Debt Priority and Options in Bankruptcy: A Policy Intervention

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Introduction

Over the past four decades, scholars from law, economics and finance have written a great deal about the priority of debt investments in business entities. The attention is warranted because priority is one of the most important features of a debt contract and of the capital structure of firms. Hierarchical capital structures can be very complex, as they combine contractual priority (subordination agreements) with property rights over pools of assets (security interests). Moreover, security interests are relatively flexible tools for allocating contingent property rights. Finance scholars and practitioners know that a debtor allocates priority among its investors in order to combat agency problems and thereby minimize its cost of capital. In the first twenty years or so of scholarly work in this area, several theories emerged to explain how this is accomplished. As summarized below, the efficiency explanations fall into two categories: (a) the static theories focus on the allocation of priority among creditors to exploit the comparative advantages in screening, monitoring and debt enforcement activities, and (b) the dynamic theories focus on the allocation of priority among investors across time (e.g. earlier versus later) to regulate the debtor's financial slack or liquidity and thus influence its investment choices. Alternative theories contemplate distributional motivations that could also lead to social welfare losses: a debtor could appropriate value from its nonconsensual (including unsophisticated) creditors (notably tort victims) by granting property interest in their assets to the more sophisticated creditors and thereby lowering its aggregate interest cost. Thus, by the turn of the century, an overall prescriptive consensus emerged that debtors should be allowed

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the freedom to allocate priority among consensual creditors but that some form of protection may be needed for the nonconsensual unsecured creditors.

Renegotiation is a central and anticipated feature of debt contracting in general, and priorities in particular. It is complicated by the fact that numerous debt contracts are interrelated and that property interests lack sufficient flexibility to resolve the problem of collective action. In particular, ex ante priority allocations may not be optimal ex post, particularly if the debtor is insolvent and has defaulted in its obligations to multiple creditors. Bankruptcy law addresses this problem by providing a collective process to resolve financial distress. In the discussion that follows, it is helpful to think of bankruptcy in two stages: the reorganization of the capital structure of the firm that emerges from bankruptcy and adjustments that occur during bankruptcy. While bankruptcy law modifies many contract terms (for example, it stays the right of creditors to remove assets from the debtor after default), it treats priority rights with much greater respect because they are property or property-like interests. Nevertheless, adjusting debt obligations is central to both stages of the bankruptcy process. For example, under a reorganization, an unsecured creditor may become a shareholder. During the bankruptcy process, a prebankruptcy security interest that would enjoy a first-in-time priority can be subordinated to a lien granted to an investor providing new funds (debtor-in-possession financing). These priority alterations are not authorized lightly—and are designed both to maximize the return to and retain the priority hierarch of prebankruptcy creditors—but they are essential, during and at the conclusion of bankruptcy, to restore an efficient capital structure in the debtor. As with any renegotiation, the objective is to improve efficiency ex post without disturbing the ex ante efficiency of the debtor's capital structure. The challenge is compounded when the ex post adjustment is done by judicial fiat instead of by consent, and the resulting complexity justifies judicial restraint in adjusting priorities. In particular, as we note below, the court should not be ordering efficiency-motivated adjustments that the parties could have done themselves.

Thus, the academic discussion of debt priorities has two dimensions: the optimal ex ante arrangement for allocating priorities and the role of the court in intervening to adjust priorities.

Over the past fifteen years or so, scholarly publications have appeared to raise additional concerns about priority allocations both outside and in bankruptcy. In our opinion, this more recent work has failed to internalize and build on the insights of the earlier scholarship that explained the motivation and effect of debt priorities. Until recently, however, these newer articles have not influenced policy debates, either in courts or legislatures. But things have changed.

In 2011, the American Bankruptcy Institute established a Commission to Study the Reform of Chapter 11. The 23-member Commission created advisory committees to hold hearings and study a range of issues, and a core focus was the role and treatment of secured creditors. The Committee released a nearly 400-page report on in December 2014. The Report begins with the observation that major revisions to the Bankruptcy Code have occurred every forty years and a new one is due soon.[1] One of the most bold and striking recommendation affects the priority rights of senior creditors and finds its roots in the writings of a group of legal academics. Briefly stated, this recommendation would give a junior, out-of-the-money creditor the right to receive in reorganization a distribution of value that reflects the possibility that the value of the debtor enterprise might rise in the three years following bankruptcy. This is a very significant reallocation of the rights the junior claimant would enjoy outside of bankruptcy and we explain this aspect below. We argue that the justifications for this nonconsensual adjustment reflect fundamental misunderstandings of debt contracts and bankruptcy policy.

Academics have played a role in commercial law reform, and their interests and incentives have been the subject of some scholarly exploration.[2] In general, the contribution of academics is a good thing. However, recognizing the cross-pollination of ideas, we are motivated to address

[1] "[E]fforts to review and assess U.S. business reorganization laws are undertaken approximately every 40 years. Such efforts have led to federal legislation effecting meaningful revisions to business reorganization laws in 1898, 1938, and 1978. It may be that four decades is the maximum amount of time that any financially driven regulation can remain relevant." American Bankruptcy Institute, Commission to Study the Reform of Chapter 11, Final Report and Recommendations (December 2014).

[2] E.g., Alan Schwartz and Robert E. Scott, The political economy of private legislatures, 143 U. Pa. L. Rev. 595 (1995); Robert E. Scott, The politics of Article 9, 80 Va. L. Rev. 1783 (1994); Barry E. Adler, Limits on politics in competitive credit markets, 80 Va. L. Rev. 1879 (1994); George Triantis, Private law-making and the Uniform Commercial Code, in P. Newman, ed., The New Palgrave Dictionary of Economics and the Law, Vol. 3, 117 (1998).

the recent academic work on debt priorities, with the ambition of putting the scholarly investigation back on the right track.

I. The Earlier Theoretical Framework

To put the analysis of the more recent scholarship and the ABI reform recommendations in context, it is useful to summarize the earlier – and voluminous -- body of scholarship. The question of why the capital structure of a business entity is hierarchical in priority allocation is best addressed from the viewpoint of the debtor. After all, it is the debtor who decides to assign priority over its assets either by contract or granting security interest. The earlier scholarship explained that the debtor might assign priority among its creditors for three sets of reasons: (a) to address information problems endemic to business finance (adverse selection and agency costs), (b) to shift risk from consensual creditors (who would lower their interest rate upon receiving priority) to nonconsensual creditors (who could not change their rates upon being thereby subordinated), and (c) to protect a current creditor from dilution from future borrowing, particularly if it were secured.

