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PRIORITY MATTERS: ABSOLUTE PRIORITY, RELATIVE PRIORITY, AND THE COSTS OF BANKRUPTCY

DOUGLAS G. BAIRD†

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

This Article uses relative priority, an entirely different priority system that flourished until the late 1930s, to show that using absolute priority even as a point of

† Harry A. Bigelow Distinguished Service Professor, University of Chicago Law School. This Article grows out of ongoing work with Don Bernstein and Tony Casey. I received valuable comments from Jesse Fried, Thomas Lee, David Skeel, Richard Squire, Margaret Schilt, and Michael Simkovic, as well as during presentations at the American Law and Economics Association, Fordham Law School, Harvard Law School, and the University of Chicago Law School. John Wilson provided valuable research assistance, and I am grateful for research support from the John M. Olin Fund.

departure is suspect. Much of the complexity and virtually all of the stress points of modern Chapter 11 arise from the uneasy fit between its starting place (absolute instead of relative priority) and its procedure (negotiation in the shadow of a judicial valuation instead of a market sale). These forces are leading to the emergence of a hybrid system of priority that may be more efficient than one centered around absolute priority.

INTRODUCTION

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

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

1 The doctrine was first established in *Case v. Los Angeles Lumber Products Co.*, which described the absolute priority rule as the "'fixed principle' according to which . . . the character of reorganization plans was to be evaluated." 308 U.S. 106, 116-17 (1939) (citation omitted) (quoting N. Pac. Ry. Co. v. Boyd, 228 U.S. 482, 507 (1913)).

2 There are many complications and many ways of sorting out rights in bankruptcy, but absolute priority remains the almost universal starting place. *See, e.g.*, Barry E. Adler & Ian Ayres, *A Dilution Mechanism for Valuing Corporations in Bankruptcy*, 111 YALE L.J. 83, 88-90, 96-100 (2001) (suggesting a novel valuation mechanism while asserting absolute priority should, as a normative matter, be the central principle of reorganization law). Indeed, for decades, academics simply assumed that absolute priority was a fixed part of the reorganization landscape. Even those like Elizabeth Warren who advocated for modifications to absolute priority began with it. *See, e.g.*, Elizabeth Warren, *A Theory of Absolute Priority*, 1991 ANN. SURV. AM. L. 9, 9 (1991) ("At the heart of corporate law is a fundamental ordering between the equity owners and the creditors: in the event of collapse, creditors will be paid in full before equity will receive any distribution from the company.").

3 The concepts of "relative" and "absolute" priority were first compared by James C. Bonbright and Milton M. Bergerman. *See generally* James C. Bonbright & Milton M. Bergerman, *Two Rival Theories of Priority Rights of Security Holders in a Corporate Reorganization*, 28 COLUM. L. REV. 127 (1928). Throughout the 1930s, the legal giants of the day debated the merits of each. *See, e.g.*, William O. Douglas & Jerome Frank, *Landlords' Claims in Reorganizations*, 42 YALE L.J. 1003, 1012-14 (1933) (discussing the Supreme Court's treatment of absolute priority in cases at the turn of the twentieth

was the central feature of the reorganization regime that reigned until New Deal reforms fundamentally changed the bankruptcy landscape.[4] This Article uses the relative-priority paradigm to illuminate structural weaknesses at the core of Chapter 11.

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century); Jerome N. Frank, *Some Realistic Reflections on Some Aspects of Corporate Reorganization*, 19 VA. L. REV. 541, 541-42 (1933) (noting that the Supreme Court ruled that an agreement "which left unsecured corporate creditors unpaid while the old stockholders were given an interest in a new corporation . . . was a . . . fraudulent conveyance"); Henry J. Friendly, *Some Comments on the Corporate Reorganizations Act*, 48 HARV. L. REV. 39, 48 (1934) (noting that early versions of the absolute priority rule "created new problems for reorganizers," resulting in legislative reform); Edward H. Levi, *Corporate Reorganization and a Ministry of Justice*, 23 MINN. L. REV. 3, 19 (1938) (suggesting legislative responses to ambiguities in the way the Supreme Court applied the absolute priority rule in the early 1900s).

A number of scholars have become increasingly skeptical of the absolute priority rule in recent years. *See, e.g.*, Edward J. Janger, *The Logic and Limits of Liens*, 2015 U. ILL. L. REV. 589, 612; Stephen J. Lubben, The Overstated Absolute Priority Rule 4 (Mar. 20, 2015) (unpublished manuscript), http://ssrn.com/abstract=2581639 ("[T]here is no absolute priority rule of the kind described in the literature under current law . . . . And even if there were, adopting such a rule would be inconsistent with Chapter 11 . . . reorganization."). Only rarely, however, does anyone identify relative priority as a sensible alternative. Tony Casey's fine work is an exception. His "option-preservation priority" is a modern incarnation of relative priority. *See* Anthony J. Casey, *The Creditors' Bargain and Option-Preservation Priority in Chapter 11*, 78 U. CHI. L. REV. 759, 765 (2011) (proposing that "when the present value of the firm is less than the face value of the senior debt, the senior creditor—rather than getting the entire firm—get[] the greater of (1) the nonbankruptcy liquidation value and (2) the entire firm net of the junior creditor's option value"). Casey's focus, however, is on aligning the incentives of parties in deciding whether to sell the assets or reorganize the firm, *id.* at 768, not on the virtues of relative priority in a regime committed to reorganizing rather than selling the debtor.

Relative priority, however, may gain a second life. The American Bankruptcy Institute Commission, a high-profile group of practitioners and judges that assessed changes in reorganization law, proposed a number of reforms. Included among these reforms is a call for a return to relative priority, although in a limited and dramatically altered form. *See* AM. BANKR. INST. COMM'N TO STUDY THE REFORM OF CHAPTER 11, 2012–2014: FINAL REPORT AND RECOMMENDATIONS, 208-09 (2014) [hereinafter COMMISSION REPORT] (proposing statutory amendments that would permit a "chapter 11 plan [to] be confirmed over the non-acceptance of a senior class of creditors, even if the senior class is not paid in full within the meaning of the absolute priority rule, if the plan's deviation from the absolute priority rule treatment of the senior class is solely for the distribution to an immediately junior class of the redemption option value, if any, attributable to such class").

4 A number of scholars have written about the evolution of the absolute priority rule. *See, e.g.*, John D. Ayer, *Rethinking Absolute Priority After* Ahlers, 87 MICH. L. REV. 963, 971 (1989) (explaining that the absolute priority rule "emerged first as a primitive pre-statutory effort to regulate receiverships in the judicial process"); Randolph J. Haines, *The Unwarranted Attack on New Value*, 72 AM. BANKR. L.J. 387, 397-98 (1998) (discussing the equity receivership method of reorganization that preceded the absolute priority rule and noting that under that regime, "[u]nsecured creditors . . . complain[ed] that equity was being treated unduly favorably"); Bruce A. Markell, *Owners, Auctions, and Absolute Priority in Bankruptcy Reorganizations*, 44 STAN. L. REV. 69, 82-84 (1991) (noting that prior to *Los Angeles Lumber Products*, railway receivership restructurings were structured around "the assumption that the receivership vehicle extinguished unsecured creditors' debts" in favor of shareholders "who contributed new value through paid assessments"); David A. Skeel, Jr., *An Evolutionary Theory of Corporate Law and Corporate Bankruptcy*, 51 VAND. L. REV. 1325, 1353-58 (1998) (discussing the role that railroad reorganizations in the late nineteenth century played in the formation the absolute priority rule).

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

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

Part I of this Article reviews the modern understanding of capital structures and the rationale for respecting priority rights in bankruptcy. Parts II and III examine absolute and relative priority, respectively, and show how the virtues of both priority schemes turn crucially on the presence or absence of a market sale.[10] Part IV shows that absolute priority is implemented only imperfectly

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5 *See, e.g.*, Adler & Ayres, *supra* note 2, at 93-96 (putting forward a nonmarket mechanism to implement absolute priority in the face of imperfect markets); Warren, *supra* note 2, at 11, 13 (noting that "the concept of absolute priority is central to the bankruptcy bargain" and explaining that in order to sell ownership and control, a debtor must "value the business and persuade the court that its valuation is accurate").

6 The costs are illustrated below. *See infra* notes 90–105 and accompanying text. That the valuations are error-prone is commonly acknowledged. A reorganization valuation, in a phrase usually attributed to Peter Coogan, is a "guess compounded by an estimate." *See* Peter F. Coogan, *Confirmation of a Plan Under the Bankruptcy Code*, 32 CASE W. RES. L. REV. 301, 313 n.62 (1982) (tracing the attribution of the phrase).

7 For a discussion of these costs, see *infra* notes 103–05 and accompanying text.

8 The weaknesses of a relative priority reorganization regime are explored below. *See infra* text accompanying notes 134–163.

9 *See* Douglas G. Baird, *Present at the Creation: The SEC and the Origins of the Absolute Priority Rule*, 18 AM. BANKR. INST. L. REV. 591, 595-96 (2010) (showing that, because of relative priority, creditors in an equity receivership focused on maximizing value of the firm rather than fighting for their own share in it).

10 This Article focuses on the reorganization of large firms. The reorganizations of small businesses present an entirely different set of problems. *See* COMMISSION REPORT, *supra* note 3, at 275-302 (recommending that a different set of principles govern small- and middle-market Chapter 11 cases). *See generally* Douglas G. Baird & Edward R. Morrison, *Serial Entrepreneurs and Small Business Bankruptcies*, 105 COLUM. L. REV. 2310 (2005) (showing empirically that small Chapter 11 reorganizations revolve around individual entrepreneurs).

in Chapter 11. Finally, the Article closes by suggesting that much of the modern commentary on reorganization law begins in the wrong place. Modern Chapter 11 might best be characterized as a hybrid system of absolute and relative priority, and such a system may be more efficient than one centered around absolute priority.

I. ABSOLUTE AND RELATIVE PRIORITY

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

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

Even if the industry is flourishing or the potential buyers lie outside the industry, there is another problem that limits the ability to sell the firm: the

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

12 Mark Roe was the first to promote the use of markets as an alternative to reorganizations. *See* Mark J. Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganization*, 83 COLUM. L. REV. 527, 559 (1983) ("The market could, better than a court, accurately and quickly determine the enterprise value of an all-common-equity structure.").

13 Andrei Shleifer and Robert Vishny developed this explanation for the way in which illiquidity can limit the effectiveness of sales. *See* Andrei Shleifer & Robert W. Vishny, *Liquidation Values and Debt Capacity: A Market Equilibrium Approach*, 47 J. FIN. 1343, 1364 (1992) (citing an industry-wide recession as an example of when asset liquidation through an auction "does not necessarily allocate assets to the highest value users").

private information problem.[14] By the time a distressed firm is sold, the investors have organized themselves. They have hired experts and spent time reviewing and assessing the quality of the managers and their plans for the business going forward. As a result, they may know much more about the value of the business than any potential buyer. Buyers may therefore fear that the existing investors want to sell the firm because things are worse than they appear. The existing investors possess private information. Buyers of firms are like buyers of used cars. They are not willing to pay top dollar because of the risk that the firm is being sold only because the current owners know it is going to fail and want to rid themselves of a lemon.[15]

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

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

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

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14 This problem is used to show that reorganizations are sometimes superior to sales in Douglas G. Baird & Donald S. Bernstein, *Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain*, 115 YALE L.J. 1930, 1949-50 (2006). This private information problem may also make it impossible for junior investors to buy out senior ones. *See id.* at 1954 (noting that the "private information problem that makes a sale of the business unattractive also makes it difficult for the junior investor to borrow the funds needed to buy out the senior investor").

15 For the iconic discussion of this problem, using the example of used cars that are "lemons," see George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488, 489 (1970), which explores, through the example of the automobile market, how private information can prevent goods from being sold for their true value.

16 *See, e.g.*, Robert C. Clark, *The Interdisciplinary Study of Legal Evolution*, 90 YALE L.J. 1238, 1252-53 (1981) (explaining that the equity receivership "procedure made economic sense whenever there were no or few potential outside buyers with accurate and timely information about the true state of affairs and the future prospects of the business, and when the process of searching for and informing outside buyers would itself be very expensive," and describing modern Chapter 11 reorganization as "a more structured version of the . . . equity receivership").

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

An artificial example can highlight the difference between absolute and relative priority. Imagine a firm has only one project and two investors. At the outset, they agree that one will be entitled to $150 when the project is completed and the other will be entitled to whatever remains. Their lawyers implement this deal by giving one investor a debt instrument and equity to the other.[19] Time passes, and it becomes clear that the project will either yield $200 or $0 with equal probability. At this point, a government regulation unexpectedly requires the firm to eliminate all debt in its capital structure in order for the project to move forward.[20] A market sale is not in the collective

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17 For a discussion of how creditors are sometimes willing to waive their rights on default and use them instead to exercise control over the debtor, see Frederick Tung, *Leverage in the Board Room: The Unsung Influence of Private Lenders in Corporate Governance*, 57 UCLA L. REV. 115, 134 (2009), which states, "While lenders generally do not accelerate precipitously, the option to accelerate [repayment] upon a covenant violation gives the lender significant leverage over management."

18 *See* Casey, *supra* note 3, at 776 ("Once the company goes into distress, the only world in which the senior creditor has a chance of realizing [full payment] is the one in which the firm receives additional financing, continues operation, and achieves the good state of the world . . . . In that world, the option value of the junior creditor remains open until the final payout.").

19 Using debt is only one of several possible ways to implement priority among investors. There are other legal devices (such as call options or preferred stock) that can produce the same effect. Venture capital deals often use preferred stock instead of debt to give outside investors priority. *See* Steven N. Kaplan, Frederic Martel & Per Strömberg, *How Do Legal Differences and Experience Affect Financial Contracts?*, 16 J. FIN. INTERMEDIATION 273, 281 (2007) (finding that "over 95% of U.S. [venture capital deals] employed some type of convertible preferred stock"). The decision of which device to use is a matter of indifference to investors, other things being equal. It usually turns on peculiarities of the legal system, not on the druthers of investors. *See id.* at 285 (comparing venture capital contracts across legal regimes and finding that "legal origins/legal regimes affect the nature and types of contracts that are written").

20 One example of such an obstacle can be found in *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106 (1939), the case that established the absolute priority rule. The inaptly named Los Angeles Lumber Products was a naval shipbuilder, and government regulations required naval shipbuilders to obtain surety bonds as a condition of bidding on government contracts. Robert K. Rasmussen, *The Story of* Case v. Los Angeles Lumber Products*: Old Equity Holders and the Reorganized Corporation*, *in* BANKRUPTCY LAW STORIES 147, 157-58 (Robert K. Rasmussen ed., 2007). Sureties refused to issue a bond unless the shipyard dramatically reduced the amount of debt it was carrying.

interest of the two investors. No outsider is willing to pay anything close to the firm's expected value.

