entity, leaving the entity an empty shell. *See id.* at 1507-09. However, we think that this strategy would not be used on any significant scale. First, the transfer of the proceeds to the owners as well as the transfer of the collateral to a related party for less than reasonably equivalent value would be considered fraudulent transfers that could, in principle, be reversed by the bankruptcy trustee. To the extent that lenders believe that the trustee will simply undo the transfers, they will have no incentive to engage in this strategy. Even if in practice it would be difficult for the bankruptcy trustee to undo the transfers, many lenders would not engage in such transactions for fear of adverse publicity. Those not deterred by the possibility of negative publicity might not find it worthwhile to create a separate legal entity for each loan transaction (because the transaction costs would be incurred not only in those cases where there is a foreclosure, but in the overwhelming majority of cases where the borrower fully repays the loan). To the extent that there would still be lenders inclined to use such vehicles, stiffer penalties could be imposed on those receiving the proceeds or otherwise profiting from the transactions.

193 *See* LoPucki, *supra* note 60, at 1927 (reporting that, in a sample of large companies that declared bankruptcy, unsecured creditors filed involuntary bankruptcy petitions when the borrower issued a security interest to existing lenders which had originally made their advances on an unsecured basis).

194 *See* LoPucki, *supra* note 11, at 1492-93, 1499-1500.

195 Lynn LoPucki argues that unsecured creditors are unlikely to file many involuntary petitions if a partial-priority rule is adopted. *Id.* at 1500-02. One reason is that under current bankruptcy rules parties filing involuntary petitions face significant risk of liability. *See id.* at 1499-1500. The other reason is that there would be little benefit to the unsecured creditor filing the petition. Any value that is made available by a partial-priority rule in the bankruptcy proceeding may be used to pay administrative expenses. Whatever is left must then be shared pro rata with other ordinary unsecured creditors. *See id.* at 1500. LoPucki suggests that an unsecured creditor would thus be better off bargaining with the secured creditor for a side-payment in exchange for not filing a bankruptcy petition. *Id.* at 1501-03.

VII
A NOTE ON THE CURRENT CONTROVERSIES OVER ARTICLE 9

This Part briefly remarks on how our analysis relates to some of the issues raised at the Symposium regarding the current revision of Article 9. The American Law Institute ("ALI") and the National Conference of Commissioners on Uniform State Laws ("NCCUSL") are now in the process of revising UCC Article 9, the body of rules that permits a lender to take security interests in virtually all of a borrower's personal (moveable or intangible) property. Most of the revisions the ALI and the NCCUSL are considering tend to further strengthen the position of secured creditors: they either extend the reach of Article 9 to property currently not covered by the statute (including certain bank deposits, tort claims, and insurance claims) or make it easier for secured creditors to achieve priority in their Article 9 collateral over the claims of third parties (such as unsecured creditors or the borrower's bankruptcy trustee).[196] In part, these revisions are intended to reverse some of the erosion of priority that has resulted from courts interpreting Article 9 against secured creditors.[197]

However, a revision drafted by Elizabeth Warren at the request of the ALI Council goes in the exact opposite direction: it would "carve out" a portion of a debtor's Article 9 collateral to pay the claims of the debtor's unsecured creditors.[198] Under the so-called "Carve-out Proposal," as much as 20% of the debtor's Article 9 collateral would be made available to pay the claims of "judgment creditors"— unsecured creditors with unpaid judgments against the debtor—that have levied on that collateral.[199]

LoPucki might be right that, if other bankruptcy rules are not changed, unsecured creditors would generally prefer to extract a side-payment rather than file for bankruptcy. But we should emphasize two points: the first is that such side-payments will have the effect of giving the secured creditor only partial priority in its collateral (although the degree of priority will be greater than if the secured creditor were brought into the bankruptcy proceeding). Second, bankruptcy rules could be changed to eliminate the disincentives and increase the incentives to file involuntary petitions. LoPucki himself offers one proposal for increasing the incentives to file involuntary petitions: giving a bounty to the filing creditor. Although LoPucki notes that such a system would not be effective in the case where the irreversible nonbankruptcy liquidation takes place before the petitioning creditors are eligible to file, *id.* at 1504, the preference period could be extended from ninety days to one year, making most nonbankruptcy liquidations reversible.

196 *See* Klee, *supra* note 32, at 1467 n.2.

197 *See* Woodward, *supra* note 13, at 1519 n.45.

198 Warren, *supra* note 12.

199 *See id.*

A. The Effort to Expand the Scope of (and Rationalize) Article 9

Let us first consider the efforts to expand the scope of Article 9 and reduce the transaction costs associated with personal-property secured lending. Expanding the scope of Article 9 may or may not be desirable from an efficiency perspective. Suppose that the proposed expansion of Article 9 would enable creditors to take security interests in certain types of assets that, until now, could not be used as collateral (under Article 9 or otherwise). The use of these security interests would give rise to priority-independent costs and benefits and priority-dependent costs and benefits. The use of such security interests might also affect the mix of value-increasing and value-decreasing projects that are financed. The desirability of enabling creditors to create such security interests would depend on whether the benefits exceed the costs.