Information efficiency gains

Turning to the information rationales, the theories fall into two categories that we label static and dynamic. The static theories explain that priority can be allocated to exploit the comparative advantages of creditors in screening and monitoring the debtor, and in enforcing debt claims upon default against the debtor's assets. Consider a debtor with two creditors, where the debtor faces a choice between leaving the creditors holding the same priority against its assets and giving priority to one creditor (the "senior" creditor) over the other. If the two creditors are consensual and identical in every way, then the saving in interest payable to the senior creditor will be offset by the increase that would be demanded by the junior creditor. The pie would simply be sliced differently, and the creditors would adjust their compensation to their allocated share. However, if the senior creditor has superior information that allows it to screen, monitor or enforce its debt claim at lower cost than the junior creditor, then the senior creditor could bear the risk of default more cheaply than the junior creditor. So, the aggregate cost of capital would be reduced by the differential priority; the amount of pie to be distributed would be

greater.[3] While the foregoing example contemplates priority across all assets of the debtor, a related explanation addresses the allocation of asset-specific priority. The debtor could reduce its capital cost by assigning to each creditor, priority only in those assets in which that creditor enjoyed a comparative screening and monitoring advantage.[4]

Turning to the dynamic theory and continuing with the two-creditor example, the debtor can reduce capital cost by allocating priority over time. It might choose between giving priority across its assets to either the earlier-in-time or later-in-time creditor. Giving the first creditor priority means that the later and subordinated creditor will be more careful in contributing funds. Accordingly, later credit will be more difficult for the debtor to obtain. This is efficient if the debtor might be inclined to borrow for high-risk and unprofitable projects, or to fund expenditures that benefit management at the expense of investors (the problem of "overinvestment").[5]

The following numerical example illustrates the overinvestment incentive and the beneficial effect of earlier-in-time priority. Suppose that a firm has assets worth $100 and owes $80 to its initial lender (C1) who enjoys the highest priority as a first-in-time lender. Lender C1 holds a perfected blanket lien over all the firm's current and after-acquired assets. One year from today, the firm has equal chance of being in one of two possible states. In the good state, the firm's current assets would be worth $150; in the bad state, they would be worth $50 (that is, the firm is insolvent in the bad state). Suppose that the firm has the opportunity to invest in Project A, which is a risky venture with negative expected value: It requires an investment of $20, and it yields $30 in the good state and nothing in the bad state. This project might be the acquisition of a new business line or simply paying for the utilities necessary to continue the existing one. In

[3] The early important works are Thomas H. Jackson and Anthony T. Kronman, Secured Financing and Priorities Among Creditors, 88 Yale L.J. 1143 (1979); Alan Schwartz, Security Interests and Bankruptcy Priorities: A Review of Current Theories, 10 J. Legal Stud. 1 (1981).

[4] Saul Levmore, Monitors and Freeriders in Commercial and Corporate Settings, 92 Yale L.J. 49 (1982).

[5] See George Triantis, A Free-Cash Flow Theory of Secured Debt and Creditor Priorities, 80 Va. L. Rev. 2155 (1994): Oliver Hart and John Moore, Debt and Seniority: An Analysis of the Role of Hard Claims in Constraining Management, 85 Am. Econ. Rev. 567 (1995).

either case, suppose the managers receive a private benefit from the venture and they approach C2 for a loan. If C1 has priority over all subsequent lenders, its priority effectively precludes the firm from obtaining financing to fund the gamble. However, if C2 enjoys priority, it will be paid in full in either state and can be enticed into the coalition by the promise of a portion of the shareholder's gain in the good state. Similarly, with later-in-time priority, C2 would be willing to finance other unprofitable actions by the managers, including distributions to shareholders, perquisites to managers, or a reserve pool of cash that insulates managers from the discipline of product or factor markets. In fact, even if C2 shares priority with C1, it will be prepared to fund unprofitable ventures because it can externalize some of the cost onto C1. So, earlier-in-time priority plays a very significant role in reducing agency costs of corporate governance.

Depending on how close the debtor is to insolvency at the time of the later investment, however, the earlier senior loan may cast an overhang that deters the financing of even profitable projects. This problem of debt overhang (or "underinvestment") is illustrated as follows. Suppose the firm uncovers an opportunity to invest in Project B, which is a risk-free, profitable project that requires an investment of $20 and will yield $30 a year from now (a certain profit of 50 percent). Suppose that the firm cannot capture the value of this venture by selling it to another entity because, for example, it has no property right protection in the opportunity. It also has no available liquid assets to invest. Suppose also that at the moment, C1 cannot finance the investment. Given C1's first-in-time priority, a new creditor C2 lending $20 would recover nothing in the bad state. C1's priority would absorb C2's investment. So, to break even on average, C2 would need to receive $40 in the good state. Yet, Project B yields only $30, so that the balance would come out of the value currently owned by the shareholders. Therefore, the shareholders and C2 would not reach an agreement to finance the project. This problem of debt overhang or underinvestment is caused by the combination of earlier-in-time priority and the existence or risk of insolvency.

If, however, C2 were given priority, its debt could be paid in full in both states. The shareholders and C2 could agree to split the gains from Project B in the good state. In this example, then, later-in-time priority for C2 is necessary to exploit the profitable project. One

might ask whether C1 could be the source of finance and thereby avoid the overhang problem of early-in-time priority. Or, it may consent to subordinate its claim when it discovers that C2's financing of Project B would not impair C1's recovery of its debt. These types of renegotiation do occur. With either approach, however, the debtor must bargain with C1 in order to finance the project. The bilateral negotiation can entail strategic hold-up behavior that could frustrate the financing of some projects. Anticipating such hold-up, the debtor might not invest in search to find the profitable opportunity. Another solution to the overhang problem would have C2 refinance the debt to C1 as well as fund the new project. However, this raises the cost of C2's financing and increases its exposure to the debtor's business, and this might deter financing of some profitable ventures.

The foregoing example illustrates the trade-off in the binary choice between first-in-time and later-in-time priority rules, particularly when the priority covers all or most assets of the debtor (e.g., a blanket lien) rather than asset based.[6] The tradeoff presents the fundamental and perhaps most vexing challenge of priority allocation. As explained elsewhere, it is very difficult for either the debtor's contracts or for the relevant statutes to provide rules to solve the tradeoff, without giving a court significant discretion to determine whether the later project is profitable or not.[7] An earlier-in-time priority rule combined with discretion on the court to deviate from it would put a lot of pressure on the court's ability to verify the relevant facts.

A debtor in bankruptcy, however, may not have the luxury to permit creditors consensually to work out the debt overhang problem created by prebankruptcy secured debt. For this reason, it is plausible that the parties themselves would agree in advance to capital structure adjustment in bankruptcy where the debtor becomes financially distressed. Bankruptcy law implements such an implicit bargain and adjusts priorities against a going concern debtor at two stages: (a) the court can authorize the debtor during bankruptcy to address overhang by giving new loans

[6] See Elazar Berkovitch and E. Han Kim, Financial Contracting and Leverage Induced Over- and Under-Investment Incentives, 45 J. Fin. 765 (1990); George Triantis, A Theory of the Regulation of Debtor-in-Possession Financing, 46 Vand. L. Rev. 901 (1993).