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

There are two approaches. The first, of course, is absolute priority.[22] The restructuring is a day of reckoning. All future possibilities are collapsed to the present. The project has an expected value of $100, reflecting the equal chance that it will be worth $200 or $0. Even if the firm could be sold today for what it was worth, no buyer would pay more than this amount. This is less than the $150 that the senior investor is owed. Hence, the senior investor should receive 100% of the securities issued by the reorganized firm, and the junior investor should receive nothing.

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

Id. The shipyard was not in default to any of its creditors, but it was carrying an enormous debt load because of past misadventure in the lumber business.

21 Framing the question as one about the hypothetical ex ante bargain among investors has been the standard trope in reorganization scholarship ever since Jackson introduced the creditors' bargain model in the early 1980s. *See* Jackson, *supra* note 11, at 860 (arguing that bankruptcy should be understood as "a system designed to mirror the agreement one would expect the creditors to form among themselves were they able to negotiate such an agreement from an *ex ante* position"); *see also* Melissa B. Jacoby & Edward J. Janger, *Ice Cube Bonds: Allocating the Price of Process in Chapter 11 Bankruptcy*, 123 YALE L.J. 862, 937 (2014) ("Preventing senior creditors from receiving *more* than they bargained for ex ante reflects the fact that priority has limits.").

22 Many have suggested ways of modifying absolute priority to ensure junior parties have the right set of incentives. *See infra* note 52 and accompanying text. Strict adherence to absolute priority, for example, might lead to bankruptcy petitions being filed too late. *See, e.g.*, Paul Povel, *Optimal "Soft" or "Tough" Bankruptcy Procedures*, 15 J.L. ECON. & ORG. 659, 660 (1999) ("Clearly, if bankruptcy is a strong punishment, a borrower keeps the unpleasant information to himself and prefers to wait and pray."). But these alternatives to absolute priority all start by asking how assets would have been shared in the event of a sale in which all accounts were squared. None of these are the same as relative priority. Relative priority is not merely a "deviation" from absolute priority. It does not possess absolute priority's defining attribute: treating the bankruptcy as a day of reckoning.

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

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

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

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

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

25 That loans can be decomposed into options and other derivatives follows from put–call parity. *See* Hans R. Stoll, *The Relation Between Put and Call Option Prices*, 24 J. FIN. 801 (1969). Formalizing the priority right of junior investors in this fashion is a familiar feature of the law and economics of bankruptcy. *See, e.g.*, Alan Schwartz, *Bankruptcy Contracting Reviewed*, 109 YALE L.J. 343, 356 (1999) ("[J]unior creditors have a call option on the insolvent firm . . . ."). What has not been appreciated is that the precise difference between absolute and relative priority is the identification of the exercise date of the call option.

26 Using options to understand investment instruments is a central and familiar feature of modern finance, beginning with Fischer Black and Myron Scholes. *See generally* Fischer Black & Myron Scholes, *The Pricing of Options and Corporate Liabilities*, 81 J. POL. ECON. 637 (1973) (offering a technique for valuing options).

The choice between absolute and relative priority has little to do with the problem of financial distress. Financial distress arises because of other features of investment instruments—in particular, cash-flow and control rights. Investment instruments typically contain cash-flow rights. A shareholder receives dividends; a debtholder is entitled to the repayment of principal and interest on a fixed schedule. Investment instruments also embody control rights. Shareholders enjoy control rights directly.[27] They have voting rights. They elect the board of directors. Creditors also enjoy control rights.[28] By virtue of their ability to waive defaults instead of accelerating their loans, creditors can also influence the behavior of their debtor.

Creditor control is not readily visible, but it is nevertheless strong because of the number and variety of covenants found in loan agreements.[29] Even when the firm is enjoying the sunniest of times, the debtor often needs permission from its lead lender to make major capital investments or take on additional debt.[30] As the firm falls deeper into financial distress, it becomes increasingly more likely that it will breach one or more covenants.[31] The breach itself might not be of great moment. For example, it may be nothing

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27 For a discussion of shareholder control rights and their mediation through managers, see FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 91-93 (1991).

28 George Triantis was the first to discuss control rights and the way in which they inhere in debt instruments. *See* George G. Triantis, *Debt Financing, Corporate Decision Making, and Security Design*, 26 CANADIAN BUS. L.J. 93, 100-02 (1996); George G. Triantis, *The Interplay Between Liquidation and Reorganization in Bankruptcy: The Role of Screens, Gatekeepers, and Guillotines*, 16 INT'L REV. L. & ECON. 101, 104-08 (1996).

Old accounts of control rights used to locate control rights exclusively in the hands of shareholders. *See* Comment, *An Economic and Legal Analysis of Union Representation on Corporate Boards of Directors*, 130 U. PA. L. REV. 919, 927-28 (1982) ("The traditional explanation for vesting corporate control in the shareholders is that shareholders, by providing the capital for the enterprise, bear the risk of failure. It this seems equitable to give the shareholders as much control as possible over their fates." (footnote omitted)). This is wrong. A growing body of work focuses on the role that creditors play in corporate governance and their ability to control corporate decisionmaking. For a review of this work, see Kenneth M. Ayotte, Edith S. Hotchkiss & Karin S. Thorburn, *Governance in Financial Distress and Bankruptcy*, *in* THE OXFORD HANDBOOK OF CORPORATE GOVERNANCE 489, 496-503 (Mike Wright, Donald S. Siegel, Kevin Keasey & Igor Filatotchev eds., 2013).

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

30 *See id.* at 404 (finding that capital expenditure restrictions are "relatively common in private credit agreements").

31 *See* Joshua D. Rauh & Amir Sufi, *Capital Structure and Debt Structure*, 23 REV. FIN. STUD. 4242, 4273 (2010) (finding "a sharp increase in the incidence of bank financial covenant violations as firms move down the credit-quality distribution"). For a study showing the incidence of covenant violations, see Michael R. Roberts & Amir Sufi, *Control Rights and Capital Structure: An Empirical Investigation*, 64 J. FIN. 1657, 1658 (2009), which found that over 25% of publicly traded U.S. firms committed a covenant violation over a ten-year period.

more than a delay in filing a financial report, but the breach is a default nevertheless, and it gives a creditor the power to terminate its loan. Creditors are usually willing to waive many defaults, but they subject their waiver to conditions. Enormous creditor control comes from their ability to impose these conditions.[32]

Financial distress often requires altering the cash-flow and control rights of junior investors.[33] Indeed, control rights and cash-flow rights are the principal drivers of financial distress.[34] When a firm may not even be able to pay its senior creditors, it is no longer sensible for junior stakeholders to call the shots or enjoy interest payments and dividends.[35]

But neither cash-flow nor control rights are relevant to the choice between absolute and relative priority. Priority is about what each investor receives at the end of the day when all accounts are squared. The firm continues to exist until senior investors seize the assets and sell them. So long as the firm continues, there is no need to square the accounts, no matter how financially distressed the firm may be. The ultimate allocation of firm value between junior and senior investors can be put off. It is possible to fix the rights of junior and senior investors at the time of the restructuring, but it is not necessary to do so.

Relative priority can be implemented simply. For example, the senior investor can be given all the equity in the reorganized firm, and the junior investor can be given a call option on this equity with a strike price equal to the amount owed the senior investor.[36] The cash-flow and control rights of

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32 *See supra* note 17.

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

34 For an empirical investigation of the characteristics of financial distress and in particular the connection between cash-flow rights and financial distress, see generally Gregor Andrade & Steven N. Kaplan, *How Costly Is Financial (Not Economic) Distress? Evidence from Highly Leveraged Transactions that Became Distressed*, 53 J. FIN. 1443 (1998). For an analysis of the role of control rights during financial distress, see generally Douglas G. Baird & Robert K. Rasmussen, Essay, *Control Rights, Priority Rights, and the Conceptual Foundations of Corporate Reorganizations*, 87 VA. L. REV. 921 (2001).

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

36 Half the time the equity will prove worthless if the value of the stake remains below the strike price. On the other hand, if the value of the stake exceeds the strike price, the junior investor will enjoy some return. In our example, if the stake is worth $200, the junior investor will exercise the call option and give the senior investor $150. In expectation, the senior investor receives $75. The automatic conversion feature of the senior investor's stake into 100% equity of the reorganized firm is quite similar to Barry Adler's chameleon equity proposal. *See* Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 STAN. L. REV. 311, 323-33 (1993) (detailing an alternative way to restructure a firm in which debt is converted automatically into equity). There is a critical difference, however. Chameleon equity implements absolute priority, *see id.* at 324 ("[A] Chameleon Equity firm would establish a multi-tiered priority hierarchy . . . ."), and all implementations of absolute priority require a liquid market, a judicial valuation, or both. *See supra* text accompanying notes 5–7.

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

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

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

In making the choice between absolute and relative priority, normative intuitions have little role to play. When large firms are reorganized, the important battles are between different layers of institutional debt.[37] Firms in bankruptcy are typically so far from being solvent that the equity lacks even option value.[38] There are some cases in which workers, tort victims, or small suppliers are at risk of not being paid, but these are not the typical

37 *See* 11 U.S.C. § 1123(a)(4) (2012) (requiring a bankruptcy plan to "provide the same treatment for each claim or interest of a particular class"). For a discussion of the players in large modern Chapter 11s, see Harvey R. Miller, *Chapter 11 in Transition—from Boom to Bust and into the Future*, 81 AM. BANKR. L.J. 375, 390 (2007), which discusses the rise of distressed debt traders, who maintain short time horizons.

38 The option value of class of claims or interests is virtually worthless unless the value of the firm ultimately exceeds the stake of the immediately senior class. *See* COMMISSION REPORT, *supra* note 3, at 222 ("[W]here the senior class is deeply impaired and its distributions on the plan confirmation or sale order date are low in comparison to the full amount of the senior class's claims, the immediately junior class is likely to be entitled to receive little or nothing."). Distributions to general creditors in large bankruptcies have been running less than fifteen cents on the dollar over the last two decades. Douglas G. Baird, *Chapter 11's Expanding Universe*, 87 TEMP. L. REV. 975, 979 (2015).

cases.[39] The operations of the firm usually continue much as before. Workers and suppliers are paid as if the bankruptcy never happened.[40]

The typical large reorganization affects only the rights of sophisticated investors.[41] Whether junior or senior in the capital structure, the investor will be a hedge fund, a large pension fund, an insurance company, or a bank.[42] By the time the bankruptcy starts, claims will have been transferred, often multiple times, and will rest in the hands of those who, far from wanting to avoid navigating the hazards of bankruptcy, relish doing battle there.[43]

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39 It is, of course, easy to find cases in which rights of tort victims, workers, and retirees are implicated. *See, e.g.*, McMillan v. LTV Steel, Inc., 555 F.3d 218, 224, 231 (6th Cir. 2009) (affirming the bankruptcy court's denial of a laid off steelworker's claim for backpay, unpaid severance benefits, and retirement account contributions); *In re* Johns-Manville Corp., 801 F.2d 60, 62 (2d Cir. 1986) ("Manville [Corporation] and the committees representing present and future tort claimants[] have long struggled to devise a reorganization plan acceptable to each.").

In cases involving large retailers, suppliers often incur substantial losses. These cases, however, are a minority of large cases in Chapter 11. *See* Baird, *supra* note 38, at 977 (noting that fewer than ten percent of those filing between 2005 and 2009 were retail businesses).

40 The prepackaged Chapter 11 of the Indiana Toll Road in September 2014 provides an illustration of the practice. *See* Motion of ITR Concession Company LLC, et al., for Entry of Interim and Final Orders (A) Authorizing the Debtors to Pay Certain Prepetition Taxes and Fees, (B) Directing Financial Institutions to Honor all Related Checks and Electronic Payment Requests, and (C) Granting Related Relief at 3, *In re* ITR Concession Co., No. 14-34284, 2014 WL 4929586 (Bankr. N.D. Ill. Sept. 23, 2014) (explaining that the debtors continued to operate their railroad throughout the process of their Chapter 11 case).

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

In any event, focusing on the treatment of nonadjusting creditors, those not able to take account of a particular debtor's creditworthiness and take specific steps to protect themselves, misses the thrust of this Article, which is to confront the virtues of absolute priority on its strongest ground—one on which the only players are professional, sophisticated investors.

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

42 *See* Marshall S. Huebner & Benjamin A. Tisdell, *As the Wheel Turns: New Dynamics in the Coming Restructuring Cycle* (detailing how Chapter 11 is evolving "into a forum by which sophisticated players in an increasingly liquid claims market resolve financial distress"), *in* THE AMERICAS RESTRUCTURING AND INSOLVENCY GUIDE 2008/2009, at 77, 80 (2008).

43 *See* Glenn E. Siegel, *Introduction: ABI Guide to Trading Claims in Bankruptcy Part 2*, 11 AM. BANKR. INST. L. REV. 177, 177 (2003) ("Perhaps nothing has changed the face of bankruptcy in the last decade as much as the newfound liquidity in claims . . . . Now, in almost every size case, there is an opportunity for creditors to exit the bankruptcy in exchange for a payment from a distressed debt trader who bets that its ultimate distribution will exceed the purchase price.").

Professional investors can adapt themselves to any priority regime.[44] To be sure, absolute priority is better for senior investors after the fact and relative priority worse. But interest rates should adjust in a well-functioning capital market so that, in equilibrium, both junior and senior investors enjoy the same return on their capital regardless of the priority rule. There is no fairness argument that requires paying the senior investor before anyone else. Nor is there any reason to insist that everyone share the hurt. Mandating sharing for its own sake makes little sense when the stakeholders are sophisticated professionals who hold diversified portfolios.[45]

Priority rights should work to the mutual benefit of all investors as a group.[46] But it is not easy to identify how priority rights matter. A pizza does not get bigger or smaller based on how it is sliced. So too with cash flows. A firm's capital structure determines which investor enjoys the cash it generates, but at first blush, the division of cash flows does not itself affect the amount of cash that the firm makes.[47] It is reasonable to start with the assumption that a firm with a capital structure built around relative priority will be worth the same as one built around absolute priority.[48]

44 *See* Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 YALE L.J. 1807, 1812-13 (1998) (describing how creditors adapt to receive the market rate of return).

45 The ability to minimize risk through diversification is a fundamental principle of modern finance. *See generally* Paul A. Samuelson, *General Proof that Diversification Pays*, 2 J. FIN. & QUANTITATIVE ANALYSIS 1 (1967) (introducing proof of the benefits of portfolio diversification).

