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THE UNEASY CASE FOR THE PRIORITY OF SECURED CLAIMS IN BANKRUPTCY

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ABSTRACT

This paper examines critically a fundamental principle of bankruptcy law--that secured claims should be paid in full before any unsecured claims are paid. We challenge the widespread consensus among legal scholars and economists that according full priority to secured claims promotes efficiency. Our analysis demonstrates that the rule of full priority actually distorts the arrangements negotiated between commercial borrowers and their creditors, producing various efficiency costs. We show that according only partial priority to secured claims could eliminate or reduce these efficiency costs; such an approach, we argue, might well be superior to the rule of full priority. We also point out that such an approach is consistent with fairness and freedom of contract considerations. The paper accordingly presents two different rules of partial priority that should be considered as alternatives to the rule of full priority.

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I. INTRODUCTION: TOWARDS A RECONSIDERATION OF THE PRIORITY OF SECURED CLAIMS IN BANKRUPTCY

This paper challenges the desirability of a fundamental and longstanding feature of bankruptcy law: the principle that secured creditors are entitled to receive the entire amount of their secured claims before any unsecured claims are paid.[1] There is a widespread consensus among legal scholars and economists that the rule of according full priority to secured claims is desirable because it promotes economic efficiency. The analysis we offer demonstrates that, contrary to this conventional view, the efficiency case for full priority is at best problematic. We find that according full priority to secured claims actually distorts the arrangements negotiated between commercial borrowers and their creditors, generating a number of efficiency costs. Our analysis also indicates that these efficiency costs could be reduced or eliminated by according only partial priority to secured claims, and that a rule of partial priority is likely to be superior to the rule of full priority from the perspective of efficiency. The paper therefore offers two such rules of partial priority that should be considered as possible alternatives to the currently prevailing rule of full priority.

In a secured transaction the borrower gives the creditor a security interest that, if the borrower defaults, permits the creditor to take possession of specified property of the debtor in partial or full

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[1] We follow the U.S. Bankruptcy Code in using the term "secured claim" to refer to that portion of a creditor's bankruptcy claim which is fully backed by collateral, and the term "unsecured claim" to refer to that part of a creditor's claim which is not backed by any collateral. See 11 U.S.C. 506(a). The principle that secured claims are to be paid in full before any unsecured claims are paid is embodied in the "adequate protection" provisions of the U.S. Bankruptcy Code, see infra note 12 and accompanying text, and reflected in the bankruptcy systems of most other countries. See, e.g., Drukarczyk, "Secured Debt, Bankruptcy, and the Creditors' Bargain Model," 11 Int'l Rev. L. & Econ. 203 (1991) (Germany); Goode, "Is the Law Too Favorable to Secured Creditors?" 8 Can. Bus. L. J. 53 (1983-84) (United Kingdom and Canada). See generally International Corporate Insolvency (D. Campbell ed. 1992).

satisfaction of the debt.[2] The practice of taking security interests in a debtor's property is quite old[3] and continues to be of widespread importance. Although there is no comprehensive source of information on secured commercial lending, the available data suggest that a substantial percentage of the total volume of business debt is secured.[4]

Under state laws governing transactions in personal and real property, a security interest in favor of a lender becomes effective when credit is extended and certain procedural requirements are followed.[5] Unless the parties agree otherwise, the secured lender retains all of the rights of an unsecured creditor with respect to the borrower. That is, if the borrower defaults on the terms of the loan agreement, the lender may seek to reduce its claim to judgment, and then instruct an agent of the court to enforce the judgment against any of the debtor's property. In addition, as a secured

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[2] Although the term "security interest" is often used to describe a lien against personal property and the term "mortgage" generally refers to a lien against real property, we follow the U.S. Bankruptcy Code in using the term "security interest" to refer to any type of consensual lien. See 11 U.S.C. 101(50).

[3] The Akkadians, Israelites, and Romans were among the ancient civilizations which made extensive use of these devices. See Goode, supra note 1, at 53; Deuteronomy 24: 10-13. Although the earliest security interests were not necessarily as elaborate as the ones used today, they were undoubtedly effective in ensuring repayment. Under Akkadian law, for example, a borrower defaulting on a secured loan might have been forced to turn over to the creditor not only his land, but also his entire family. See Goode, supra note 1, at 53. For a brief discussion of the evolution of security interests in the U.S., see D. Baird and T. Jackson, Security Interests in Personal Property, 1-81 (1987).

[4] See, e.g., Leeth and Scott, "The Incidence of Secured Debt: Evidence from the Small Business Community," 24 J. Fin. & Quant. Analy. 379 (1989) (reporting a 1982 Interagency Task Force on Small Business Finance study finding that 80% of the dollar volume of large and small business loans were secured and a 1983 National Federation of Independent Business study finding that 78% of the total volume of small business loans was secured).