[7] George Triantis, Financial Slack Policy and the Laws of Secured Transactions, 29 J. Legal Stud. 35 (2000).

priority ahead of the prebankruptcy claims; and (b) the firm that emerges from bankruptcy reorganization has less debt, with some debt converted to equity.

More specifically, a reorganization plan addresses the overhang by reducing the face amount of priority debt. Although reorganization is largely a consent procedure under which the creditors vote in class to accept the plan, the court has the discretion to cram down a plan if it is fair and equitable. The accepted doctrinal rule, however, is that the plan may not adjust priorities among prebankruptcy claimants without consent of the adversely affected claimant. This absolute priority rule is codified in the cramdown requirements of §1129(b)(2) of the Bankruptcy Code. The absolute priority rule, so codified, is not without its pitfalls for prebankruptcy creditors. A judge may incorrectly determine that a reorganized firm honors priority, but current law is mostly judicious in its respect for absolute priority. For instance, judicial engineering created a so-called new value exception to absolute priority, under which the prebankruptcy owners whose interest was out of the money could have an interest in the reorganized firm, even though unsecured creditors were not paid in full, in exchange for new value contributed in money or money's worth. Judicial valuation, though, was problematic for objecting creditors and, consequently, the Supreme Court reined in this exception in *203 North LaSalle Street* by requiring a market test to ensure that the owners paid market value for their interest.[8]

To elaborate further, even if debt overhang is resolved at confirmation of the reorganization plan, it is usually an urgent problem that must be addressed while the plan is being negotiated, drafted and processed. Otherwise, the going concern of the debtor may expire before the plan is confirmed. During bankruptcy, therefore, the court can authorize debtor-in-possession financing that takes priority over prebankruptcy unsecured credit or even over earlier secured credit.[9] To authorize the priming of the earlier secured creditor in this manner, the court must find that the secured creditor's interest is adequately protected. At least in doctrine (if not always in application), this requires that the value of the creditor's security interest is preserved and not captured by the debtor in the new financing. The urgency of the overhang problem at the

[8] Bank of America v. 203 North LaSalle Street Partnership, 526 U.S. 434 (1999).

[9] Bankruptcy Code §364.

beginning and during bankruptcy provides a stronger justification for judicially-mandated priority adjustment than at the confirmation of the reorganization plan.

Distributional harms

The debtor's priority allocation may be distorted by the fact that some of its creditors are nonconsensual (including because they are unsophisticated) so that the interest rate they charge does not compensate for variations in the default risk they bear. A debtor may exploit this to reduce its cost of capital by selling security interests in its property to lenders who would lower their interest rates and thereby put such property out of the reach of its nonconsensual creditors. In addition to the undesirable distributional consequence, this motivation may undermine the efficiency gains described above. In particular, a debtor who does not internalize the full cost of the capital it uses will tend to overinvest, from a social welfare perspective, in risky endeavor, and its managers will tend to be suboptimally monitored as well.

While there are doubts as to the extent to which debtors consciously pursue this strategy,[10] several solutions have been proposed to address this problem. One, focused on tort victims, would give them a superpriority over the assets of the debtor, ahead of secured creditors.[11] There is little academic opposition to this proposal and we have none here.

Anti-dilution protection

Another proposal for reform is based on a concern more broadly about nonadjusting creditors, those incapable of response to changes in a debtor's financial condition. Such a proposal would limit the extent to which debtors could transfer security interests in their assets. Advocates of this reform have proposed, for example, that personal property lenders could have

[10] E.g., Mann (1997); Listokin (2008).

[11] A student note by Christopher Painter seems to be the genesis of this proposal, to which there has not been any significant objection in academic scholarship. Note, Tort Creditor Priority in the Secured Credit System: Asbestos Times, the Worst of Times, 36 Stan. L. Rev. 1045 (1984). For an elaboration, see Barry E. Adler, Bankruptcy Primitives, 12 Am. Bankr. Inst. L. Rev. 219 (2003).

recourse to only 75% of the value of the assets offered by the debtor.[12] The carve-out of the remaining 25%, whether under Article 9 of the U.C.C. or the Bankruptcy Code, would be available for the benefit of all unsecured creditors.

The genesis of this proposal is investor concern about dilution of their claims, particularly future indebtedness that will add a competing claim without a compensating increase in the asset value of the firm. The risk of dilution is even more severe when it anticipates the granting of a future security interest. Loan documents often have restrictive covenants regulating future borrowing and pledges of firm assets but these can only be enforced against the debtor, which is problematic when the debtor is insolvent. Earlier priority provides stronger reassurance under the first-in-time rule.[13]

Many types of creditors do not typically receive such reassurance and therefore they anticipate being diluted by the debtor's granting of future security interests. Many such creditors are sufficiently sophisticated to anticipate being subordinated to future secured creditors, without the ability to adjust their rate of interest at that later time. So, these nonadjusting creditors will charge the debtor a higher interest rate to reflect the expected subordination of their claims. Lucian Bebchuk and Jesse Fried have argued that the debtor, having been compelled to pay this high rate, will have an incentive to borrow later on a high-priority basis from other creditors, to bring down its blended cost of capital.[14] Therefore, as noted, the authors proposed

[12] Lucian Ayre Bebchuk and Jesse M. Fried, The Uneasy Case for the Priority of Secured Claims in Bankruptcy, 105 Yale L.J. 857 (1996); Elizabeth Warren, Letter to the Council of the American Law Institute (April 25, 1996); Lynn M. LoPucki, Should the Secured Credit Carve Out Apply Only in Bankruptcy? A Systems/Strategic Analysis, 82 Cornell L. Rev. 1483 (1997). Bebchuk and Fried's concern went beyond the distributional harms of secured credit and are discussed infra.

[13] See Alan Schwartz, A Theory of Loan Priorities, 18 J. Legal Stud. 209 (1989). For an explanation of why early debt is not always high priority, see Barry E. Adler, An Equity-Agency Solution to the Bankruptcy-Priority Puzzle, 22 J. Legal Stud. 73 (1993).

[14] Lucian A. Bebchuk and Jesse M. Fried, The Uneasy Case for the Priority of Secured Claims in Bankruptcy, 105 Yale L.J. 857 (1996); see also Lucian A. Bebchuk and Jesse M. Fried, The Uneasy Case for the Priority of Secured Claims in Bankruptcy: Further Thoughts and a Reply to Critics, 82 Cornell L. Rev. 1279 (1997).

that a reduction in priority for secured claims through a carveout would mitigate both the expectation of dilution of the initial creditor and the urgency of the debtor to follow through.