46 *See* Douglas G. Baird & Thomas H. Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. CHI. L. REV. 97, 108 (1984) ("How a firm's assets are deployed should not turn on whether one, ten, or ten thousand people have rights in them. Bankruptcy law, accordingly, should aim to keep the asset-deployment question separate from the distributional question, and to have the deployment question answered as a single owner would answer it.").

47 Franco Modigliani and Merton Miller proved in the 1950s that capital structures have no effect on the value of a firm as long as a handful of specified assumptions hold. Their foundational article is Franco Modigliani & Merton H. Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 AM. ECON. REV. 261 (1958). For an accessible overview, see generally Merton H. Miller, *The Modigliani-Miller Propositions After Thirty Years*, 2 J. ECON. PERSP., Fall 1988, at 99. The Modigliani and Miller irrelevance propositions are the starting place for every modern discussion of capital structures. To make sense of capital structures, one needs to identify which of their assumptions does not hold and why it matters.

48 It has long been known that the choice between absolute and relative priority has no effect on firm value, so long as the Modigliani and Miller assumptions hold. *See* Eugene F. Fama, *The Effects of a Firm's Investment and Financing Decisions on the Welfare of Its Security Holders*, 68 AM. ECON. REV. 272, 272 (1978) (explaining why "me-first rules" are not necessary for the Modigliani–Miller theorem to hold true). It is an unfortunate accident that modern economists returned to the study of corporate reorganizations in earnest when this point was not clear. The idea of absolute priority started as a convenient assumption. *See, e.g.*, Jerold B. Warner, *Bankruptcy, Absolute Priority, and the Pricing of Risky Debt Claims*, 4 J. FIN. ECON. 239, 239 (1977) ("A standard assumption in financial economics is that the firm's claimholders protect their interests with priority arrangements such as 'me-first' rules."). It was not seriously reexamined when it was found to be unnecessary. Absolute priority remained the starting place and everything else was a "deviation."

Assume that under a regime of absolute priority, a firm raises $95 from outside investors. It receives $49 from a senior lender in return for a promise to pay $50 in a year. At the same time, it receives $46 from a junior investor in return for a promise to pay $50 in a year. An efficiency explanation for absolute priority must show why the firm could not also obtain a total of $95 from senior and junior investors under a regime of relative priority in return for a promise to pay $100 in a year. Because of the higher risk, the senior investor, everything else equal, will not offer as much as $49 for the right to receive $50 in the future, but the junior investor faces correspondingly less risk and should be willing to invest more than $45.

Some justifications for absolute priority posit an agency problem.[49] An owner–manager of the firm seeks outside investment with the goal of maximizing the amount she raises. The outside investors have no easy way to tell whether the owner–manager is doing everything she can to make the venture succeed. Nor can they tell whether she is taking unnecessary risks. The owner–manager and the outside investors can minimize this agency problem by maximizing the share that the outside investors receive when things turn out badly.[50] When the owner–manager takes nothing until and unless the investors are paid in full, she has every incentive to make the business succeed. She enjoys the benefit of each marginal dollar the firm makes and incurs the cost of each marginal dollar the firm loses above the value of outside investments. In the presence of this or other similar agency costs, it makes sense to implement a regime of absolute priority.

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

49 *See, e.g.*, Alan Schwartz, *A Normative Theory of Business Bankruptcy*, 91 VA. L. REV. 1199, 1207-11 (2005) (noting that "[t]he firm can take unobservable actions after borrowing that affect the creditors' expected return").

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

51 *See* Alan Schwartz, *The Absolute Priority Rule and the Firm's Investment Policy*, 72 WASH. U. L.Q. 1213, 1224 (1994) (asserting that if absolute priority is not followed, a firm will be unable to induce investments in certain circumstances).

52 *See* Povel, *supra* note 22, at 660 (explaining that if bankruptcy is too tough on borrowers, it will not be used to maximum benefit). There are a large number of papers that offer additional reasons for deviating from absolute priority without identifying relative priority as the alternative. *See, e.g.*, Robert Gertner & David Scharfstein, *A Theory of Workouts and the Effects of Reorganization Law*, 46 J. FIN. 1189, 1212-15 (1991) (stating that departures from absolute priority may be needed to minimize risk-taking and underinvestment problems); Lucian Arye Bebchuk & Randal C. Picker,

absolute priority undermine the need to ensure that the manager has the right incentives.[53] They require justification. Absolute priority is, in any event, the starting place.[54]

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

There is, of course, an agency problem between the investors and the managers. The managers need proper incentives to persuade them to act in the best interests of the investors,[55] but the choice of priority regimes has no effect on this. Put–call parity ensures that managers can be given stakes in the firm that correctly align their incentives regardless of the priority regime.[56]

It was once common to think that there was an agency problem in large corporate reorganizations because the managers were beholden to the shareholders.[57] But in modern reorganizations, shareholders hold little power. In the vast majority of cases, they are going to be wiped out.[58] As soon as a firm is in financial distress, the managers pay more attention to the creditors

Bankruptcy Rules, Managerial Entrenchment, and Firm-Specific Human Capital 18 (Univ. of Chi. Law Sch., John M. Olin Law & Econ. Working Paper No. 16 (2d Series), 1993) (arguing that deviations from absolute priority encourage development of firm-specific human capital). These papers typically provide rationales for giving bargaining leverage to junior stakeholders, in particular equityholders, in reorganizations. *See, e.g.*, Povel, *supra* note 22, at 662.

53 *See* Bebchuk, *supra* note 50, at 457 (arguing that deviations from absolute priority "exacerbate the problems of asset substitution, asset dilution, and claim dilution").

54 *See supra* note 2.

55 *See* Steven N. Kaplan & Per Strömberg, *Leveraged Buyouts and Private Equity*, 23 J. ECON. PERSP., Winter 2009, at 121, 130 ("[P]rivate equity firms pay careful attention to management incentives in their portfolio companies.").

56 The essential lesson of put–call parity is that the cash-flow rights associated with any investment instrument can be recreated with a bundle of other investment instruments and derivatives. For an overview of put–call parity, see Alvin C. Warren, Jr., Commentary, *Financial Contract Innovation and Income Tax Policy*, 107 HARV. L. REV. 465-67 (1993).

57 *See* Bebchuk, *supra* note 50, at 447 ("Equityholders (and managers seeking to maximize the value of equity) might favor a risky project over a safer one even if the risky project offers a somewhat lower expected return, because the returns from favorable outcomes of the risky project would be captured by the equityholders, whereas the losses from its unfavorable outcomes would be partly borne by the debtholders.").

58 *See* Baird, *supra* note 38, at 978 (noting that "[b]y the early 2000s, equity commonly received nothing in the vast majority of cases").

who will control the firm going forward.[59] By the time of the bankruptcy, creditors are in complete control.[60]

In short, when the priority debate is between sophisticated investors holding different layers of debt, one cannot use simple agency-cost theory to identify the optimal priority rule. There are, to be sure, other theories that try to explain why some creditors strongly prefer priority over others.[61] Consistent with the structure of Anglo-American law, many of these theories are asset-based. A creditor might prefer to take a security interest in a particular asset because of that creditor's ability to monitor that asset's value and condition. A seller of a particular type of equipment might finance the sale and be able to ensure that the debtor properly maintains and insures the equipment. And if the firm is liquidated, the seller of the equipment might also be best equipped to repossess and sell it and realize its value.[62] But asset-based

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59 As a matter of black-letter law, the fiduciary duty of the board is to maximize the value of the firm for all investors, not only for shareholders or any other constituent group. As shareholders are typically the ones who gain or lose the most from the board's decisions, the board typically looks to them, but it does this only to a point. Creditors gain the ability to bring derivative actions against the board when the firm becomes insolvent. It is at that point that they are its residual claimants. *See* Quadrant Structured Prods. Co. v. Vertin, 102 A.3d 155, 176 (Del. Ch. 2014) ("The fiduciary duties that creditors gain derivative standing to enforce [when the firm becomes insolvent] are not special duties to creditors, but rather the fiduciary duties that directors owe to the corporation to maximize its value for the benefit of all residual claimants."). In addition, quite apart from their duties, managers pay attention to those who control the firm because they want to keep their jobs. That creditors exercise such control as firms become more financially distressed is empirically established. *See* Nini, Smith & Sufi, *supra* note 29, at 401 ("[L]enders regularly impose explicit limits on capital expenditures, particularly after a borrower's credit quality deteriorates . . . ."). The dismissal of the CEO of Krispy Kreme at the behest of its principal creditor is one example. *See* Press Release, Krispy Kreme Doughnuts, Inc., Management Changes and Retention of Financial Advisor (Jan. 18, 2005), http://www.prnewswire.com/news-releases/krispy-kreme-announces-management-changes-54041687.html [https://perma.cc/ZC3C-SHPE] (announcing the replacement of the Krispy Kreme CEO and "anticpat[ing] that [the decision] will be viewed positively by its lenders").

60 *See* Huebner & Tisdell, *supra* note 42, at 77 (observing that in large reorganizations "creditors effectively play[] the same role as shareholders of a solvent enterprise").

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

62 For the classic analyses of monitoring and secured credit, see generally Thomas H. Jackson & Anthony T. Kronman, *Secured Financing and Priorities Among Creditors*, 88 YALE L.J. 1143 (1979), which describes debtor behavior monitoring as an alternative to raising interest rates for lenders attempting to

priority justifications have a harder time explaining capital structures in which some creditors have blanket priority over all the assets of the firm.[63]

There are some plausible justifications for blanket security interests over all of a firm's assets. For example, the optimal priority structure may depend upon which creditor is better positioned to monitor the debtor. A senior priority position might be more desirable for an investor who is distant and has limited ability to detect misbehavior. An investor who is close to the debtor and able to monitor the debtor's business may find it worthwhile to bear the added risk that goes with low priority in return for a higher rate of return.[64]

A creditor who puts in place a revolving credit facility might want priority over other investors.[65] Such a creditor needs to be close to the debtor and understand its business. More to the point, her loan is constantly in flux. She needs to be confident that she will recover each new penny she injects into the firm's operations.

Investors as a group might be better off with the liquidity and the oversight such a senior lender provides. The senior investor with control rights may exercise them in a way that benefits the firm as a whole. She might, for example, insist on the replacement of the CEO long before junior investors and shareholders sense trouble.[66] Alternatively, she might install a Chief Restructuring Officer to sort out the financial condition of the firm.[67] These steps might benefit investors as a whole.

Of course, a senior investor's exercise of control is not necessarily value-enhancing for the investors. The senior investor is not a Good Samaritan. She

price the riskiness of a loan, and Saul Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 YALE L.J. 49 (1982), which discusses the freeriding problems among monitors.

63 The law does require investors who want a blanket priority over the entire firm to acquire priority by taking security interests in each of the firm's various assets, Douglas G. Baird, *The Rights of Secured Creditors After* Rescap, 2015 U. ILL. L. REV. 849, 856, but this is an artifact—and not necessarily a desirable artifact—of Anglo-American law.

64 This is one of the most conventional justifications for a mix of secured and unsecured credit. *See, e.g.*, Douglas G. Baird & Anthony J. Casey, *No Exit? Withdrawal Rights and the Law of Corporate Reorganizations*, 113 COLUM. L. REV. 1, 14 (2013) ("Those who are well positioned to monitor do not need a withdrawal right.").

65 *See* Cheol Park, *Monitoring and Structure of Debt Contracts*, 55 J. FIN. 2157, 2158 (2000) (justifying such a lender's priority on the grounds that "a lender's incentive to monitor is maximized when he appropriates the full return from monitoring").

66 The dismissal of the CEO of Krispy Kreme, discussed *supra* note 59, may have been such an instance. *See* Douglas G. Baird & Robert K. Rasmussen, Essay, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. 1209, 1212 (2006) ("The price the banks demanded for the waivers [to various covenants] included firing the [Krispy Kreme] CEO and replacing him with a seasoned turnaround specialist.").

67 For a discussion of these Chief Restructuring Officers (CRO) and the work they do, see generally Bob Rajan et al., *The ABCs of the CRO*, EUROFENIX, Summer 2014, at 24, http://www.alvarezandmarsal.com/sites/default/files/sidebar-callouts/chief-restructuring-officer.pdf [https://perma.cc/ML7Q-2A37].

will focus on what advances her own self-interest. Because the senior investor enjoys first priority, she may play things too safe. She may decide, for example, not to go forward with a risky product even though—from the perspective of the investors as a whole—it is likely to raise the value of the company. For the senior creditor's exercise of control rights to be efficient, her self-interest must align with the interests of the firm as a whole. Even if this is not the case, however, it may be that the interests of the junior and senior investors align over most dimensions.[68]

There are more explanations for priority. For example, when one creditor has priority over another, neither wastes time or resources keeping a place in line.[69] But each explanation is in tension with the others. The presence, as well as the absence, of monitoring is used to explain why a creditor is senior or junior to another.

Of course, the way investors structure their deals suggests that there must be some value in priority. Recently, there has been a dramatic rise in second-lien financing.[70] In these transactions, two creditors enter into a bargain with each other and with a common debtor in which one creditor takes a position junior to another. This creditor explicitly agrees to remain passive and allow the now-senior creditor to exercise her control rights without interference.[71] Sophisticated parties would not establish such priorities between themselves, nor parcel out control rights in this fashion, unless it was in their mutual interest. Priority must be doing something more than making one investor safer at the expense of another.

Existing practices, however, do little to identify which priority regime parties prefer when a firm is being reorganized. To be sure, senior creditors have an unqualified right to foreclose in the event of default,[72] and debtors who file for bankruptcy are usually in default. Moreover, the definition of "default" almost always includes the filing of bankruptcy.[73] This might seem to suggest the secured creditors have bargained for absolute priority, but it is

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68 *See* Rauh & Sufi, *supra* note 31, at 4276 (explaining that "the announcement of a new bank credit facility elicits a positive equity price response" and that a bank's imposition of tighter controls "after credit-quality deterioration improves the borrower's market valuation[]").

69 *See, e.g.*, Randal C. Picker, *Security Interests, Misbehavior, and Common Pools*, 59 U. CHI. L. REV. 645, 646 (1992) ("[S]ecured credit is a sensible response to the problem of creditor misbehavior.").

70 *See* Chamblee, *supra* note 61, at 1 (noting that second-lien lending exceeded $29 billion in 2006).

71 For a helpful overview of second-lien financing, see generally C. Edward Dobbs, *Negotiating Points in Second Lien Financing Transactions*, 4 DEPAUL BUS. & COM. L.J. 189 (2006) and George H. Singer, *The Lender's Guide to Second-Lien Financing*, 125 BANKING L.J. 199 (2008).