Because the priority-dependent costs and benefits of these security interests depend on the degree of priority accorded to secured claims in bankruptcy, the overall desirability of expanding the scope of Article 9 might depend on whether there is full or partial priority in bankruptcy. (Similarly, the desirability of full or partial priority might depend on the types of assets that can serve as collateral for a security interest.) It should be emphasized, however, that the issues of priority and the scope of Article 9 are otherwise independent. There are two separate questions: (1) should it be possible to create an Article 9 security interest in all types of personal property assets, and (2) should security interests have partial priority in bankruptcy? Even if one believes that it would be preferable to give less priority to secured claims in bankruptcy than they enjoy currently, one can also believe that it would be desirable to enable creditors to take security interests in all personal-property assets (regardless of the priority regime). Similarly, one may believe that it is optimal to give full priority to security interests in certain types of assets, while, at the same time, believing that certain types of assets should not be permitted to serve as collateral under any regime of priority.

The net effect of reducing the transaction costs associated with Article 9 lending could also be either positive or negative. Consider Article 9 security interests that firms would use in any event. With respect to these security interests, it is clearly desirable to reduce the transaction costs associated with their use. Now consider Article 9 security interests that firms would use only if the transaction costs associated with their use are reduced by the proposed rationalization of Article 9. With respect to these security interests, a reduction in transaction costs could have either positive or negative efficiency effects, depending on whether the resulting increase in the use of Article 9

security interests is desirable. The use of these security interests would be desirable to the extent that they add value to transactions, but undesirable to the extent that they make the transactions less efficient. Similarly, to the extent the reduction in transaction costs permits financing of good projects, this would be desirable. Likewise, to the extent such a reduction gives rise to loans for bad projects, the effect would be undesirable.

B. The "Carve-Out Proposal"

Contributors to this Symposium and others have discussed the details and design of the "Carve-out proposal."[200] Here, we will simply make some brief general points about an Article 9 collateral carve-out rule.

An Article 9 carve-out rule would differ from the partial-priority rules we consider in three important respects. First, the carve-out applies only to personal property, while the partial-priority rules we put forward apply both to personal and real property.[201] Second, the carve-out rule "carves out" a portion of a secured creditor's collateral for unsecured claims, while the partial-priority rules "carve out" a portion of the secured creditor's secured claim and make it unsecured. The difference is as follows: under the carve-out rule, a secured lender could completely insulate itself from risk of loss by oversecuring its loan. Under our partial-priority rules, a lender could not, because its secured claim would be subject to a cut-back. Third, the carve-out rule applies both inside and outside of bankruptcy; our partial-priority rules apply only in bankruptcy.

The first difference between our partial-priority rules and the carve-out rule is that the carve-out rule would apply only to Article 9 personal-property collateral. Personal property accounts for only a fraction of the collateral backing secured debt in the United States, perhaps as little as 10%.[202] A 20% carve-out rule might thus carve out as little as 2% of total business collateral for unsecured creditors. The

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200 *See, e.g.*, Bossetti & Kurth, *supra* note 117; Klee, *supra* note 32; Woodward, *supra* note 13, at 1511.

201 Many of the partial-priority rules that other countries have considered or adopted apply only to personal property (or specific types of personal property). *See* Eisenberg & Sundgren, *supra* note 39 (discussing bankruptcy laws in Finland); Bebchuk & Fried, *supra* note 7, at 909-10 (discussing 1985 German Bankruptcy Commission proposal). In 1982, the U.K.'s Cork Commission proposed a more limited version of the fixed-fraction priority rule under which 10% of the property subject to floating charges (such as inventory) would be made available to pay unsecured claims. *See* Goode, *supra* note 44, at 66-67.

202 *See* Picker, *supra* note 5, at 649-50 (estimating real property mortgage debt at $3.85 trillion, automobile-backed debt at $285 billion, and $96 billion of other debt, secured primarily by personal property). These figures presumably include both commercial and non-commercial loans. Thus, the percentage of commercial secured debt that Article 9 collateral backs could be more or less than 10%. *See* Mann, *supra* note 11, at 12 n.4.

benefits (and costs) of an Article 9 carve-out rule would thus be lower than the benefits of a partial-priority rule that applies to both real and personal property security interests.

The second difference is that the carve-out rule applies to collateral, while the partial-priority rules apply to claims. As explained above, under the carve-out rule, a secured creditor could insulate itself from risk of loss by oversecuring the loan (taking collateral worth at least 125% of the amount it expects to be owed in the event of default). Thus, even if the carve-out rule applied both to personal and real property, one would expect it to lead to less monitoring of borrowers than a rule such as the fixed-fraction rule, which always exposes a secured lender to risk of loss.

Third, the carve-out rule would operate both inside and outside of bankruptcy, while our rules would operate only in bankruptcy. The carve-out rule would have the advantage of reaching a larger number of insolvent companies. However, it would also apply to solvent companies, creating potential costs without generating any offsetting benefits.

Conclusion

This Article has responded to criticisms of *The Uneasy Case* and further developed the analysis of that article. The analysis confirms our earlier conclusion that the case for the full priority of secured claims in bankruptcy is an uneasy one. The contributions to this Symposium and the discussion during its sessions suggest to us that many others are coming around to accept this view.

In closing, however, we wish to caution against rushing to conclude that a partial-priority rule would be superior to full priority. Much more work needs to be done before one can determine with confidence which rule would be desirable. We hope that our articles can provide a useful basis and agenda for such future work.