The premise of this mandatory limitation on priority is that secured debt is inefficient or at least that it is something that ought typically to be postponed. This premise is weak because it fails to acknowledge the benefit of early priority debt described above. The proposed rule would deprive a debtor of the ability to bond itself against the ease with which it could later borrow to finance unprofitable ventures. Indeed, allowing nonadjusting creditors, such as trade creditors, to operate under the assumption that they will not hold entirely subordinated claims can exacerbate the overinvestment problem that priority credit is designed to address. Borrowing cheaply from trade creditors as firms burn through asset value is a common ill.[15] Where a debtor would like to credibly promise to keep its assets unencumbered, a better solution is a revision to the law of secured credit so that a debtor could commit on the public record not to encumber its assets beyond a specified level.[16] Particularly in the modern world of instant communication, such a reform could be implemented so that even a small creditor who cannot justify the expense of significant investigation could easily verify such a pledge.[17]

In sum, by the turn of the century, a rich scholarly framework had evolved to explain the priority structure in business finance, as well as the very targeted role of bankruptcy in adjusting priorities to address the problem of debt overhang. Although there was some contrast between the authors who focused on the efficiency explanations for secured credit priority and those who criticized the unfair distributional consequences of such priority, there was broad consensus that the two classes of explanations co-existed at least to some extent. While the carve-out proposal

[15] See Adler, Capkun, and Weiss, cited above in note 7.

[16] See Barry E. Adler, Secured Credit Contracts, 3 The New Palgrave Dictionary of Economics and the Law 405 (Peter Newman ed., 1998).

[17] Bebchuk and Fried might respond that any creditor who could verify a nonencumbrance pledge would not be a nonadjusting creditors as they define the term. We are unconvinced, however, that nonadjusting creditors exist in the real world, at least not enough of them to be the tail that wags the huge dog of priority finance.

did not attract widespread support, most scholars would agree that enhanced priority for tort victims, for example, would be good policy.

We now turn to more recent scholarship that took aim at other aspects of secured credit financing and advanced proposals to allow further unwinding of the debtor's priority allocations.

II. The secured creditor's deficiency claim

A security interest is a property interest in the collateral assets. Secured debt can be incurred without or with recourse against the debtor personally. Most secured creditors have recourse against the debtor for any deficiency in the value of the collateral. Therefore, if a debtor owns two pools of assets and grants a security interest in one pool to a creditor with recourse, that creditor enjoys priority over the unsecured creditors with respect to the collateral assets and also shares ratably with the unsecured creditors in the value of the unencumbered assets. To be sure, this compounds the unfair exploitation of nonconsensual creditors such as tort victims compared to the corresponding nonrecourse secured loan.

In a recent article, Richard Squire raises doubts about the efficiency of the secured party's recourse and advocates in favor of "symmetric" priority in which the secured creditor would be subordinated to the claim of the other creditors in the unencumbered assets while enjoying priority in the collateral assets.[18] He argues that the asymmetric priority that currently follows from a recourse loan fails to optimize the efficiency gains from specialized monitoring and screening, while exacerbating the pernicious redistribution of wealth away from non-adjusting creditors. If each of two creditors has the comparative advantage in monitoring a distinct subset of the debtor's assets, then each should be given priority in one pool and subordinated to the other creditor in the other asset pool. Squire concludes that "only symmetry corrects how the

[18] Richard Squire, The Case for Symmetry in Creditors' Rights, 118 Yale L.J. 806 (2014). He makes a similar argument in Strategic Liability in the Corporate Group, 78 U. Chi. L. Rev. 605 (2011).

law of secured lender now discourages efficient monitoring… symmetry is the only proposal with no evident downside." [19] As discussed below, the downside may be quite significant in fact.

Squire at the same time overstates the gains in monitoring economies from a mandatory regime of symmetric priority and the mitigation of the distributional concerns. Symmetry will not prevent the debtor from exploiting nonconsensual creditors. If a borrower seeks to exploit nonconsensual creditors, it would simply give the secured creditor a blanket priority in all assets, which would be more harmful than a priority in one pool with a pro rata claim in the other. Perhaps the latter is a more subtle strategy that could trap creditors who would otherwise notice blanket interests, but this speculation seems far-fetched. As to the monitoring efficiencies, the parties themselves can choose how to allocate priority and whether to allow recourse, without the help of statutory or judicial rules. As observed earlier in this paper, a debtor can exploit comparative monitoring advantages by pledging the distinct asset pools to different creditors, with or without recourse.[20] As we also explain earlier, the reason for legal intervention with the parties' agreement is to resolve the obstacles to renegotiation and ex post efficiency during financial distress. Squire's concern is with ex ante efficiencies, which the parties can attend to themselves.

By focusing on monitoring efficiencies, Squire misses several other factors that would play into the parties' optimal allocation of priority. We have discussed the dynamic efficiencies in Part I. When it limits the reach of the earlier-in-time priority, the symmetric approach might mitigate the overhang problem. In some sense, it lies in the range between earlier-in-time and later-in-time priority. However, it does not resolve the tradeoff: it exacerbates the overinvestment problem. As we have explained, resolving the tradeoff requires the application of a standard that examines whether the new venture is profitable or not. Moreover, the parties themselves can

[19] Id. at 866. The advantages of appraisal and bankruptcy speed refer to the convenience of bankruptcy administration when the value of specific assets are easily identified as belonging to specified creditors. Further elaboration is unnecessary for the purposes of this article.

[20] The Bankruptcy Code allows a creditor to convert a nonrecourse loan to a recourse loan for purposes of Chapter 11 administration. §1111(b)(2). But this option is an inside-basis detail that arguably lacks a theoretical basis to begin with and certainly could be jettisoned as a preferable alternative to the abandonment of absolute priority.

opt for symmetric priority if it optimizes the balance ex ante in their particular set of circumstances. In the circumstances in which overinvestment is clearly the more significant threat (for example, because the debtor is in a declining industry and has a rich cash flow), the symmetric priority would be inefficient and Squires mandated symmetry would most certainly have an economic downside.

There are several others sources of efficiency worth mentioning. First, a creditor with priority over asset A and no recourse to B, may have inefficient enforcement incentives.[21] In particular, this creditor might exercise its rights to liquidate asset A even in circumstances under which A and B are worth more together than apart. The creditor would be more likely to preserve the synergies if it had priority in both assets. Priority in A and a pro rata claim to B might be the optimal arrangement across various incentive concerns (including the monitoring/screening specialization efficiency). It is instructive in this respect to observe that non-recourse is a more common feature of real estate financing, where there are unlikely to be such synergies between plots of land, but not in operating companies with assets in equipment, inventory and receivables.