72 *See* U.C.C. § 9-601(a)(1) (AM. LAW INST. & NAT'L CONFERENCE OF COMM'RS ON UNIF. STATE LAWS 2013–2014).

73 *See* DAVID ZARFES & MICHAEL L. BLOOM, CONTRACTS AND COMMERCIAL TRANSACTIONS 299-300 (2011) (discussing prevalence of "ipso facto" clauses that make bankruptcy an event of default and noting that these are "commonly included in contracts").

wrong to draw such an inference. Regardless of its theoretical right to foreclose, the secured creditor can never use it without the acquiescence of the debtor and the junior creditors. Bankruptcy terminates the secured creditors' ability to foreclose, and the debtor will always have the option to file for bankruptcy. A debtor cannot waive its right to file for bankruptcy.[74]

The ability of the debtor and junior creditors to file a bankruptcy petition[75] limits the senior creditor's ability to foreclose no matter what the agreement says. Because the power of junior investors to trigger a bankruptcy cabins the right to foreclose, having the theoretical right to foreclose in the event of bankruptcy imposes no costs even if such an unqualified right is suboptimal. It is therefore a mistake to conclude that the priority embedded in a blanket right to foreclose in the event of default is efficient on the ground that the arm's length ex ante bargain calls for it. When words in a contract have no legal effect, there is no reason to think that they reflect what parties want.[76]

Parties can (and do) enter into subordination agreements with one another, and these are enforceable in bankruptcy.[77] But such agreements are also written in the shadow of existing law. The way two parties would allocate value between themselves when other investors enjoy absolute priority is not necessarily the same as when all parties were subject to relative priority. Moreover, the priority rights bargained for today account for the constraints that current law places on the ability of junior creditors to waive their right to participate in a reorganization.[78] For example, it is not clear that parties

74 *See* United States v. Royal Bus. Funds Corp., 724 F.2d 12, 15 (2d Cir. 1983) ("We by no means intend to disturb the general rules that a debtor may not agree to waive the right to file a bankruptcy petition [and] that the pendency of an equitable receivership rarely precludes a petition in bankruptcy . . . .").

75 *See* 11 U.S.C. § 303 (2012) (providing for involuntary bankruptcy filings).

76 The catalog of those who have made the mistake of assuming that foreclosure rights inform the appropriate priority rule in bankruptcy is long and distinguished. It begins with Jerome Frank and includes most law-and-economics scholars who write about bankruptcy. *See* Frank, *supra* note 3, at 541 ("A mortgagor by buying in at a mortgage foreclosure sale cannot cut off the rights of his unsecured creditors to proceed against the property purchased at the sale.").

These academics usually failed to understand that the presence of broad foreclosure rights in bonds today reflects considerable path dependence. Bonds take the form they do because when they were first adopted for railroad reorganizations in the nineteenth century, they followed the form of real estate mortgages. *See* WILLIAM Z. RIPLEY, RAILROADS: FINANCE AND ORGANIZATION 121-26 (1915) (discussing the real estate roots of railroad bonds). Once the foreclosure language found its way into the loan documents, no one had an incentive to take it out. Foreclosure could be prevented no matter what the agreement said.

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

78 Courts treat some protections granted to creditors as nonwaivable regardless of the agreements they have reached with other creditors. *See, e.g.*, Bank of Am., Nat'l Ass'n v. N. LaSalle St. Ltd. P'ship (*In re* 203 N. LaSalle St. P'ship), 246 B.R. 325, 327 (Bankr. N.D. Ill. 2000) (refusing to enforce the terms of a subordination agreement allowing senior investors to vote claims of juniors). For discussions of possible limits on the ability of parties to waive bankruptcy rights in subordination agreements, see Edward R. Morrison, *Rules of Thumb for Intercreditor Agreements*, 2015

can change through agreement such things as the ability of junior creditors to object to asset sales.[79] A senior lender might insist today on absolute priority only because other parts of the bargain are fixed.

Subordination agreements are in any event elaborately negotiated, and junior investors rarely commit to refrain from asserting their rights unless and until senior creditors are paid in full.[80] Indeed, subordinated parties sometimes bargain for the right to receive junior securities in a restructuring that provide for a payoff to them if, and only if, those to whom they are subordinated are paid in full.[81] These "X-Clauses," as they are called, are examples of relative priority emerging through contract.[82]

Therefore, the debate about relative and absolute priority must take place in an empirical vacuum. It is not even easy to draw inferences from the relative priority regime that existed before the absolute priority rule took hold.[83] Although largely consensual, this regime was norm-based. An investor, whether junior or senior in the capital structure, would depend upon J.P. Morgan to come up with capital structures that made sense.[84] Working alongside Morgan were many others who could be trusted because of their need to return to the investors in distressed firms when they had new investments to sell. These included August Belmont and Kidder Peabody. Their lawyers also needed to protect their reputations, as they too planned to be around for the long haul. There were widely shared understandings about what one could and could not do. Among other norms, reorganization lawyers could not receive fees until the reorganization was over or abandoned. Indeed,

U. ILL. L. REV. 721, 723-26, and see generally Shane G. Ramsey, *Are Subordination Agreements Really Enforceable?*, AM. BANKR. INST. J., Apr. 2012, at 52.

79 *See* Jeffrey N. Pomerantz et al., *Delaware Bankruptcy Court Weighs In on Intercreditor Agreements*, 31 AM. BANKR. INST. J., July 2012, at 14, 14 (outlining a "series of [conflicting] bankruptcy court decisions ruling on the enforceability and parameters of waivers found in pre-petition intercreditor agreements").

80 *See* Dobbs, *supra* note 71, at 202 (detailing the many rights that second lienholders commonly insist upon).

81 Mark N. Berman & Jo Ann J. Brighton, *The* Dura *Decision: Junior Creditors Again Strike Out Interpreting the Elusive X-Clause: What Might This Mean for Second-Lien Financings?*, AM. BANKR. INST. J., Mar. 2008, at 30, 30.

82 *See, e.g.*, *In re* Metromedia Fiber Network, Inc., 416 F.3d 136, 139-40 (2d Cir. 2005) ("In a nutshell, when subordinated and senior note holders are given securities under a plan of reorganization, an X-Clause allows the subordinated note holder to retain its securities only if the securities given to the senior note holder have higher priority to future distributions and dividends (up to the full amount of the senior notes). This provides for full payment of the senior notes before any payment of the subordinated notes is made.").

83 *See supra* notes 3–4 and accompanying text.

84 J.P. Morgan took the lead in reorganizing the Santa Fe, the Erie, and the Northern Pacific railroads among others. *See* ALFRED D. CHANDLER, JR., THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS 171 (1977); Carlos D. Ramirez, *Did J. P. Morgan's Men Add Liquidity? Corporate Investment, Cash Flow, and Financial Structure at the Turn of the Twentieth Century*, 50 J. FIN. 661, 676-77 (1995) (finding that Morgan's participation likely lowered the cost of capital).

they could not even ask for them.[85] Formal legal rules entered only at the margins in this world, usually to protect nonparticipants.[86] No legal rules developed to adjudicate fights among those seated at the negotiating table as none were needed. Norms and long-term reputational capital ensured that relative priority was respected among those actively participating in the reorganization.[87]

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

II. THE SALE PARADIGM

A going-concern sale of the firm is the most straightforward way to resolve the problem of financial distress.[88] The new buyers can put in place whatever capital structure makes the most sense for the firm, given the condition in which it finds itself. If there is an actual sale, the most obvious priority rule is one of absolute priority. The investors' role in the ongoing enterprise has come to an end. The only question is one of dividing cash, and the easiest way to do this is to collapse all future possibilities to present value.

Of course, it is possible to implement a regime of relative priority even when there is an actual sale. One can always require a judge to determine how much the junior investments would have been worth if there had not been a sale. Recognizing option value in this environment, however, requires a judge

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85 *See* DAVID A. SKEEL, JR., DEBT'S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA 68-69 (2001).

86 *See, e.g.*, N. Pac. Ry. Co. v. Boyd, 228 U.S. 482, 505 (1913) ("Any arrangement of the parties by which the subordinate rights and interests of the stockholders are attempted to be secured at the expense of the prior rights of either class of creditors comes within judicial denunciation." (internal quotation marks omitted) (quoting Louisville Tr. Co. v. Louisville, New Albany & Chi. Ry. Co., 174 U.S. 674, 683-84 (1899))). In protecting such creditors, the Court emphasized that ensuring the right to participate was not the same as vindicating a substantive entitlement: "If he declines a fair offer he is left to protect himself as any other creditor of a judgment debtor, and, having refused to come into a just reorganization, could not thereafter be heard in a court of equity to attack it." *Id.*

87 For a discussion of how lawyers and investment bankers established long-term relational bonds with the investors during the era of the equity receivership, see Douglas G. Baird & Robert K. Rasmussen, Boyd*'s Legacy and Blackstone's Ghost*, 1999 S. CT. REV. 393, 402. For an account of the role investment bankers and their lawyers played in equity receiverships, see Robert W. Gordon, *Legal Thought and Legal Practice in the Age of American Enterprise, 1870–1920*, *in* PROFESSIONS AND PROFESSIONAL IDEOLOGIES IN AMERICA 70, 101-105 (Gerald L. Geison ed., 1983).

88 *See* Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J. LEGAL STUD. 127, 136 (1986) ("The simplest collective proceeding is a sale of the firm for cash and the distribution of the proceeds to all the investors.").

to engage in a valuation exercise.[89] The sale price gives her a valuation of the firm as a whole, but the sale price alone is not enough to establish how much out-of-the-money options are worth. One must also estimate how likely the firm is to change in value. The more likely the value of the firm will change, the greater the chance that it might ultimately be worth enough to make the option worth exercising. Measuring asset volatility is essential when allocating sale proceeds under relative priority, but unnecessary under absolute priority where the amount realized in the sale provides all the information needed.

Matters are reversed, however, when the firm is reorganized instead of being sold to a third party. Relative priority requires no valuation of the firm, but absolute priority does. To decide who gets what under absolute priority in the absence of a sale, the judge must determine the value of the firm. The empirical evidence does suggest that, in large reorganizations, judicial valuations are unbiased, but these unbiased valuations are made with high variance.[90] Even if bankruptcy valuations could be improved,[91] a major problem remains: "All estimates of value are noisy."[92] Coming within ten percent of the true value of the firm merits high praise even when the best experts do it.[93]

Valuation of a large corporation in an adversarial process is particularly costly. A party may find it to be in its self-interest to spend millions to shift a valuation by only a few percentage points. In the reorganization of Residential Capital, more than $100 million was spent in a dispute over how much to value the claim of a single group of secured creditors.[94] Or, to provide another

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

90 *See* Stuart C. Gilson, Edith S. Hotchkiss & Richard S. Ruback, *Valuation of Bankrupt Firms*, 13 REV. FIN. STUD. 43, 44 (2000) ("We find that estimates of value are generally unbiased, but the estimated values are not very precise.").

91 For an example of a mechanism that could be designed to induce each party to reveal its own private assessments of value by penalizing those who stray farthest from an expert benchmark, see Keith Sharfman, *Valuation Averaging: A New Procedure for Resolving Valuation Disputes*, 88 MINN. L. REV. 357, 364-65 (2003).

92 Fischer Black, *Noise*, 41 J. FIN. 529, 533 (1986). For Black, a market was efficient if the price at which a security traded was somewhere between half of and twice its true value. *Id.* Black, of course, was hardly hostile to efficient markets. He was one of the co-discoverers of the Black–Scholes option pricing model, the tool that powers trading in many billions of dollars of options and other derivatives every day. *See generally* Black & Scholes, *supra* note 26.

93 *See, e.g.*, Steven N. Kaplan & Richard S. Ruback, *The Valuation of Cash Flow Forecasts: An Empirical Analysis*, 50 J. FIN. 1059, 1076 (1995) (finding that between 37% and 57% of valuations sampled showed errors of less than 15%).

94 At the end of one of the many long opinions in the reorganization of Residential Capital, the plainly exasperated judge singled out one particularly recalcitrant group of creditors. *See In re* Residential Capital, LLC, 501 B.R. 549, 624 (Bankr. S.D.N.Y. 2013) (observing that one group of creditors "ha[s] pursued from the start a strategy where [it] contest[s] everything and concede[s]

example, the valuation hearing in the reorganization of Mirant continued for twenty-seven days over an eleven-week period, with separate experts testifying for the debtors, various creditor constituencies, and equity holders.[95] The experts' valuations ranged from $7.2 billion to $13.6 billion.[96]

Valuations, of course, are not infinitely costly. The marginal benefits of providing the judge with more information are diminishing. A few key assumptions drive valuations, and a good judge can establish ground rules that limit costs.[97] Nevertheless, the prospect of a contested valuation hearing casts a shadow over every large reorganization.

It might seem that a bankruptcy valuation is similar in spirit to the appraisal remedy in corporate law.[98] But the appraisal remedy has come in for its own share of criticism,[99] and yet it is far more benign than a valuation in a reorganization. First, the stakes are greater in bankruptcy. The contest is between different layers of the capital structure. As soon as a junior stakeholder pushes a valuation above the amount owed to those senior to her in the hierarchy, she enjoys the benefit of the entire increase. By contrast, if a five-percent stakeholder persuades the judge in an appraisal hearing that the firm is worth one dollar more, she receives only five additional cents.

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

In addition, a valuation battle in bankruptcy affects the operation of the firm, while appraisal hearings generally do not. As long as the reorganization

nothing" and lamenting that these creditors "stand virtually alone in this case in failing to reach a consensual agreement to resolve their issues"). This creditor group's post-petition fees and expenses (paid for out of the estate as the creditors were secured) alone amounted to $128 million. Stewart Bishop, *Rising Star: Kelley Drye's Jason Adams*, LAW360 (Apr. 3, 2015, 7:24 PM), http://www.law360.com/articles/639427/rising-star-kelley-drye-s-jason-adams [https://perma.cc/A33Q-U3MJ].

95 *In re* Mirant Corp., 334 B.R. 800, 809 (Bankr. N.D. Tex. 2005).

96 *Id.* at 824.

97 For an overview of the basic elements of bankruptcy valuation of firms, see generally Christopher S. Sontchi, *Valuation Methodologies: A Judge's View*, 20 AM. BANKR. INST. L. REV. 1 (2012). Judge Sontchi has limited efforts to derail a valuation by excluding expert witness testimony on the grounds that the testimony was unreliable. *See In re* Nellson Nutraceutical, Inc., 356 B.R. 364, 374-75 (Bankr. D. Del. 2006) (excluding an expert witness's testimony for relying "on an invented methodology that has not been generally accepted by experts in the field").

98 For an overview of the appraisal remedy, see generally Hideki Kanda & Saul Levmore, *The Appraisal Remedy and the Goals of Corporate Law*, 32 UCLA L. REV. 429 (1985).