[5] In the United States, the creation of security interests in personal property is governed by Article 9 of the Uniform Commercial Code ("U.C.C."), a version of which has been adopted by every state. The creation of mortgages in real property is also governed by state law. See generally R. Powell, The Law of Real Property (1989).

creditor, the lender enjoys two further rights: a "property right" and a "priority right."[6] The "property right" gives the lender the right to take possession of the assets covered by the security interest in the event of default without resorting to judicial process.[7] The "priority right" gives the lender a right to these assets which is generally superior to those of other claimants - including purchasers, transferees, and other creditors.[8] The "priority right" is typically established when the lender "perfects" its security interest either by taking possession of the assets or by filing a financing statement in the appropriate public registries.[9] Both the "property right" and the "priority right" may be fully exercised only outside of bankruptcy.

Our focus, however, is on the rights of a secured creditor when the debtor becomes insolvent

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[6] Deans Baird and Jackson have used the terms "property right" and "priority right" to describe the special rights accorded secured creditors. See Baird and Jackson, supra note 3, at 87.

[7] The rules concerning the repossession of personal property collateral are found in U.C.C. Sections 9-501 et. seq. Although we adopt the term "property right" to refer to the repossessory right of the secured creditor, see supra note 6, we do not intend to enter the debate over whether the secured creditor has property rights with respect to the security interest and what those rights, if any, might mean. Compare Harris and Mooney, "A Property-Based Theory of Security Interests: Taking Debtor's Choices Seriously," 80 Va. L. Rev. 2021 (1994) (taking the position that a secured creditor has a property interest in its security interest) with Lopucki, "Unsecured Creditor's Bargain," 80 Va. L. Rev. 1887, 1952-1954 (1994) (responding that property theory is not applicable to security interests) and Rogers, "The Impairment of Secured Creditors' Rights in Reorganization: A Study of the Relationship Between the Fifth Amendment and the Bankruptcy Clause," 96 Harv. L. Rev. 973 (1983) (arguing that by preselecting the particular property to be used in satisfying its claim, the secured creditor does not acquire "property" rights deserving greater constitutional protection than those accorded the contractual rights of an unsecured creditor).

[8] See, e.g., U.C.C. Sections 9-201, 9-301, and 9-312. However, a person who in good faith buys the collateral from another person in the business of selling goods of that kind will have rights in the collateral superior to that of the lender. See U.C.C. Section 9-307.

[9] The requirements for the perfection of a security interest in personal property are found in U.C.C. Sections 9-302 through 9-306.

and enters bankruptcy.[10] Once the debtor enters bankruptcy, a secured creditor will be "stayed" by the bankruptcy law from exercising its "property right" to take possession of the collateral covered by the security interest.[11] The secured creditor's "priority right" in the collateral is also suspended. The secured creditor is, however, entitled to the value of his "priority right": the bankruptcy rules require that, by the end of the proceeding, the creditor be given an amount equal to his secured claim.[12]

In contrast, unsecured claims (including the unsecured claims of any undersecured creditors) must generally share pro rata in any assets which remain after secured claims (and the claims of

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[10] Since only federal bankruptcy courts have the power to discharge debts, they are the most common fora for major collective insolvency proceedings. See E. Warren and J. Westbrook, The Law of Debtors and Creditors, (2nd ed. 1991), at 175-177. However, a substantial number of firms are liquidated outside of bankruptcy court either under state insolvency law or without any legal proceedings. See Lopucki, "A General Theory of the Dynamics of the State Remedies/Bankruptcy System," 1982 Wisc. L. Rev. 311, 311 (1982) (reporting that a large percentage of businesses which close and fail to fully pay their debts do not enter federal bankruptcy). Although our analysis applies regardless of the setting in which the bankrupt firm is liquidated or reorganized, for ease of exposition we assume throughout that an insolvent debtor will enter federal bankruptcy (either voluntarily or involuntarily).

[11] See 11 U.S.C. 362(a). However, a secured creditor can demand that the court lift the "stay" if its interest in the debtor's property is not "adequately protected." See infra note 12.