Second, some institutional lenders can provide valuable expertise to borrowers and the granting of broad security interests encourages them to do so by allowing them to participate in the upside of the borrower's prospects.[22] In the simple example, this might explain why a bank would be given a security interest with priority in ***both*** A and B (even if it had no monitoring advantage with respect to B). If this broad priority can be efficient in some cases, then presumably priority in A and a pro rata share in B might also be efficient in others, particularly in order to optimize across the various incentive considerations (including monitoring specialization). Third, if a secured creditor has a claim only against asset A (e.g. receivables) and not asset B (e.g. inventory), it might try to persuade the borrower to shift value from A to B (e.g. the sale of inventory to create receivables). While there are other mechanisms to address this misbehavior, such as avoidable preferences in bankruptcy, a simple way to avoid this inefficiency is to grant the creditor priority over both assets. As in the previous two examples, the

[21] Randall C. Picker, Security Interests, Misbehavior, and Common Pools, 59 U. Chi. L. Rev. 645 (1992).

[22] See Robert E. Scott, A Relational Theory of Secured Financing, 86 Colum. L. Rev. 901(1986).

combination of a priority claim in A and a pro rata interest in B may be a solution that optimizes across efficiency considerations.

III. The debtor's right to redeem and the related options

A security interest is a contingent property interest. It is typically nonpossessory until default by the debtor and it can be redeemed by the debtor upon payment of the full amount outstanding on the secured obligation. When default has occurred and the secured party has exercised its right to seize and sell the collateral, then the redemption right of the debtor is foreclosed. Until foreclosure, the debtor's right to redeem is an option defined by the underlying asset (the collateral), an exercise price (the obligation outstanding) and maturity (foreclosure). A key feature of an option is the ability to walk away at no cost when it is out of the money – when the value of the collateral is less than the amount outstanding. As noted earlier, the option concept is also commonly used to describe the relationship between shareholders and unsecured creditors, in light of the ability of unsecured creditors to remove firm assets through judicial processes involving judgment liens, execution liens, and garnishment orders.

When the debtor has a hierarchical capital structure, the debtor's option is somewhat more complex and essentially distributed among the various levels of investors. Consider, for example, a corporation with blanket secured debt of $100 and unsecured debt of $150. If the value of the firm's assets is $80, then all options are out of the money because if foreclosure were to happen immediately, they would not be worth exercising. If the firm value is $180, then the secured debt would be paid but the shareholder's option would be out of the money. The unsecured creditors would take the assets after paying off the secured creditor if foreclosure were to happen immediately. In this sense, the unsecured creditors are the beneficiaries of the option. Finally, if firm value were $260 and shareholders were facing foreclosure, they would exercise their option by paying off all the debt.

Several important implications flow from the options characterization. First is the importance of foreclosure, which defines the maturity of the option. As noted earlier, the value of an option is directly related to the time to maturity, so the longer that the debtor can prevent default and

postpone foreclosure, the more the option is worth. Of course, its actions to prevent default, such as making scheduled payments on the debt, are costly and effectively the price of holding the option open. Second, the value of the option also varies with the volatility in the value of the underlying asset. Therefore, once the option price has been settled through the contract rate of interest, shareholders have the incentive to increase the riskiness of the firm assets. Creditors are aware of this moral hazard, of course. They try to control it through contractual covenants and monitoring activity, and they demand compensation for the residual risk. Finally, the options are valuable rights that are key to the parties' bargain; they are priced and paid for ex ante.

The filing of a bankruptcy petition automatically imposes a stay on the default rights of creditors. In particular, they cannot begin or continue to foreclose the debtor's right of redemption and they lose their ability to enforce protective covenants. Effectively, then, the options described above remain alive at least during the bankruptcy process. These options have attracted closer attention recently from legal scholars. Unfortunately, in our opinion, their proposals distort the bargain of the parties without sound policy justification.

a. The shareholders' option and control right

Earlier we emphasized that bankruptcy generally respects the priority allocation of the debtor, otherwise known as "absolute priority". The notable exception—in form but not, ideally, in substance—is driven by the objective of mitigating the debt overhang or underinvestment problem, particularly at the beginning and during the bankruptcy case and even there, we observed, the permitted adjustment in priority is between holders of new loans and old creditors as a group, with a goal of maximizing the aggregate return of the latter; absent judicial valuation error, there is no substantive violation of absolute priority among prebankruptcy claims.

In advocating the alternative of "relative priority", Douglas Baird and Robert Rasmussen presented a strong case for permitting owner-managers of an insolvent firm to retain an interest in the reorganized entity.[23] The debt overhang problem under insolvency would otherwise deter

[23] Douglas G. Baird and Robert K. Rasmussen, Control Rights, Priority rights, and the Conceptual Foundations of Corporate Reorganizations, 87 Va. L. Rev. 921 (2001)

the managers from investing either new capital or their effort in the business. Strict absolute priority would create other inefficient incentives as well: for example, the managers would delay the day of reckoning in bankruptcy and entrench themselves to raise their value and improve their bargaining prospects in reorganization. However, allowing these shareholders to keep an interest in the firm, even when their old equity is under water, can have deleterious ex ante effects too. It leads to overinvestment in risky ventures. In the case of managers, the prospect of retaining equity interest despite business failure dilutes the effort incentives set by the initial stockholdings of the managers. The weighing of the positive and negative ex ante incentive effects of deviations from absolute priority is complex, as would be the determination of the conditions under which the prospect of deviation in bankruptcy would optimize incentives on balance.[24] The question remains whether a court is better at making the determination than the parties themselves.

The shareholder interest of a manager in an insolvent firm is underwater and therefore closely analogous to out-of-the-money executive stock options. In both contexts, the out-of-the money interests have attenuated effects on the future effort incentives of management. In addition, a manager with an out-of-the-money interest may imbue the firm with an excessive taste for risk, as would be the case for a manager of a firm in bankruptcy facing the expiration of her equity interest at the end of the case. Moreover, the reduction in the value of the stock or option makes retention an issue. In the case of stock options, firms often reset their executive options in response: They lower the exercise price, extend the maturity and/or issue additional options. A reorganization plan that leaves management with stock in the reorganized firm has the same effect: It resets the stockholder's option on firm assets by lowering the exercise price (the face value of the debt) and by extending the maturity (by cancelling the earlier default). This adjustment persuades the managers to remain with the firm and restores the desirable incentives of performance-based compensation.