99 *See, e.g.*, George S. Geis, *An Appraisal Puzzle*, 105 NW. U. L. REV. 1635, 1676 (2011) (urging reform of the existing appraisal remedy to deal with competing types of abuse by majority and minority shareholders).

is ongoing, the firm lacks direction. Board members fail to act decisively. They are not rewarded for taking the long view because they are typically replaced when the reorganization is over.[100] The board's interest lies in minimizing the harm that the firm's failure does to their own reputations.[101] They are unlikely to take bold steps, even when necessary. Their freedom of action is limited in any event, as decisions not in the ordinary course of business require the blessing of the bankruptcy judge.[102] The firm cannot make major strategic changes without vetting them first in open court. While rights are being sorted out, investors can threaten to upend transactions that are in everyone's interest in order to gain a larger share for themselves.[103] By contrast, the appraisal has comparatively little effect on the ongoing operations of the business, as the business does not need to be put on hold while the appraisal is being done.

Another difference between appraisals and reorganizations is the relative ease of reaching a settlement that renders a costly valuation unnecessary. In an appraisal dispute, the contesting parties come in two flavors: majority and minority shareholders.[104] Negotiations are harder in Chapter 11, where multiple competing groups of investors occupy different parts of the capital structure. Under some facts, a Coasean bargain may not even be possible. The core may be empty.[105]

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100 *See* Douglas G. Baird & Robert K. Rasmussen, Reply, *Chapter 11 at Twilight*, 56 STAN. L. REV. 673, 697 n.80 (2003) (noting that creditors appoint new boards a majority of the time in Chapter 11 reorganizations that are not prenegotiated).

101 Board members suffer consequences following the financial failure of their firms. *See, e.g.*, Stuart C. Gilson, *Bankruptcy, Boards, Banks, and Blockholders: Evidence on Changes in Corporate Ownership and Control when Firms Default*, 27 J. FIN. ECON. 355, 376 (1990) (finding that the number of boards on which a director sits declines by a third when one of those firms suffers financial distress); Suraj Srinivasan, *Consequences of Financial Reporting Failure for Outside Directors: Evidence from Accounting Restatements and Audit Committee Members*, 43 J. ACCT. RES. 291, 331 (2005) (finding evidence that is "consistent with directors, particularly audit committee members, bearing a reputational penalty for weak board and audit committee oversight").

102 *See* 11 U.S.C. § 363(b)(1) (2012) (requiring "notice and a hearing" for transactions "other than in the ordinary course of business").

103 *See, e.g.*, *In re* Adelphia Commc'ns Corp., 368 B.R. 140, 159-60 (Bankr. S.D.N.Y. 2007) (describing a creditor group's threat to delay a major transaction, at great cost to the estate, to gain a larger share for itself (citing 336 B.R. 610, 618-19 (Bankr. S.D.N.Y.), *aff'd*, 342 B.R. 122 (S.D.N.Y. 2006))).

104 An appraisal pits the majority shareholder against the minority shareholders it wants to cash out. *See* Geis, *supra* note 99, at 1643 ("In more recent years, . . . the appraisal remedy has been [used] as a defense against abusive freezeout mergers by majority shareholders.").

105 Under some conditions, the set of stable, mutually beneficial bargains has no members. No matter what deal is struck, one or more parties will always have an incentive to defect. This is what it means to say that the core is empty. *See* Baird & Rasmussen, *supra* note 41, at 690 n.190 ("An 'empty core' exists when three or more parties cannot reach a stable agreement with each other because some other agreement always exists that at least one party prefers.").

These difficulties make actual sales attractive in a legal regime committed to absolute priority.[106] It should be no surprise that going-concern sales have become commonplace in bankruptcy.[107] They are shorter and less costly than full-blown reorganizations.[108]

The bankruptcy forum assembles the firm's assets for sale at a single place and time. This is hard to do outside of bankruptcy, especially when the firm's assets consist of land, hard assets, and intellectual property scattered across multiple jurisdictions.[109] Moreover, when the sale takes place in bankruptcy, buyers can be confident that they will receive good title.[110] This confidence brings higher prices.[111] Bankruptcy serves its purpose of protecting the rights

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106 *See* Baird, *supra* note 88, at 128 (observing that actual sales helpfully "eliminate[] the potential distortions from a fictive valuation of a firm"). In addition to those who have advocated for outright sales, there are those who propose market-mimicking mechanisms that avoid judicial valuations and attempt to minimize bargaining costs. *See, e.g.*, Philippe Aghion, Oliver Hart & John Moore, *Improving Bankruptcy Procedure*, 72 WASH. U. L.Q. 849, 861 (1994) (proposing a new bankruptcy procedure to address imperfect capital markets and high bargaining costs in which a "group of people with different claims . . . [are transformed] into a homogenous class of shareholders, and then [the company's future is] put[] . . . to a simple vote"); Lucian Arye Bebchuk, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775, 777 (1988) ("The new method involves no bargaining or litigation, nor does it require that the value of the reorganized company be identified. Under the method, the participants in a reorganization would receive a set of rights with respect to the securities of the reorganized company. These rights are designed so that, whatever the reorganization value, the participants will never end up with less than the value to which they are entitled."); Lucian Arye Bebchuk & Jesse M. Fried, Commentary, *A New Approach to Valuing Secured Claims in Bankruptcy*, 114 HARV. L. REV. 2386, 2413, 2429 (2001) (proposing a three-stage market-based approach to valuation "based on the insight that the amount of a secured creditor's secured claim is equivalent to the value of a nonrecourse note for the amount owed the creditor, backed by the creditor's collateral"). These proposals, embodying a commitment to absolute priority, Aghion, Hart & Moore, *supra*, at 861; Bebchuk & Fried, *supra*, at 2419 n.6, are cut from the same cloth. They depend upon a well-functioning capital market. As long as the junior creditors face liquidity constraints, these mechanisms have the same virtues and face the same problems as an actual sale of the entire firm. *See* Baird & Bernstein, *supra* note 14, at 1953-54 (describing the forced sale valuation procedure and highlighting its dependence on the availability of capital). See *supra* note 13 for an explanation of how illiquidity limits the effectiveness of sales.

107 *See* Jacoby & Janger, *supra* note 21, at 879 (noting that "it is common for debtors to enter bankruptcy announcing an intended going-concern sale").

108 *See id.* (noting that for large Chapter 11 cases, "the median time between filing and final sale approval is 110 days"); *see also* Jared A. Wilkerson, *Defending the Current State of Section 363 Sales*, 86 AM. BANKR. L.J. 591, 595-98 (2012) ("The obvious advantage of these sales is the ability to quickly sell a debtor's assets . . . .").

109 *See* Janger, *supra* note 3, at 607 (explaining that "secured creditors now often prefer to liquidate their assets in bankruptcy rather than relying on their state law remedies [because] [i]n bankruptcy, a debtor can sell a whole division, or a group of buildings, in a way that is calculated to maximize value [and] [s]uch a sale could not be compelled under state law").

110 *See* 11 U.S.C. § 363(f) (2012) (permitting the trustee to sell property in bankruptcy "free and clear of any interest in such property").

111 *See* Janger, *supra* note 3, at 607 (explaining that § 363(f) "increases the value realizable by the estate and the secured party on its collateral, because the purchaser knows that she will take clear

of investors and ensuring that assets are put to their best use. And sales do not require the judge to value the firm.

But conducting an actual sale is neither easy nor cheap. Moreover, senior lenders have an incentive to force premature sales for less than top dollar.[112] As long as the sale yields enough to pay them in full, they have no interest in spending time looking for a buyer who will pay more.[113] The senior creditors can often use their ability to withhold financing as a lever to ensure the speedy sale happens.[114]

As sales in Chapter 11 have become more common, courts have devised rules and procedures to protect the integrity of the sale process.[115] A number of reform proposals have been put forward to ensure that sales are better run.[116] But the most finely crafted procedures cannot solve all the problems an actual sale presents. In a substantial fraction of large reorganizations, an outright sale may not be in the interests of the parties.[117]

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title and thus will not have to invest in dealing with junior liens and other encumbrances . . . which may be expensive").

112 *See* Baird & Jackson, *supra* note 46, at 106 (observing that senior lenders "tend to favor an immediate liquidation").

113 *Id.*

114 *See* Huebner & Tisdell, *supra* note 42, at 81 ("The code's limitations on the use of cash collateral and on the ability to grant priming liens to debtor-in-possession lenders in the absence of adequate protection may well make it difficult or impossible to reorganise without the consent and cooperation of secured creditors."); Harvey R. Miller & Shai Y. Waisman, *The Creditor in Possession: Creditor Control of Chapter 11 Reorganization Cases*, 21 BANKR. STRATEGIST 1, 2 (2003) (observing the increased control exhibited by creditors during the reorganization process); *see also* Kenneth M. Ayotte & Edward R. Morrison, *Creditor Control and Conflict in Chapter 11*, 1 J. LEGAL ANALYSIS 511, 539 (2009) ("A Chapter 11 case is significantly more likely to result in a sale if secured lenders are oversecured . . . .").

115 For a survey of some court rules, see George W. Kuney, *Let's Make It Official: Adding an Explicit Preplan Sale Process as an Alternative Exit from Bankruptcy*, 40 HOUS. L. REV. 1265, 1305-22 (2004). Courts, for example, approve paying breakup fees to stalking horse bidders. *See* Casey, *supra* note 3, at 787 (explaining how the practice of permitting breakup fees to stalking horse bidders—potential purchasers given access to inside information to perform due diligence as to the firm's value—mitigates the lemons problem in bankruptcy sales). The procedures used to sell assets are themselves contested. *See, e.g.*, Christopher Norton, *Sun-Times Creditors, Trustee Question Asset Sale*, LAW360 (Sept. 21, 2009, 3:09 PM), http://www.law360.com/articles/123524/-sun-times-creditors-trustee-question-asset-sale?article_related_content=1 [https://perma.cc/B8LG-GC2H] (discussing objections to bidding procedures in the Sun-Times reorganization).

116 The American Bankruptcy Institute has proposed a number of narrow reforms of the sale process. *See* COMMISSION REPORT, *supra* note 3, at 83-87 (proposing a sixty-day moratorium on going-concern sales, "absent the most extraordinary of circumstances"). Academics have made more sweeping proposals. *See, e.g.*, Jacoby & Janger, *supra* note 21, at 871 (proposing a "mandatory holdback of a portion of 363 sale proceeds to allow later resolution of disputes about value and priority").

117 *See supra* notes 13–15 and accompanying text. Some take the view, however, that the domain is small in which reorganizations—as opposed to sales—are even necessary. *See* Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751, 756 (2002) ("The [modern] ability to sell entire firms and divisions eliminates the need for a collective forum in which the different players must come to an agreement about what should happen to the assets.").

Modern corporate reorganizations attempt to mimic the results of a sale that never happens. It is possible to debate the best way to do this. Some take the view, for example, that the senior creditor is entitled only to what she would have received had she foreclosed on the property outside of bankruptcy.[118] The secured creditor should not be able to lay claim to value that the bankruptcy process itself generates. Others argue that, if the secured creditor is not to enjoy any of the upside that the reorganization brings with it, she should not be exposed to the downside either. For example, if she is limited to foreclosure value, the time value of her interest should be respected as well.[119] Antecedent to these questions, however, is the question of why the sale paradigm should be imported into the reorganization mechanism in the first place.

III. RELATIVE PRIORITY

Existing reorganization law is built around the paradigm of a sale.[120] The bankruptcy brings about the same reckoning as a foreclosure sale.[121] It is useful to ask what a reorganization regime would look like if did not treat bankruptcy as a day of reckoning. Valuations are unnecessary when junior investors are given call options. The court's inability to value businesses accurately and at a reasonable cost is irrelevant.[122] When the restructuring keeps priority rights in place, there is no need to decide whether the firm is worth enough to pay the senior creditors in full.

Of course, any mechanism that alters investors' rights gives some parties an incentive to trigger it and others an incentive to avoid it.[123] But the stakes are much lower when the priority rights of the junior creditor are untouched. Junior investors are worse off to the extent that they lose cash-flow and control rights, but they do not lose the investment outright as they would if the reorganization required a final reckoning.[124] The reorganization gives the

118 *See* Janger, *supra* note 3, at 606 (asserting that, when discussing the senior creditor's entitlement, "one must start from the baseline of what the creditor could actually receive" outside of bankruptcy).

119 *See, e.g.*, Baird & Jackson, *supra* note 46, at 114-25 (asserting that a proper understanding of the nature of private property demands accounting for the time value of an asset).

120 *See* Clark, *supra* note 16, at 1250-54 (reviewing the history of corporate reorganization law and finding that liquidation value has consistently informed the process across multiple historical paradigms).

121 The New Deal reformers who pushed for the absolute priority rule made this link explicit. *See* Frank, *supra* note 3, at 551-52 (drawing a link between the mechanism of a foreclosure sale and the role of an absolute priority in forbidding fraudulent conveyances stemming from a sale in name only).

122 For a discussion of the problematic nature of judicial valuations, see *supra* text accompanying notes 90–96.

123 *See* Douglas G. Baird, *The Initiation Problem in Bankruptcy*, 11 INT'L REV. L. & ECON. 223, 223 (1991) (contemplating that those who trigger a bankruptcy proceeding will look to their self-interest, which may not correspond to the collective interest of the group).

124 When they have only options, junior investors lack any cash-flow rights. They are therefore necessarily worse off when they no longer receive interest payments or dividends that they could

junior creditors an investment instrument in the restructured firm that, at first approximation, has the same value as the investment instrument they had before the process was triggered.[125]

Under a regime of relative priority, no one has an incentive to fight many of the battles that currently plague Chapter 11. Return to the example of the two investors who must restructure their business because of an unanticipated government regulation.[126] If they had thought about it, the investors might have preferred relative priority over absolute priority because of the way that absolute priority distorts their attitude to the prospect of government regulation—or anything else that would force a restructuring. Under a regime of relative priority, both investors look at the prospect of any event that would trigger a restructuring in the same way. By contrast, under absolute priority, the investor who is senior will affirmatively desire a restructuring and will have an incentive to press for it, even if it is wasteful and unnecessary. The junior investor will oppose it, even if it is entirely sensible and comes at modest cost. Quite apart from the merits of the restructuring, senior investors are better off if junior investors are wiped out. For their part, junior investors have little desire for a procedure that will extinguish their rights.