[12] The secured creditor's "priority" right is in principle protected by the "adequate protection" provisions of the U.S. Bankruptcy Code, which require that secured creditors whose "property right" is stayed be given "adequate protection" during the bankruptcy proceeding in the form of either cash payments or substitute liens so that at the end of the process they receive the full amount of their secured claim. See 11 U.S.C. 361-364. The legislative history of these provisions makes it clear that their purpose was to respect the secured creditor's "priority right": "Secured creditors should not be deprived of the benefit of their bargain... Though the creditor might not be able to retain his lien upon the specific collateral held at the time of filing, the purpose of the section [361] is to ensure that the secured creditor receives the value for which he bargained)." S. Rep. No. 989, 95th Cong., 2d Sess. 54 (1978). As is explained in Part V.C., however, the actual treatment of secured claims in bankruptcy provides secured creditors with less than "adequate protection."

certain priority unsecured creditors) are paid.[13] The effect of this priority scheme on the distribution of bankruptcy value is significant. If, as is usually the case, the debtor is immediately or eventually liquidated in Chapter 7,[14] general unsecured creditors are unlikely to receive any payment, and can expect to receive only 4-5 cents on the dollar if payment is made.[15] Even in the relatively few cases where a debtor successfully reorganizes under Chapter 11,[16] the mean recovery

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[13] The U.S. Bankruptcy Code gives full priority (over general unsecured claims) to certain unsecured claims within the following categories: (1) post-bankruptcy administrative claims, (2) claims arising after the commencement of an involuntary bankruptcy, (3) wage and other compensation-related claims, up to $2,000 per individual, (4) employee benefit claims, (5) claims of farmers and fishermen, (6) customer claims up to $2000, (7) government tax claims, and (8) claims of the FDIC and other financial regulatory agencies. 11 U.S.C. 507(a). These priority claims are in principle subordinated to secured claims; all other unsecured claims then share pro rata in any remaining assets. See 11 U.S.C. 726(b).

[14] The overwhelming majority of bankruptcies end in liquidation. See Baird, "The Reorganization of Closely Held Firms and the 'Opt Out' Problem," 92 Wash. U. L. Q. 913, 916 (1994); White," Efficiency Justifications for Personal Property Security," 37 Vand. L. Rev. 473, 482 (1984).

[15] See, e.g., U.S. Gen. Accounting Office, Pub. No. GGD-94-173, Bankruptcy Administration: Case Receipts Paid to Creditors and Professionals 1-2 (1994) (Report to the Chairman, Subcommittee on Economic and Commercial Law, Committee on the Judiciary, House of Representatives)(finding that general unsecured creditors received no payment in 97.2% of the 1.2 million Chapter 7 bankruptcy cases closed in 1991 and 1992); Herbert and Pacitti, "Down and Out in Richmond, Virginia: The Distribution of Assets in Chapter 7 Bankruptcy Proceedings Closed During 1984-1987," 22 U. Rich. L. Rev. 303, 311 (1988) (95.6% of Chapter 7 cases closed in Richmond, Virginia during 1984-1987 involved no payment to general creditors); Lopucki, supra note 10, at 311 (finding that 80% of liquidation cases studied involved no distribution to general creditors; in the remaining cases, general creditors received on average 4.5 cents on the dollar); White, "Bankruptcy Liquidation and Reorganization," in Handbook of Modern Finance, Chapter 35, at 1-49 (D. Logue ed. 1984) (in a sample of 90 small firms which liquidated in bankruptcy, the average payoff rate to unsecured creditors was 4.5%).

[16] Following a Chapter 11 reorganization, the debtor firm continues operating as a going enterprise. In exchange for their pre-bankruptcy claims, creditors typically receive equity or debt interests in the continuing business. See generally Whitford, "What's Right About Chapter 11," 72 Wash. U. L. Q. 1379 (1994).

of general unsecured creditors is typically only 20-30 cents on the dollar.[17]

While current bankruptcy rules for the most part respect the full priority accorded to secured claims, in practice secured creditors often receive less than the full amount of their secured claims. When the proceedings begin under the Chapter 11 reorganization provisions rather than under Chapter 7, a number of rules and practices work to erode the priority of secured claims.[18] Indeed, while secured claims do enjoy a substantial advantage over unsecured claims in bankruptcy, it is widely believed that secured claims are not always fully paid before unsecured claims in bankruptcy.[19]

The principle of according full priority to secured claims is firmly established in the bankruptcy laws of the U.S. and other countries.[20] A number of commentators have expressed concern about

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[17] See, e.g., White, supra note 15 (in a study of 64 small firms which filed to reorganize, unsecured creditors received on average 16% of their claims in cash and 18% (undiscounted) of their claims in promised installment payments when the firm was able to reorganize); Lopucki, supra note 10, at 311 (finding that the average payout to general unsecured creditors in reorganization cases was about 32% of allowed claims, although that figure includes amounts that were promised but which may not have been actually paid). Even in successful Chapter 11 reorganizations of large publicly traded corporations with relatively little secured debt, the average return to general unsecured creditors is less than 50 cents on the dollar. See Lopucki and Whitford, "Bargaining Over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies," 139 U.Pa.L.Rev. 125, 142 (1990). Results similar to these were found in a recent study of Canadian bankruptcy reorganizations. See Aghion, Hart, and Moore, "Improving Bankruptcy Procedure," 72 Wash. U. L. Q. 849, 867 n.30 (1994).