Even in firms in which continuation of the going concern is desirable and the manager is necessary to the going concern, this resetting of the option of owner-managers is unlikely to be

[24] See Barry E. Adler and George G. Triantis, The Aftermath of North LaSalle Street, 70 U. Cin. L. Rev. 1225 (2001).

efficient. Given that there are incentive efficiencies to reset and not to reset – ex ante and ex post – it is plausible that some deviation from priority is efficient under some circumstances. The desirability of resetting executive stock options has been examined in finance.[25] This scholarship weighs the detriment to ex ante incentives against the gains in ex post incentives, and find as a theoretical matter that some resetting is efficient, even when anticipated by executives. However, given the complexity of the balancing task, it would be a matter of chance if bankruptcy judges reached the efficient degree of deviation in their review and confirmation of reorganization plans. They are handicapped in such attempt by their inability to incorporate nonverifiable information. The parties are more likely to reach efficient reductions in debt and extensions in maturity through renegotiation. Bankruptcy law should not purport to manipulate the debtor's threat point.

Further, equity interests in the reorganized firm are a crude mechanism for aligning managerial incentives, even when established by the private parties themselves. In general, there is no reason to intertwine compensation packages with capital structure decisions, inside or outside bankruptcy. An employment contract with performance-based compensation can exploit verifiable variables and remove the unnecessary costly risk of exogenous factors that accompany managerial equity ownership. Given the delicate balancing that must be achieved among various incentives and between those incentives and risk bearing, the flexibility in contracting is likely to be valuable. Moreover, even if the right balance is reached through stock ownership, changes in circumstances – particularly market stock value – may throw off that balance. An incomplete compensation contract can be renegotiated at lower cost than further recapitalization of the debtor firm.

Thus, even though incomplete, the management's contract in the reorganized firm should be left to negotiation between the firm's new owners after bankruptcy. We are skeptical of the claim that transaction costs systematically impede such a bargain.

[25] E.g., Viral V. Acharya et al, On the Optimality of Resetting Executive Stock Options, 37 J. Fin. Econ. 65 (2000).

b. The unsecured creditor redemption option

As described earlier, unsecured creditors also hold options in a hierarchically levered firm and have written other options for the benefit of the shareholders. Therefore, as illustrated earlier, the unsecured options are particularly significant when they are in the money but the shareholders' option is not. The unsecured creditors are in a different position from the shareholders because they do not have control over the firm assets during the life of the option. Therefore, many of the factors discussed in the preceding section are not applicable here. Yet, until the senior creditors foreclose the right of redemption, the unsecured creditors have the option to pay off the indebtedness to the senior creditors and thereby purchase the senior creditors' claims against the assets of the debtor. As noted earlier, when the automatic stay is triggered by the filing of a bankruptcy petition, it freezes the ability of the secured creditor to foreclose on the right of redemption held by the junior claimants and interests. Outside bankruptcy, the options would be terminated by foreclosure; yet they are extended inside bankruptcy, to the benefit of the junior claims and interests. The confirmation of the reorganization plan, particularly under an absolute priority rule, will terminate those options. This concerns some academics and practitioners and has motivated the ABI Reform Recommendation described earlier and addressed more fully in the next section.

Anthony Casey contends that modern bankruptcy process improperly deprives junior claims of their option value.[26] Commentators have generally observed that secured creditors have significantly more control over business bankruptcy cases than a couple of decades ago. Casey contends that they frequently exercise such control to (a) expand their priority beyond the liquidation value of collateral assets and to include the going concern value preserved in bankruptcy and (b) eliminate the option value of junior claims in this going concern which derives from the continuing possibility that the debtor's value will increase to exceed the amount of the senior claims.[27] In an analogous fashion to the proposal for relative priority of manager/owners

[26] Anthony Casey, The Creditors' Bargain and Option-Preservation Priority in Chapter 11, 78 U. Chi. L. Rev. 759 (2011).

[27] In one illustration, Casey imagines that at the time it files for bankruptcy a firm subject to $100 in senior debt, as well as to some junior debt, will be worth $0 in a future bad state and $200 in an equally likely future good state.

described in the preceding section, Casey proposes that the reorganization plan confirmation process should guarantee the junior claims their option value. Yet, in both respects, Casey's contentions are based on faulty premises about the terms of the senior debt contracts. First, debtors do often pledge going concern (and not simply liquidation) value to secured lenders and do so in order to discourage overinvestment.[28] Second, the junior options expire – and would be worth nothing -- upon foreclosure, which would have happened but for the intervention of the bankruptcy case.

Casey misunderstands the terms of the debtor's option. Loan agreements typically have acceleration clauses that the lender can enforce outside of bankruptcy, whereby the creditor can demand to be repaid in full from the debtor – immediately -- if the debtor defaults in payment or fails to comply with a covenant. The creditors are not obliged to wait until the maturity of their loan at a later time, when the firm might be worth more (or less). Financial creditors who are juniors are well aware that this is the typical structure of the seniors' loan. Therefore, contrary to Casey's premise, acceleration clauses are widespread and their lenders have bargained for the right to collapse the probability distribution, if and when the firm faltered and violated a provision of the loan agreement. The automatic stay upon the filing of a bankruptcy petition postpones acceleration and foreclosure. By the time that confirmation proceedings come around, the junior claimants have already enjoyed an extension of maturity. Indeed, bankruptcy also permits the junior claimants to keep their option alive by curing and compensating the earlier default and

Thus, at the time of bankruptcy, the firm is worth, in expectation, $100, the amount of the senior claim and, according to the absolute priority rule, the entire value of the firm consequently belongs to the holders of the senior claim. Casey contends that this distribution overcompensates the senior claim and undercompensates the junior claim because it deprives holders of the junior claim the value of what is, in essence, a call option on the firm's assets, which the author identifies as the expected value of the $100 surplus over the senior claim should the good state materialize. As explained in the text above, however, the junior claim is in fact not being deprived of its contract right when one considers the terms of its option, particularly its maturity. At the date of the bankruptcy petition, which stays the senior claim's foreclosure right, is also the proper expiration date of the junior claim's call option, thus almost certainly here worth $0 at the time of bankruptcy.

[28] See Barry E. Adler, Priority in Going-Concern Surplus, forthcoming Ill. L. Rev. (2014). This position was adopted by the ABI Recommendations.

reinstating the terms of the senior debt.[29] Casey's proposal goes even further without justification.

If Casey's proposal is not explained by the parties' actual agreement, another justification might be that it is a mandatory provision that the parties would have chosen in a world of lower transaction costs. This justification fails as well. Acceleration and foreclosure, triggered by an event of default, is intended to eliminate the option when the moral hazard of the junior interests becomes especially intense. Default often signifies either that the debtor has engaged in behavior that enriches junior interests (or management) at the expense of the senior lender, or that it will soon be tempted to do so by conditions of financial distress.