When a firm needs a new capital structure, negotiations typically begin outside of bankruptcy. Parties are often able to restructure the firm outside of bankruptcy and avoid the substantial costs of a Chapter 11 reorganization.[127] Doing this, however, is harder when one of the parties stands to gain when bankruptcy is filed. Instead of focusing exclusively on the capital structure that makes the most sense for the firm as a whole, the prospect of absolute priority, with its sharply differential effects on senior and junior investors, complicates matters. Senior creditors balance the costs of bankruptcy against the benefit of being able to wipe out junior parties. Junior investors balance the benefits of bankruptcy against the possibility that there will be a day of reckoning in which they are left with nothing.

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keep if the firm ultimately fails and the senior investors are not paid in full. They are also worse off to some extent if they lack control rights. *See* Peter Feldhütter, Edith Hotchkiss & Oğuzhan Karakaş, *The Value of Creditor Control in Corporate Bonds*, 121 J. FIN. ECON. 1, 2 (2016) (analyzing the impact of control rights on bond prices and estimating the premium as the "difference in the bond price and an equivalent synthetic bond without control rights that is constructed using" credit default swap contracts).

125 This is only an approximation. Junior investors are worse off to the extent that cash may continue to be returned to others senior to them in the capital structure. They are also worse off from the loss of control rights. A bundle of derivatives against a firm is worth less than bonds with the same cash-flow rights. *See id.*

126 *See supra* text accompanying note 20.

127 *See generally* Henry C. Shelton III, *The Debtors' Dance: Restructuring Strategies for Debtor and Creditor Clients* (discussing the advantages of out-of-court restructurings), *in* BEST PRACTICES FOR DISTRESSED LAWYERS ON EVALUATING ALTERNATIVES, ASSEMBLING A WORKOUT TEAM, AND FORECASTING POSSIBLE OUTCOMES (INSIDE THE MINDS) (2008).

Parties, of course, can bargain in the shadow of bankruptcy and avoid its costs, but bargaining is never costless. Absolute priority requires bargaining over the size of the haircut that junior creditors must take by virtue of accelerating the exercise date of their option. Relative priority introduces no such complications. To a much greater extent than absolute priority, it induces parties to work toward a common purpose.[128]

During the era of equity receiverships, senior and junior creditors did not have interests adverse to each other.[129] As a result, they accepted conflicts of interest that would be unthinkable today, such as hiring the same lawyer to represent them in the same case at the same time.[130] Relative priority minimizes conflicts among different tranches of debt.

If judicial valuations drive bankruptcy costs and if the benefits of absolute priority over relative priority are otherwise small, the optimal reorganization regime might be one of relative priority. Under a regime of relative priority, the bankruptcy judge has less to do. Claims might be disputed, but such claims can be adjudicated independently of what happens to the firm. The litigation can take place after the firm reorganizes and, depending on the outcome, the court can simply dilute the equity or the options to the extent that those holding disputed claims prevail.

It is also worth noting that we do not see anything as simple as the absolute priority rule in an analogous environment in which free contracting is permitted. Consider the way venture capital deals are structured. The providers of outside capital typically have preferred stock.[131] The venture capitalist and the entrepreneur strike an explicit deal about what happens to the existing shareholders' equity stake when additional capital is needed to keep the firm going. These deals often provide for granting a share of the equity to a new investor in return for additional capital, and the effect of this

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128 Thomas Jackson and Robert Scott were the first to show how sharing rules in bankruptcy had this effect. They drew an analogy to admiralty's rule of the general average. 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, 171-72 (1989) ("The threat of a business failure owing to complex and interactive contingencies . . . may be seen as a common risk that, *despite individual efforts*, will inevitably occur unless creditors agree to sacrifice a portion of their claim in order to save the enterprise.").

129 *See, e.g.*, Baird, *supra* note 9, at 595 (discussing the cooperation that existed during the Atchison, Topeka, and Santa Fe restructuring between junior and senior bondholders).

130 In the Atchison, Topeka, and Santa Fe reorganization, for example, the same lawyer represented the senior and junior bondholders at the same time. No one perceived a conflict. *See* 1 ROBERT T. SWAINE, THE CRAVATH FIRM AND ITS PREDECESSORS 1819–1947, at 502-03 (1946) (describing how separate bondholder groups were represented by the same counsel during the Atchison, Topeka, and Santa Fe reorganization).

131 *See* Steven N. Kaplan & Per Strömberg, *Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts*, 70 REV. ECON. STUD. 281, 286 (2003) ("[C]onvertible preferred stock is the most commonly used security, appearing in 204 of 213 [venture capital] financing rounds.").

restructuring is to dilute the existing shareholders' equity stake.[132] But the equity stake is diluted, not eliminated altogether. The entrepreneur still holds a stake.[133]

Whether relative priority makes sense turns on whether it avoids the costs of absolute priority without introducing costs of its own. The most obvious, but perhaps least problematic, challenge is the need to establish the exercise date of the call option that junior investors receive.[134] The exercise date in theory should be at the end of the term of the loan to the senior lender.[135] But many senior tranches of debt are revolving credit arrangements.[136] Defaults give the senior creditor the option of foreclosing on the assets, but as long as the senior creditor chooses not to exercise this right, the call option remains intact. Hence, the exercise date of the call option is uncertain.[137]

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

Relative priority might prove costly if the simplicity of the reorganization process set the stage for taking advantage after it was over. Once senior lenders become the equityholders of the firm, they have the ability to sell it.

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132 Robert P. Bartlett III, *Venture Capital, Agency Costs, and the False Dichotomy of the Corporation*, 54 UCLA L. REV. 37, 64 (2006).

133 When there is no debt in the capital structure, the venture capitalist does not have rights analogous to the foreclosure rights of a creditor. The dispute is typically over the extent of the dilution, not whether it is eliminated altogether. *See* José M. Padilla, *What's Wrong with a Washout?: Fiduciary Duties of the Venture Capitalist Investor in a Washout Financing*, 1 HOUS. BUS. & TAX L.J. 269, 270-71 (2001) (describing the circumstances and effects of the process of venture capital washout financing, which dilutes the founders' equity stake).

134 *See supra* text accompanying note 36.

135 When the loan comes to an end, the lender is entitled to insist on being paid. If she is paid, her rights are terminated. If she is not, she can choose to exercise her default rights. If she does exercise them, she forces a sale of the assets that wipes out junior interests as well as her own. *See* U.C.C. § 9-617(a)(3) (AM. LAW INST. & NAT'L CONFERENCE OF COMM'RS ON UNIF. STATE LAWS 2013–2014) (stating that a "secured party's disposition of collateral after default . . . discharges any subordinate security interest"). If she does not exercise them, the status quo is preserved. The junior interests remain in place.

136 *See* Baird & Rasmussen, *supra* note 66, at 1228-29 (discussing modern revolving credit facilities and the ability of lenders to terminate them).

137 To make the same point somewhat more formally, the option component of a junior investment instrument outside of bankruptcy is best modeled as having an exercise date that is accelerated with some probability during each period.

Like any sale, such a sale is a recognition event that accelerates call options. Senior lenders might trigger such a sale even if it was a fire sale.[138] Alternatively, they could extract value from the firm by awarding themselves dividends or spinning off subsidiaries.[139]

In this post-bankruptcy environment, there is no longer a bankruptcy judge to ensure that the sale procedure protects everyone's rights. There is room for strategic behavior if the senior investor is better informed than the market as a whole. The senior investor, for example, might know that the firm could eventually be sold for more than it is owed before the market recognizes this. The senior investor could postpone such a sale until after the options had lapsed. The junior investors can protect themselves only if they both know what the firm is worth and possess sufficient liquidity to exercise the options before they expire.

It is important, however, not to overstate the possibility of misbehavior. Sales are comparatively easy to monitor.[140] As long as the equity is publicly traded, it should be possible to learn whether dividends are being made.[141] Moreover, the risk of fire sales is largely self-policing. Senior investors have every reason to be zealous in ensuring a sale price at least equal to the full amount they are owed. Up until that point, they enjoy a dollar for every additional dollar that the sale yields, and once they initiate a sensible sale process, competition between bidders may drive the sale price more than their own efforts at the margin. The problem is small as long as there is a market for the options and those holding the options have enough time to act before a sale is consummated. Those who hold them can either exercise them or, if they lack the liquidity, can sell them to someone else.

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138 There is evidence suggesting that senior lenders sell firms suboptimally. *See, e.g.*, Ayotte & Morrison, *supra* note 114, at 532-34 (finding data "consistent with the hypothesis that secured lender preferences distort real economic outcomes"); Lynn M. LoPucki & Joseph W. Doherty, *Bankruptcy Fire Sales*, 106 MICH. L. REV. 1, 31 (2007) (presenting data suggesting a loss of value when firms are sold in Chapter 11).

139 Modern corporate law places relatively few limits on the ability of a firm with no debt to issue dividends or repurchase stock. For a discussion of the limitations that do exist, see Edward B. Rock, *Adapting to the New Shareholder-Centric Reality*, 161 U. PA. L. REV. 1907, 1949 (2013), which notes that the "board may . . . repurchase shares or pay dividends so long as total assets are greater than total liabilities plus capital."

140 Even though the directors will have been put in place by the senior lender, they will find it hard to keep a sale secret, given their duty to seek the highest bidder once the firm is going to be sold. *See* Revlon, Inc. v. MacAndrews & Forbes Holdings, 506 A.2d 173, 182 (Del. 1986) (describing the duty of the board in a sale process as the "maximization of the company's value at a sale for the stockholders' benefit").

141 Generally Accepted Accounting Principles require disclosure in the financial statements of "material related party transactions." Accounting Standards Codification 850-10-50-1. This would include large distributions or dividends to directors or managers. Publicly traded firms are required to follow these principles in their financial statements. Roberta S. Karmel & Claire R. Kelly, *The Hardening of Soft Law in Securities Regulation*, 34 BROOK. J. INT'L L. 884, 905 (2009).

A rule that protects relative priority rights after the reorganization may not need to be that elaborate, at least if there is a short period of time after the reorganization is over in which sales and dividends are not permissible. One might craft special rules that protect the junior option holders. But once the market for the equity and the call options develops (perhaps after three months or so), it might be enough to make only modest changes in existing director duties to protect the option holders.[142]

Implementing relative priority in this fashion distorts incentives in one other way. A capital structure in which so many out-of-the-money options exist for an extended period of time seems to create a mismatch between control rights and ownership rights. After the reorganization is over, the senior investors are in control of the firm, but they do not enjoy the entire upside. Once the senior investors improve the firm's fortunes sufficiently, the options will be in the money and the senior investors will be cashed out. Beyond a certain point, they are not compensated with greater returns for taking greater risks. If a senior creditor controls the firm and is owed $100 and the firm's only asset is a $100 riskless security, the senior creditor will not allow the riskless security to be exchanged for a project that pays $300 or $0 with equal likelihood, even though a sole owner of the firm would jump at the opportunity. The senior creditor has nothing to gain from investing in the risky project and everything to lose. Without the ability to capture upside gains, senior creditors are, by nature, inclined to pursue inefficiently cautious strategies.[143]

But these costs may not be large either. Creditors today exercise substantial control even though they are not the residual owners of the firm.[144] During the equity receiverships, voting trusts put control of the firm in the hands of senior investors and returned it to junior investors only after things stabilized.[145] Venture capital investors typically have preferred stock and exert considerable control over those junior to them in the capital structure.[146] They too might be inclined to take actions that are in their own interests and

142 As noted, directors already have a duty to obtain the highest price they can once they decide to put the firm on the auctioneer's block. *Revlon*, 506 A.2d at 182. One can imagine a legal rule that gave option holders some forms of equitable relief to ensure that the old senior creditors maximized value when they tried to sell the firm.

143 The incentives of senior stakeholders are always skewed in this fashion. *See* Roe, *supra* note 12, at 542 (explaining that creditors "want to make the firm more viable only if viability enhances the chance or size of their repayment, or otherwise provides them with a greater net present value").

144 *See supra* notes 29–32 and accompanying text.

145 *See* RIPLEY, *supra* note 76, at 403-04.

146 *See* Kaplan & Strömberg, *supra* note 131, at 290-91 (reporting the results of a study indicating that "board rights, voting rights, and liquidation rights [in venture capital financing agreements] are allocated such that if the firm performs poorly, the [venture capital investors] obtain full control"); *see also supra* note 131 and accompanying text.

contrary to those of the firm as a whole, but sophisticated parties nevertheless bargain for these arrangements.[147]

The old senior stakeholders are unlikely to have many opportunities to make decisions about running the firm that favor themselves at the expense of junior stakeholders.[148] Those in control of large publicly traded firms rarely choose between strategies with radically different risk profiles. Rare is the firm that finds itself at a crossroads in which it must invest in either pizza ovens or fusion reactors. Even when such choices are made, they typically come from the initiative of the CEO rather than the board.[149] Although the old senior creditors can pick the CEO, it is unlikely that they will screen for the one whose risk profile best suits them. Picking a CEO is sufficiently hard such that finding the executive who is best for the firm is almost always the first-order concern.[150]

In short, it seems unlikely that the presence of out-of-the-money options would create large inefficiencies. Even if call options seriously interfered with the incentives of the senior lenders, the senior lenders have the ability and the incentive to fix the problem by buying the options themselves and returning to a more traditional all-equity capital structure. The price at which the call options trade puts an upper limit on their potential costs. Senior lenders do not even need to buy all of the options. They can ensure that the firm remains on its existing trajectory by buying only enough to ensure they remain in control. Buying a majority of the call options would necessarily be sufficient,[151] and control can often be gained with significantly less.[152]

Alternatively, during the reorganization, senior creditors can bargain with the junior creditors and propose a plan in which the juniors receive cash or

147 *See* William W. Bratton & Michael L. Wachter, *A Theory of Preferred Stock*, 161 U. PA. L. REV. 1815, 1819 (2013) (noting that preferred stockholders "straddle[] the wall" between "insider[]" common stockholders and "outside" lenders (internal quotation marks omitted)).

148 In presenting his option-preservation mechanism designed to ensure that the decision between going-concern sales and reorganizations is made efficiently, Casey discusses granting call options to junior creditors and argues, as here, that there are "a number of reasons to think that this problem [of inefficient incentives on the part of equity holders subject to call options] might be small in practice." Casey, *supra* note 3, at 805.

149 Douglas G. Baird & Robert K. Rasmussen, *The Prime Directive*, 75 U. CIN. L. REV. 921, 925-26 (2007) (noting that fundamental changes in the direction of a business are rare and, when they do occur, typically come at the initiative of the CEO, not the board).

150 *See id.* at 931 (noting that "[f]inding good managers [in the first place] is much harder and much more important than writing their contracts").

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

152 For a discussion of what is required to become a controlling shareholder as a legal matter and examples where control was found when the largest shareholder owned less than 50%, see *In re* Crimson Exploration Inc. Stockholder Litig., No.8541-VCP, 2014 WL 5449419, at *10-12 (Del. Ch. Oct. 24, 2014).

some other consideration instead of call options.[153] Bargaining in the shadow of these options is easier than bargaining in the shadow of a full-blown valuation hearing. The junior stakeholders cannot demand more than the costs that the senior stakeholders would incur by simply walking away from the negotiations.[154] In any event, senior creditors cannot be made worse off by having the ability to negotiate with junior investors in addition to the option of giving them call options.

There are, however, at least two other obstacles that will make relative priority hard to implement. First, it is too simple to equate the strike price of the option with the amount of debt outstanding. The strike price needs to include the entire amount that is owed the senior creditor, including interest and other costs associated with the extension of credit.[155] In the absence of a simple rule, calculating these amounts may itself prove costly. Many recent bankruptcy cases involve protracted disputes over interest rates and other rights to payment to which the senior creditor is entitled, such as make-whole premiums.[156] It is possible that the typical reorganization has so many valuation issues in addition to the challenge of valuing the entire firm as a whole that the benefit of avoiding this particular valuation does not loom that large. Absolute priority is to be preferred simply because it is the simplest to implement.[157]

More importantly, any justification for a relative priority regime must contend with structural priority. The assets of large firms are commonly

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153 The ABI Commission provides for cashing out call options as an alternative to issuing them. *See* COMMISSION REPORT, *supra* note 3, at 221 (explaining the commission's approach to calculating the redemption option value).

154 The holdout value that the junior investors receive can never be greater than the value of the exit option of the senior investors. *See* Alberto Dalmazzo, *Outside Options in a Bargaining Model with Decay in the Size of the Cake*, 40 ECON. LETTERS 417, 417 (1992) (modeling two-party bargaining with exit options). For a formal application of this principle to bankruptcy, see Douglas G. Baird & Randal C. Picker, *A Simple Noncooperative Bargaining Model of Corporate Reorganizations*, 20 J. LEGAL STUD. 311, 328-47 (1991).

155 The secured claim includes "interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement." 11 U.S.C. § 506(b) (2012); *see also* COMMISSION REPORT, *supra* note 3, at 223 (explaining that junior creditors are only likely to be entitled to some redemption option value where the senior class's distributions on the plan confirmation or sale order date are close to the full principal amount of their claims plus interest).

156 Interest rate battles are a major point of conflict in modern reorganizations. *See, e.g.*, *In re* MPM Silicones, LLC, 531 B.R. 321, 324 (S.D.N.Y. 2015) (upholding the bankruptcy court's decision to calculate interest rates based on the seven-year Treasury rate, rather than the national prime rate), *appeal docketed*, 15-1771 (2d Cir. June 1, 2015). The treatment of make-whole provisions is similarly a fiercely contested issue in modern reorganizations. *See In re* Energy Future Holdings Corp., 842 F.3d 247, 261 (3d Cir. 2016) (upholding make-whole clause in a loan agreement); *In re* Sch. Specialty, Inc., No. 13-10125(KJC), 2013 WL 1838513, at *5 (Bankr. D. Del. Apr. 22, 2013) (denying motion to disallow a make-whole payment); *In re* Trico Marine Servs., Inc., 450 B.R. 474, 476 (Bankr. D. Del. 2011) (denying trustee's motion for full and immediate payment of make-whole premium).

157 *See* Baird & Rasmussen, *supra* note 34, at 940 ("Absolute priority may be the appropriate rule in this environment only because it is the simplest.").

dispersed among different corporate entities.[158] A key asset essential to the firm's survival as a going concern may be parked in a separate subsidiary, with its own creditors. If this subsidiary is also insolvent, then in a regime of relative priority, the parent (and, indirectly, creditors of the parent) has a call option only on the key asset. It has no ability to direct how it is used. If this asset is essential to the operation of the firm as a whole, those running the parent need to control it. Merely having a call option without any control rights is not enough.

It is possible, in principle, to value both the asset in the subsidiary and the value of the option that the parents have in it and cash out the creditors of the subsidiary accordingly, but the need for such a valuation is a serious weakness. Indeed, some of the most expensive valuation battles in large Chapter 11s involve creditors with rights against different members of a corporate group: creditors with rights against a subsidiary square off against creditors of the parent or another subsidiary.[159] When a corporate group is involved, relative priority may trigger the same costly litigation and bargaining that absolute priority brings with it.[160]

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

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

The case for relative priority rests on the idea that it serves the interests of investors as a group. There is no reason to force it on investors in a particular firm if, under the circumstances in which they find themselves, they do not want it. Indeed, a regime that implements relative priority while respecting structural priority may provide the best of both worlds. Most

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158 *See* Anthony J. Casey, *The New Corporate Web: Tailored Entity Partitions and Creditors' Selective Enforcement*, 124 YALE L.J. 2680, 2682 (2015) ("Firms regularly separate assets and place them in different legal entities to create value."). Casey's article discusses corporate structure and the implications for bankruptcy. *See generally id.*

159 *See, e.g.*, *In re* Adelphia Commc'ns Corp., 368 B.R. 140, 146-47 (Bankr. S.D.N.Y. 2007) (noting that a settlement of intercreditor disputes among 230 related entities so at loggerheads that a sale everyone considered optimal was almost derailed).

160 *See supra* notes 104–06 and accompanying text.

institutional investors might prefer relative priority, while others might want the ability to opt out of bankruptcy entirely. Structural priority, when it is respected, provides one set of investors with a strong form of absolute priority that may come with lower costs than under existing law. It gives creditors of a separate legal entity the ability to exit the bankruptcy process entirely.[161]

Capital structures are themselves endogenous to the priority regime that the law provides.[162] The capital structures that we see today, ones in which corporate groups are the norm,[163] may be a product of a reorganization regime that imposes absolute priority and the costs associated with it.

IV. Bargaining in the Shadow of Absolute Priority

Parties have the ability to avoid the costs of a full-blown judicial valuation through negotiations. Indeed, much of the reorganization process consists of these negotiations. But these negotiations are themselves costly. Moreover, bargaining in anticipation of a judicial valuation itself introduces distortions. The fog and uncertainty of financial distress allows some creditors to manipulate the process to capture value from others.[164]

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

The first obstacle to implementing absolute priority in a nonmarket environment arises from the asymmetrical positions of senior and junior lenders. Assume that a senior investor is owed $100 and the firm is worth exactly $100. Both the senior and junior investors have this information, but the judge does not. The judge will make an unbiased valuation, but her valuation will have greater variance than that of the parties themselves. Half the time, she will find the firm is worth $110; half the time, she will find it is worth $90.

Under the absolute priority rule, the senior creditor is entitled to the entire firm. Absolute priority requires that the senior creditor receive $100 in

161 *See* Baird & Casey, *supra* note 64, at 7-8 ("[P]artitioning can give individual investors the ability to withdraw assets from a business that encounters financial distress, notwithstanding bankruptcy law.").

162 *See* Casey, *supra* note 158, at 2683 ("[F]irms can tailor the impact and degree of any legal partition to create a precise structure.").

163 *See id.* at 2682 ("Firms regularly separate assets and place them in different legal entities to create value.").

164 For a summary of these issues, see *supra* notes 103–05 and accompanying text.

expectation. But bargaining in the shadow of an unbiased—but uncertain—judicial valuation does not produce this result. When the senior lender and junior lender strike a bargain with each other, the senior lender will likely be willing to take less than $100.

If the judge finds that the firm is worth $90, which she will do half the time, she will give the entire firm to the senior lender. The judge undervalues the firm, but the junior creditor is no worse off. Even with a correct valuation of $100, she would still not receive anything. But errors in the other direction are not equally benign. Half the time the judge will find that the firm is worth $110. When this happens, the judge's error will lead her to award the junior creditor something, and the senior creditor will end up with less than $100. The benefit the junior creditor enjoys when the judge overvalues the firm is not offset by any corresponding loss when she undervalues it.

This phenomenon of valuation variance is pervasive.[165] Bargaining in Chapter 11 tends to generate relative priority outcomes, even in the face of a judge's unflinching commitment to absolute priority. Junior investors are likely to enjoy option value from the variance associated with the valuation.[166] The uncertainty associated with the valuation may lead senior lenders to accept less than what they would receive if the firm could be sold at the valuation that the parties themselves expect the court to place on the firm.[167]

Both junior and senior creditors will take account of this departure from absolute priority in their negotiations. Valuation variance itself creates option value, and this option value will be cashed out in any deal they strike.

Valuation variance is just one way in which junior creditors can take advantage of the bankruptcy judge being imperfectly informed about the value of the firm. Of course, it is possible to implement rules that mitigate the valuation variance and other ways in which junior investors can take advantage of the judge's information deficit.[168] Indeed, a number of rules in

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165 *See supra* note 90 and accompanying text.

166 Junior creditors, however, do not always benefit from valuation variance. As Bo Huang shows, if the bankruptcy judge overvalues the firm and the junior investor receives a stake in the firm instead of cash, the junior investor is being paid in a diluted currency. *See* Bo Huang, Absolute Priority, Options, and Bargaining Dynamics in Chapter 11 Organizations 14-19 (Sept. 19, 2011) (unpublished manuscript), http://dx.doi.org/10.2139/ssrn.1930404 (describing the "ceiling effect" that arises when "securities to be distributed under a Chapter 11 plan could not be worth in the aggregate any more than the debtor's enterprise value, so that, at a certain point, a higher valuation by the judge could not lead to any additional recovery for the junior class"). It is even possible that, in some cases, valuation variance might favor senior creditors.

167 For an exploration of valuation variance, see Baird & Bernstein, *supra* note 14, at 1957-60.

168 Bo Huang was the first to show how put options can correct the distortion to absolute priority brought about by bargaining in the shadow of a judicial valuation. He also provides a formal proof. Huang, *supra* note 166, at 16-19.

the Bankruptcy Code serve this function.[169] These rules, however, are themselves costly to implement[170] and lead to reorganization plans that are themselves inefficient. Moreover, a rule designed to ensure that absolute priority is observed with respect to one party may increase the risk of undercutting the priority right of someone else.

Many of Chapter 11's most complicated rules are the ones designed to prevent junior investors from exploiting the judge's inability to value the firm with precision. For example, the plan must give senior creditors senior securities.[171] To be confirmed over a senior creditor's objection, a plan must give the senior creditor senior securities or their "indubitable equivalent."[172] By giving the old senior creditor senior securities, it will be entitled to be paid first. This offers some protection when the firm is undervalued because the value of the firm flows in the first instance to the senior creditor. This protection for the senior creditor comes at a cost, however. By insisting that senior creditors receive senior debt,[173] the Bankruptcy Code induces reorganized firms to leave Chapter 11 with too much debt in their capital structure. This in turn increases the chance that the firm will fail again and there will be another costly reorganization.[174]

Let us assume that the firm is worth $100 and the senior creditor is owed $100, but the bankruptcy judge erroneously thinks the firm is worth $120. The

169 For an exploration of how many of Chapter 11's rules are designed to prevent the undervaluation of secured claims, see Anthony Sexton, *Indubitably Uncertain:* Philadelphia Newspapers *and the Role of Valuation Uncertainty in Attempted Cramdown of All-Equity Plans*, 28 EMORY BANKR. DEV. J. 55, 67 (2011), which explains that "[m]any of the Code's protections for secured creditors are based on an arguably justifiable fear about the vagaries of the judicial valuation process."

170 *See* Huebner & Tisdell, *supra* note 42, at 81 (describing these procedures as "incredibly complicated and costly").

171 *See* Consol. Rock Prods. Co. v. Du Bois, 312 U.S. 510, 528-29 (1941) (maintaining that although creditors may be given inferior grades of securities, their superior rights vis-à-vis the stockholders must be recognized).

172 11 U.S.C. § 1129(b)(2)(A)(iii) (2012).

173 *Id.* § 1129(b)(2)(A)(i)(I).

174 This phenomenon of "Chapter 22s" is a familiar one. Recent examples include Patriot Coal and Revel Casinos. *See* Harold Brubaker & Amy S. Rosenberg, *A Second Bankruptcy for Struggling Revel Casino*, PHILLY.COM (June 20, 2014, 1:08 AM), http://www.philly.com/philly/hp/news_update/20140620_Revel_casino_files__again__for_bankruptcy.html [https://perma.cc/G8JM-HE44] (describing Revel's second bankruptcy filing in thirteen months); Tom Hals, *Update 2-Patriot Coal Files Chapter 11 Again, Is in Talks with Buyer*, REUTERS (May 12, 2015, 6:18 PM), http://www.reuters.com/article/patriot-coal-bankruptcyidUSL3N0Y36G620150512 [https://perma.cc/P6AW-YL3M] ("Patriot Coal Corp filed for bankruptcy protection on Tuesday, just 18 months after emerging from its previous Chapter 11 . . . .").

Many of these arise because of the capital structure the firm has on exiting the first Chapter 11. *See* Edward I. Altman, *Revisiting the Recidivism-Chapter 22 Phenomenon in the U.S. Bankruptcy System*, 8 BROOK. J. CORP. FIN. & COM. L. 253, 274 (2014) (finding that "a large proportion of debtors filing a subsequent bankruptcy petition[] . . . had a significantly worse financial profile upon emergence from the initial filing than those emerging as going concerns and not filing again").

senior creditor will receive a note for $100. The note will not be worth $100. The judge's erroneous belief that there is a $20 equity cushion will lead her to set an artificially low interest rate. Nevertheless, the note should still be worth more than $80, which is the value of the equity that the senior lender would receive if she lacked the right to demand a senior security.[175]

Many of Chapter 11's other rules are similarly designed to prevent junior investors from lowballing senior investors. Secured creditors are able to waive their deficiency claims and insist on a stream of payments equal, in nominal terms, to the face amount of the debt.[176] Secured creditors are entitled to press deficiency claims even if, outside of bankruptcy, they are nonrecourse creditors.[177] But this expansion of the secured creditor's rights protects against undercompensation only by introducing the risk of overcompensation.

Other rules aimed at protecting senior creditors invite strategic behavior on the part of junior investors. For example, at least one impaired class must accept the plan.[178] This rule induces plan proponents to manipulate classes to pass this hurdle.[179] These manipulations both generate costly litigation and lead to distortions of their own. (For example, the plan proponent must ensure that enough is given to the gerrymandered class of junior creditors so that they support the plan. This itself introduces the risk of overcompensating them.)

It is commonly thought that Chapter 11's nonmarket valuation mechanism systematically undercompensates senior creditors.[180] Academics typically

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

176 This is the combined effect of the § 1111(b) election, which allows a secured creditor to assert the full amount it is owed as a secured claim, and the treatment of a dissenting class of secured creditors under § 1129(b)(2)(A), which requires every secured claim to be paid in full in nominal dollars. *See* 11 U.S.C. § 1111(b)(1)(A); *id.* § 1129(b)(2)(A)(i)(II).