IV. Judicial valuation

As noted earlier, the term "absolute priority" refers to the enforcement of the debtor's priority allocation in the bankruptcy reorganization confirmation process, particularly in the cram down against classes who have voted against the plan. Yet, the parties' priority allocation contemplates an actual foreclosure sale, while bankruptcy reorganization is based on a virtual sale conducted by a combination of creditor vote and judicial fiat (via the cramdown). Valuation is key to giving effect to absolute priority in reorganization, but it is largely a product of experts, adversarial hearings and judicial determination. In an article published in 2006, Douglas Baird and Donald Bernstein argued that uncertainty in asset valuation–an unavoidable consequence of the turmoil that accompanies the bankruptcy process–makes it theoretically impossible for the judicial process strictly to honor priority.[30] They also suggested that the negotiation or litigation among creditors in the shadow of such uncertainty is costly. Inasmuch as the ideal of absolute priority is, in their view, unachievable, they suggest minimizing the cost of judicial error and uncertainty through an alteration of priority. For publicly traded firms, Baird and Bernstein offer

[29] This leaves the senior claim unimpaired, by which the claimant is deemed to have accepted the plan in the confirmation process. Bankruptcy Code §§1124(2), 1129(a)(8).

[30] Douglas G. Baird and Donald S. Bernstein, Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain, 115 Yale L.J. 1930 (2006).

as an example of such alteration a process through which a court would issue claims against and interests in a reorganized debtor consistent with a judge's initial asset valuation, but then look back at the distribution after such claims and interests are allowed to trade in the marketplace. If hindsight confirms the initial valuation, then nothing would change. But if the market revealed what appeared to be a misallocation, the look-back process would reallocate the claims and interests accordingly.

Such a look back comes with an implicit bias that would tend to undercompensate senior interests and overcompensate junior interests. The bias would be especially prominent under the scenario that motivates Baird and Bernstein's proposal: high uncertainty and wide variance in the probability distribution of future values in the look back period. The reason for this is that senior claims are truncated by the amount of the claims and so any increase in value above that amount would be to the advantage of junior interests. By contrast, a reduction in asset value would come fully at the expense of initially underwater senior claims.

Baird and Bernstein do not deny that value fluctuation so disadvantages senior claims. But they assert that the prospect of judicial valuation error, even unbiased error, under the current system also necessarily tends to undercompensate seniors and overcompensate juniors compared to the ideal of absolute priority, but with the added cost of negotiation and litigation rather than the use of market valuation with the lookback they propose. We disagree with the conclusion that fallible judicial valuation implies overcompensation of juniors and undercompensation of seniors and thus disagree that a look back is desirable.

To explain, we begin with an example from their article. Senior Creditor has a blanket security interest covering all of Debtor's assets. Those assets are in fact worth $100, which is also the amount of the claim the assets secure. Suppose that, given imperfect information, the judge will, with equal probability, arrive at an estimate of $75 or $125. Because the secured claim is capped at $100, Senior Creditor expects a return of $90. If the judge estimates that the $100 assets are worth only $75, she will award all interest in the debtor to Senior Creditor, for an expected return of 0.5($100) = $50; while if the judge estimates that the $100 assets are worth $125, she will award Senior Creditor only 100/125 of the interests in the debtor, for an expected return of

0.5(0.8)$100 = $40, with the remainder allocated to junior claims or interests entitled in fact to nothing.

This illustration does, of course, demonstrate how valuation error borne of inherent uncertainty can lead to an absolute priority violation at the expense of seniors and in favor of juniors. The illustration does not, however, demonstrate that a bankruptcy valuation process must systemically undervalue senior claims. With knowledge of this systematic bias, a judge could (or could be instructed by statute to) make an adjustment analogous to what sophisticated bidders do in an auction: correct for winner's curse through a bid reduction to account for the probability of a high estimate.[31]

Baird and Bernstein's finding of a necessary bias against the senior claim is an artifice of the numbers they chose for their illustration, in which the holder of the senior claim is *by hypothesis* entitled to the entire value of the firm. If one chose different numbers, there could be a different result. Suppose that in the current illustration the Debtor's assets are worth not $100 but $110. And now assume that the judge corrects for what we'll call senior-creditor's curse by placing a value on the assets equal to 80% of her estimate, and assume that her estimate will be $85 or $135 with equal probability. Now Senior Creditor expects about $106, which is more than its entitlement. This is so because: if the judge estimates that the $110 assets are worth only $85, she will, even without correction, award all interest in the debtor to Senior Creditor, for an expected return of 0.5($110) = $55; while if the judge estimates that the $110 assets are worth $135, she will apply the 80% correction, 0.8($135) = $108, and award Senior Creditor 100/108 of the interests in the debtor, for an expected return (as rounded) of 0.5(0.93)$110 = $51. Of course, if the Senior Creditor expects $106, the junior interests would expect only $4 on account of their $10 claim.

Thus, Baird and Bernstein are mistaken in asserting that estimation variance systematically implies senior claim *under*compensation. Perhaps the surest way to see this is through an even

[31] For a description of the winner's curse correction in a legal context, though not this one, see, e.g., J. Russel Denton, Stacked Deck: Go-Shops and Auction Theory, 60 Stan. L. Rev. 1529 (2008).

simpler illustration, where a judge worried about senior undercompensation simply eschewed asset valuation altogether, assigning an estimate of $0 and awarding all assets, regardless of their true value, to the holder of the senior claim. This process would, of course, systemically overcompensate seniors at the expense of juniors.[32]

The goal is not, of course, to overcompensate senior claims. A proper senior-creditor-curse correction–one that would, like Goldilocks, choose "just right"–would require a sophisticated algorithm that took into account, among other things, variance of estimates (just as a proper winner's curse correction does). Such an algorithm is beyond the scope of this article and, even with expert testimony, perhaps also beyond the ken of most courts. Yet, even rough rules of thumb could yield expected returns that, while noisy, center on absolute priority. Thus, while Baird and Bernstein may be on to something when they suggest that taking time to gather more information after the conclusion of bankruptcy may usefully reduce the uncertainty of bankruptcy valuations, where such time permits significant fluctuation in actual asset valuation a look back is not without a cost in violation of absolute priority, a cost that, as we have demonstrated, is *not* inevitable.

V. The ABI Reform Recommendations of 2014

The role and priority of secured creditors were central to the hearings, debate and recommendations of the ABI Reform Commission. The Committee debated the proposal for a carve-out of security interests for the benefit of junior creditors, but recommended against it. The Commission also considered whether the fair and equitable standard for cramdown against secured creditors should protect the going concern value attributable to the collateral assets, and recommended that it should.[33] Then, motivated by the desire to balance the interests of

[32] In an alternative, though isomorphic, version of this illustration, a court would be asked to value collateral for the purpose of cashing out the claim and having the debtor retain the collateral. In this case, the cap on claim amount would tend to undercompensate seniors and overcompensate juniors if a court valued the collateral based on an unadjusted estimate. But, again, an adjustment for senior creditor's curse could eliminate senior undercompensation. The system could, moreover, yield systemic senior overcompensation if the cap were removed altogether with the senior cashed out at a judge's uncorrected estimate.