177 11 U.S.C. § 1111(b)(1)(A).

178 11 U.S.C. § 1129(a)(10).

179 *See In re* Vill. at Camp Bowie, 710 F.3d 239, 247-48 (5th Cir. 2013) (rejecting the argument that the plan proponent violated § 1129(a)(3) good faith obligations by artificially impairing one class of creditors for the purpose of meeting § 1129(a)(10)).

180 *See, e.g.*, Arturo Bris, Alan Schwartz & Ivo Welch, W*ho Should Pay for Bankruptcy Costs*,*?* 34 J. LEGAL STUD. 295, 296 (2005) (suggesting that junior creditors spend resources capturing value from seniors in violation of absolute priority).

assume deviations from absolute priority run in only one direction.[181] In modern practice, however, overcompensation of senior creditors is the bigger problem. Chapter 11 provides few rules to protect junior investors against attempts by senior creditors to put in place a plan that overcompensates them.[182] The drafters thought such protections unnecessary as they did not envision that the senior creditors would gain control of the case, as they have in recent years.[183] The Bankruptcy Code does not even explicitly prohibit plans that pay senior creditors more than 100 cents on the dollar.[184]

Rules aimed at protecting senior creditors often provide a channel that allows senior creditors to take control of the process. For example, to ensure that junior creditors do not gamble with the senior creditors' money, the Bankruptcy Code provides that the nonbankruptcy rights of senior creditors must be adequately protected.[185] It also imposes strong limits on the ability of the debtor to borrow and give new lenders security interests that prime the senior lender.[186]

The effect of these two provisions ensures that, as a practical matter, the senior lender is often the only viable source of financing during the case.[187] Hence, she is free to insist on control rights as a condition of providing the

181 *See id.* (discussing that the junior creditors spend on professionals to get more than what the absolute priority rule would grant them while senior creditors spend to merely defend against these efforts).

182 *See* Jonathan C. Lipson, *Bargaining Bankrupt: A Relational Theory of Contract in Bankruptcy*, 6 HARV. BUS. L. REV. 239, 277 (2016) ("[L]arge and medium-sized chapter 11 cases came to be dominated or influenced by 'distress investors,' hedge funds, private equity funds, and investment banks that invest in or purchase claims against troubled companies with a view towards making a profit on the investment.").

183 *See* Miller, *supra* note 37, at 385 ("The chapter 11 process, as contemplated in 1978, has been overwhelmed by marginalization of the debtor-in-possession[] [and] expansion of [secured] creditor . . . control . . . .").

184 *See* 11 U.S.C. § 1129(b)(2)(A) (2012) (discussing to what secured claim holders are entitled as a fair and equitable plan, and omitting any prohibition of plans that pay creditors more than they are owed).

185 *See id.* § 362(d)(1) (providing that the absence of "adequate protection" is grounds for lifting the § 362(a) automatic stay of proceedings). "Adequate protection" is a concept that the Bankruptcy Code incorporates from pre-Code case law. *See, e.g.*, *In re* Murel Holding Corp. 75 F.2d 941, 942 (2d Cir. 1935) (L. Hand, J.) (noting that a company can compel unwilling creditors to accept a reorganization only when such a plan provides those creditors with "adequate protection" for the realization of their claims and this adequate protection must be "completely compensatory" (internal quotation marks omitted)).

186 *See* 11 U.S.C. § 364(d)(1) (limiting such borrowing by the debtor to situations where the trustee is unable to obtain unsecured credit and there is adequate protection for the senior lien holders).

187 *See* Kenneth N. Klee & Richard Levin, *Rethinking Chapter 11*, 21 NORTON J. BANKR. L. & PRAC. 465, 473 (2012) ("Due to the prevalence of companies granting lenders blanket liens over all their assets, prepetition secured lenders more often than not end up being the only lenders willing to provide postpetition financing to debtors. Postpetition financing proposals often come with onerous terms that result in the debtor losing the ability to control the course of the chapter 11 case and providing lenders with benefits they would not otherwise be entitled to outside of chapter 11.").

financing.[188] These control rights include milestones that the debtor must meet in order to maintain its credit line. A milestone might require the debtor to confirm a plan or consummate a sale within a prescribed period of time.[189] A failure to meet a milestone is a default that allows the senior lender to seize the firm's assets. The senior lender can waive these milestones if they are not met, but their presence allows the senior lender to dictate how the reorganization process unfolds and the sorts of plans that are introduced.[190]

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

The bankruptcy judge, of course, tries to be on guard against plans that give senior creditors too large a share. She will not confirm a plan that gives all the equity of the firm to a senior creditor unless she believes the firm is worth less than what the senior creditor is owed. But the judge needs sufficient information to do this. She depends upon other interested parties to ensure that she has the relevant information or that at least she is in a position to draw inferences from silence.[191]

Senior creditors have discovered ways to keep the bankruptcy judge in the dark. For example, the senior creditor can use its control rights to accelerate the process and limit the amount of information that flows to the judge.[192] Alternatively, she can bargain strategically with those (such as the existing

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188 *See* Harvey R. Miller & Shai Y. Waisman, *Does Chapter 11 Reorganization Remain a Viable Option for Distressed Businesses for the Twenty-First Century?*, 78 AM. BANKR. L.J. 153, 185 (2004) (explaining that secured creditor demands "can permeate and control every facet of a debtor's operations").

189 *Id.*

190 For example, in the Molycorp reorganization, the judge's decision granting a dip financing motion reduced the value of junior creditors in half, a drop in value of over $50 million. *See Molycorp 10%s Test Single Digits as Mountain Pass Security Dwindles with Oaktree DIP*, REORG RES. (July 6, 2015), http://platform.reorg-research.com/app#company/all/intel/view/13779 [https://perma.cc/3MYB-HX4N]. In the abstract, it is not possible to tell whether the decision brings the parties closer to their substantive entitlements under the absolute priority rule, but it does underscore that a decision that nominally affects only the bankruptcy process and does not affect any substantive rights can have substantial distributional consequences.

191 *See* Paul Milgrom & John Roberts, *Relying on the Information of Interested Parties*, 17 RAND J. ECON. 18, 27 (1986) ("The parties may not report information about one another's preferences, although the decisionmaker might be able to infer something about them from the suggested alternatives.").

192 *See* Jacoby & Janger, *supra* note 21, at 895 ("The bankruptcy court has no more information than the informationally disadvantaged claimants. Consequently, the melting ice cube argument places the estate at the mercy of the sale's advocates . . . .").

managers) who might otherwise vindicate the rights of others.[193] Bankruptcy judges, of course, try to limit such misbehavior.[194] Indeed, controlling such misbehavior is a large part of what bankruptcy judges do in Chapter 11. But there are limits to the amount of control they can exercise over the process.[195]

CONCLUSION

Over time, the dual commitment to absolute priority and nonmarket valuations has become harder to maintain. In the first two decades after the enactment of the Bankruptcy Code, certain well-established norms provided focal points for the bargaining.[196] The players gravitated towards only a few.[197] But in recent years, the bargaining process became harder.

Dramatic changes in the reorganization landscape over the last two decades have made the dangers of an unwavering commitment to absolute priority more apparent. A new set of players now occupies the bankruptcy stage, and they have brought increasingly expensive fights over priority that would be unnecessary under a relative priority regime. Claims trading is now ubiquitous, and many of the players in large reorganization today are professionals who specialize in trying to promote their positions at the expense of others.[198] Today, their positions are large enough that they willingly and rationally spend millions or tens of millions of dollars to increase their

193 The senior creditor can try to persuade the plan proponent through "gifting." The "gift" can be anything of value given to gain cooperation. For example, the secured creditor, in return for having a plan quickly approved to her liking, might agree to continue to employ the former CEO even though there is no expectation that the former CEO will do any work. *See, e.g.*, *In re* Bush Indus., 315 B.R. 292, 305-06 (Bankr. W.D.N.Y. 2004) (finding bad faith under § 1129(a)(3) because of a golden parachute agreement between the debtor and the CEO, who had left the company and moved to Florida).

194 *See In re* DBSD N. Am., Inc., 634 F.3d 79, 100 (2d Cir. 2011) (prohibiting a plan that provided for a "gift" to a junior class because of the possibility of "serious mischief between senior creditors and existing shareholders").

195 *See, e.g.*, *In re* Jevic Holding Corp., 787 F.3d 173, 177-85 (3d Cir. 2015) (allowing an "unsatisfying" settlement that served to end the case on the ground that no other alternatives existed that would give value to anyone other than the senior creditors), *cert. granted sub nom.* Czyzewski v. Jevic Holding Corp., 136 S. Ct. 2541 (2016).

196 *See* Huebner & Tisdell, *supra* note 42, at 78-79 (noting that "[t]wenty-five years ago[,] significant bankruptcy claims . . . rarely changed hands" and discussing the recent rise of claims trading and distressed investing that began in the 1990s).

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

198 *See* Miller, *supra* note 37, at 394 ("[H]edge funds have been described as often destructive and instigators of litigation."). One should be careful, however, since there is some empirical evidence that the presence of an activist hedge fund is utility-enhancing; *see also* Wei Jiang, Kai Li & Wei Wang, *Hedge Funds and Chapter 11*, 67 J. FIN. 513, 540 (2012) ("The strong relation between hedge fund presence and debt recovery suggests an overall efficiency gain, which could only be accomplished by the hedge funds' ability to counter the power of the debtor.").

share.[199] Different classes of creditors—as well as those holding blocking positions within a class—exploit weaknesses within existing rules to expand their shares at the expense of others.[200] Forming coalitions that avoid a contested valuation hearing has become harder.[201] These changes compound the difficulties of strict adherence to absolute priority.

Proposing sensible reforms in this environment best begins by recognizing that religious adherence to any particular system of priority is a mistake. It costs too much and compromises other values. The debate should shift from the question of how to find a bankruptcy mechanism that best vindicates the absolute priority rule to the question of identifying the priority rule that minimizes the costs of bankruptcy itself.[202] Whether a priority rule helps to implement a successful plan at reasonable cost is a better point of focus than debating which priority rule provides the best set of ex ante incentives.

We have long become accustomed to thinking that our bankruptcy regime has rejected relative priority.[203] But this has not been true on the ground. The Bankruptcy Code itself recognizes the option value of junior creditors if their options come into the money by the time the plan of reorganization is confirmed.[204] The time of confirmation, not the time the petition is filed, is the moment of reckoning in Chapter 11.

Out-of-the-money junior creditors often receive some form of rain check, at least if they agree to support a plan of reorganization.[205] Giving options to

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199 *See* Bishop, *supra* note 94 (showing that fees associated with a single creditor group in one case can exceed $100 million).

200 *See* Baird & Rasmussen, *supra* note 41, at 691 ("[T]he plan does matter to the parties themselves, as each valuation mechanism tends to favor some at the expense of another.").

201 *See* Huebner & Tisdell, *supra* note 42, at 81 (explaining that junior creditors respond to efforts of senior creditors to gain control of the firm by pressing for valuations and noting that "such disputes among creditors can be incredibly complicated and costly").

202 *See, e.g.*, Anthony J. Casey & Edward R. Morrison, *Beyond Options,* ("[W]e focus on designing the most efficient reorganization system with whatever priority scheme happens to go along with it."), *in* HANDBOOK ON CORPORATE BANKRUPTCY (B. Adler ed., forthcoming 2017) (manuscript at 8), https://ssrn.com/abstract=2855954.

203 *See, e.g.*, Bris, Schwartz & Welch, *supra* note 180, at 300 n.6 (assuming that the Bankruptcy Code "requires the court to follow the absolute priority rule").

204 *See* 11 U.S.C. § 1129(b)(2)(A)(i)(II) (2012) (requiring valuations at "the effective date of the plan," or the time of the reorganization, rather than at the time the petition is filed).

205 It is common, however, for plans to provide for worse treatment if junior creditors as a group reject the plan. *See, e.g.*, *In re* MPM Silicones, LLC, No. 14-22503-rdd, 2014 WL 4637175, at *3 (Bankr. S.D.N.Y. Sept. 17, 2014) ("Such fish-or-cut-bait, death-trap, or toggle provisions have long been customary in Chapter 11 plans." (citing *In re* Adelphia Commc'ns Corp., 368 B.R. 140, 2715 (Bankr. S.D.N.Y. 2007); *In re* Drexel Burnham Lambert Grp., 138 B.R. 714, 717 (Bankr. S.D.N.Y. 1992))). The junior noteholders rejected a plan that, had they accepted it, would have paid them the principal amount of their claim in full. *Id.* at *1. Because they rejected the plan, they received a note in lieu of cash at a rate that was substantially below market. They chose to risk receiving less because of the prospect of persuading the bankruptcy judge to reject the plan on the ground that they were entitled to interest as well as principal.

junior out-of-the-money creditors is a common way to resolve the tensions that absolute priority brings.[206] Junior creditors end up enjoying a payoff for the option value of their claim in part because of the valuation variance that arises from the uncertainty of a judicial valuation.[207] In all events, the idea that junior creditors end up with options is not at all alien to modern practice.[208]

The existing priority system is an uneasy compromise between absolute and relative priority. Senior lenders, in return for enjoying a continuing stake in the firm—rather than the proceeds of a foreclosure sale—recognize the option rights of the junior investors until the reorganization is over. Recent calls for bankruptcy reform, both from the academy and practitioners, reflect the tug of relative priority.[209] The time to confront the costs of implementing absolute priority is long overdue.

206 Warrants are a common feature of securities issued in large Chapter 11 reorganizations. *See, e.g.*, Press Release, Sandridge Energy, Sandridge Energy Emerges from Reorganization with Approximately $525 Million of Liquidity 2 (Oct. 4, 2016), http://s21.q4cdn.com/174552385/files/doc_news/2016/JS100416-SD-Emerges-from-Reorganization.pdf [https://perma.cc/S82G-NWQC] (detailing a new capital structure, including nearly seven million warrants).

207 For a discussion of valuation variance, see Baird & Bernstein, *supra* note 14, at 1957-60.

208 *See, e.g.*, *In re* Young Broad., Inc, 430 B.R. 99, 106, 109 (Bankr. S.D.N.Y. 2010) (approving of a plan in which junior creditors received warrants); *see also* Casey, *supra* note 3, at 803 & n.72 (providing additional examples of junior investors receiving options).

209 *See, e.g.*, COMMISSION REPORT, *supra* note 3, at 207-24 (discussing the "redemption option value" method); Casey, *supra* note 3, at 765 (calling for "Option-Preservation Priority").