[33] Id., at 207 ("value equal to the reorganization value… attributable to the collateral security their claims as of the effective date of the plan"). See Adler, supra.

senior and junior interests, the Commission concluded that for purposes of determining adequate protection during the bankruptcy case (e.g., in priming a secured claim with a DIP loan), foreclosure value should be used. The balancing of interests in this context seems to us to be an empty and undefined goal. We would argue instead that this lower valuation provides the room to overcome the urgent overhang problem during bankruptcy, to give time for a more permanent restructuring to be negotiated. But here our disagreement with Commission is just a quibble.

More significantly, the Commission addressed the problems with valuation that had been raised by academics and are summarized above: particularly, (a) that the valuation of security interests occur at discrete moments in time and increasingly under the control of secured creditors, and (b) that these valuations are subject to uncertain and error-prone judicial determination. The Commission then made the following recommendation to protect (and, from our perspective, improperly enhance) the option of junior interests:[34]

> The valuation date set by the effective date of a plan or the date of a section 363x sale order (the sale of the entire debtor) should not foreclose, in appropriate cases, a distribution in the chapter 11 case on account of the possibility of future appreciation in the firm's value due to the firm's continuation as a going concern. Although the valuation at any point in time will necessarily reflect the debtor's future potential, the valuation may occur during a trough in the debtor's business cycle or the economy as a whole, and relying on a valuation at such a time may result in a reallocation of the reorganized firm's future value in favor of senior stakeholders and away from junior stakeholders in a manner that is subjectively unfair and inconsistent with the Bankruptcy Code's principle of providing a breathing spell from business adversity.
>
> Accordingly, except in small and medium-sized enterprise cases, the general priority scheme of chapter 11 should incorporate a mechanism to determine whether distributions to stakeholders should be adjusted due to the possibility of material changes in the value of the firm within a reasonable period of time after the plan effective date or

[34] Report, supra note --, at 207-8.

> section 363x sale order date, as the case may be. This adjustment should consider whether the class immediately junior to a senior class benefitting from preserving the firm's value as a going concern… (the "immediately junior class") should receive an allocation of value to recognize that the future possibilities of the ongoing firm include the possibility that such an immediately junior class might have been in the money or received a greater recovery if the firm had been valued at a later date.[35]

The Recommendation proposed that this "redemption option value", payable to the immediately junior class, be calculated to reflect the possibility that, during the years following the conclusion of the bankruptcy, the value of the firm might become sufficient to pay the senior class in full with interest. Under this proposal, this option value would be guaranteed to the class of junior claims. And, a plan that provided for such a payment could nevertheless be enforced over the objection of the senior class. The "redemption option value" is the value of a hypothetical option to purchase the entire firm with an exercise price equal to the redemption price and a duration equal to the redemption period from the effective date of the plan or the date of the sale order to the third anniversary of the petition. The Recommendation contemplated the use of Black Scholes option price valuation or other generally accepted market-based valuation models, and provided that the value be paid on the effective date of the plan in cash, debt, stock, warrants or other consideration.

Significantly, the Commission was not motivated in this proposal by a desire to protect nonconsensual creditors. That, we would understand and appreciate. If the Commission's proposal is motivated by a desire to give effect to the creditors' bargain, it fails for reasons elaborated in Part III. The junior creditors' option is subject to termination after default, upon acceleration and foreclosure. Outside of bankruptcy, the foreclosure date is almost entirely in the control of the secured creditor. The junior creditors' option would be vulnerable to the randomness or strategic timing of the secured creditor. Notwithstanding the fact that secured creditors have a much greater voice in bankruptcy today than two decades ago, they still have

[35] If the senior class would receive only a small payoff under the confirmation valuation and thereby would enjoy the payoff from the possible higher values that might be achieved in the 3 years after, then the redemption option value may be that senior creditors…

less control than they would have outside of bankruptcy. Outside of bankruptcy, the junior's under the water option would be terminated and worthless.

There is another sense in which the Commission's proposal lacks justification. We mentioned in Part III that repricing and extending an owner-manager's option in bankruptcy might be justified for the same reasons as it may be desirable to reset executive stock options outside of bankruptcy. The resetting would retain managers and provide them with incentives to invest effort. One might imagine circumstances – though very rare -- in which there might be analogous justifications to resetting the options of junior creditors: for example, to retain relations with these creditors and give them incentives to make monitoring or other investments in the reorganized debtor. Even so, to capitalize instead the value of these reset options makes no sense. It would not address the ex post efficiency challenge of debt overhang or improve incentives. The junior claimants would receive the same value whether or not the firm is profitable after bankruptcy. The payment of the redemption option value is a simple one-time redistribution of value that would be paid for ex ante by junior claimants, who would receive a lower interest rate as a result, and it threatens to undermine the ex ante efficiency goals of priority allocations that have been described in this paper.

Finally, without any economic upside, the calculation of the redemption option value will be complicated and controversial in many cases. Consider the variables that enter into the calculation of option value: the value of the underlying asset, the volatility of that value, the exercise price, and the time to maturity. The uncertainty in current bankruptcy valuations that motivated Baird and Bernstein's lookback proposal concerned only one of those variables, the value of the underlying asset. This uncertainty and consequent cost of negotiations would be compounded by the uncertainty over the other factors. The exercise price, for example, would be quite complicated in a complex capital structure, in which senior claims had security interests in different pools of assets. To avoid persistent and prolonged disputes, the Commission proposed that the burden on the plan proponent be set at a good faith measure of the redemption option value. The Commission is more optimistic than we are about the mitigating effect of this standard. We doubt strongly that the parties themselves would invite this added

valuation and lump-sum transfer in their ex ante contract or that they would have reason to do so.

Conclusion

Priority issues are particularly difficult. Much is at stake and the effects of priority allocations are broad and deep. We are delighted that these issues continue to be analyzed and debated by academic scholars, practitioners, and policy makers. Setting aside the external costs borne by nonconsensual creditors, we believe that the optimal combination of first-in-time and later-in-time priority and the optimal maturity of the redemption option of junior claims or interests ought to be left largely to private contract and renegotiation. To be sure, there are information and other transaction costs that impede the optimal arrangement, as they do in other contracting contexts. For reasons explained in this paper, the bankruptcy process can help in addressing the obstacles to a renegotiation solution to the ex post overhang problem. Mandatory bankruptcy rules that deviate from absolute priority for other reasons are likely to be counterproductive. In this paper, we explore several proposals that would adjust priority in bankruptcy reorganization for such other purposes and rejected them as being contrary to the parties' intentions and their collective interest. The redemption option value proposal of the ABI Chapter 11 Reform Commission, in particular, is based on inaccurate premises and faulty reasoning. It would not have happened without the prompting of bankruptcy academics and, therefore, its release has prompted us to make this intervention.