[18] The erosion of the value of secured claims in the current bankruptcy system is described in Part V.C.

[19] See, e.g., Triantis, "Theoretical Observations as the Nature of Secured Debt" (Stanford Law School S.J.D. Dissertation 1989); Baird and Jackson, "Corporate Reorganization and the Treatment of Diverse Ownership Interest: A Comment on Adequate Protection of Secured Creditors in Bankruptcy," 51 U. Chi. L. Rev. 97, 473 (1984); White, "The Recent Erosion of the Secured Creditor's Rights Through Cases, Rules, and Statutory Changes in Bankruptcy Law," 53 Miss. L. J. 389 (1983); Weiss, "The Bankruptcy Code and Violations of Absolute Priority," J. Appl. Corp. Fin. 71 (1991).

[20] See Baird and Jackson, supra note 3, at 473. For a discussion of the treatment of secured claims under foreign bankruptcy laws, see International Corporate Insolvency, supra note 1.

the fairness of permitting a debtor to encumber its assets in favor of secured creditors so that little or nothing is left for unsecured creditors in the event of bankruptcy.[21] The predominant view of those who have examined the issue from an efficiency standpoint, however, is that the "priority right" of secured creditors outside of bankruptcy should be respected as much as possible in bankruptcy.[22] It is this view — the "creditors' bargain" view[23] — that we question in our

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[21] Scholars critical of the ease with which a debtor can use security interests to deny unsecured creditors payment in bankruptcy include Countryman, "Code Security Interests in Bankruptcy," 75 Com. L. J. 269 (1970); Gilmore, "The Good Faith Purchase Idea and the Uniform Commercial Code: Confessions of a Repentant Draftsman," 15 Ga. L. Rev. 605 (1981); and LoPucki, supra note 7. However, these commentators' concern about the fairness of according full priority to secured claims did not cause them to focus, as we do, on the ex ante efficiency effects on debtor behavior of according priority to secured claims, or to consider either of the two alternatives to full priority presented in this paper.

[22] The premise of those writing from an economic perspective has generally been that the widespread use of security interests according priority to the secured creditor indicates that the current treatment of secured claims yields efficiency benefits. Much of the scholarly work has focused on what those efficiency benefits might be. While there is some disagreement as to the relative importance of the benefits which have been identified, the consensus in the literature is that according full priority to secured claims in bankruptcy is socially desirable. Contributions in this area include Jackson and Kronman, "Secured Financing and Priority Among Creditors," 88 Yale L. J. 1143 (1979); Smith and Warner, "Bankruptcy, Secured Debt, and Optimal Capital Structure: Comment," 34 J. Fin. 247 (1979); Levmore, "Monitors and Freeriders in Commercial and Corporate Settings," 92 Yale L. J. 49 (1982); Schwartz, "Security Interests and Bankruptcy Priorities: A Review of Current Theories" 10 J. Legal Stud. 1 (1981) [hereinafter, "Schwartz (1981)"]; Schwartz, "The Continuing Puzzle of Secured Debt" 37 Vand. L. Rev. 1051 (1984) [hereinafter, "Schwartz (1984)"]; White, supra note 14; Schwartz, "A Theory of Loan Priorities," 18 J. Legal Stud. 209 (1989) [hereinafter, "Schwartz (1989)"]; Stulz and Johnson, "An Analysis of Secured Debt" 14 J. Fin. Econ. 501 (1985); Buckley, "The Bankruptcy Priority Puzzle," 72 Va. L. Rev. 1393 (1986); Scott, "A Relational Theory of Secured Financing," 86 Colum. L. Rev. 901 (1986); Leeth and Scott, supra note 4; Shupack, "Solving the Puzzle of Secured Transactions," 41 Rutgers L. R. 1067 (1989); Triantis, supra note 19; Weiss, "Bankruptcy Resolution: Direct Costs and Violation of Priority of Claims." 27 J. Fin. Econ. (1990); Johnson, Jr., "Adding Another Piece to the Financing Puzzle: The Role of Real Property Secured Debt," 24 Loy. L.A. L. Rev. 335 (1991); Picker, "Security Interests, Misbehavior, and Common Pools," 59 U. Chi. L. Rev. 645 (1992); Triantis, "Secured Debt under Conditions of Imperfect Information," 21 J. Legal Stud. 225 (1992); Adler, "An Equity-Agency Solution of the Bankruptcy-Priority Puzzle," 22 J. Legal Stud. 73 (1993); Schwartz, "Taking the Analysis of Security Seriously," 80 Va. L. Rev. 2073 (1994) [hereinafter, "Schwartz (1994)"]; Kanda and Levmore, "Explaining Creditor Priorities," 80 Va. L. Rev. 2103 (1994); Carlson, "On the Efficiency of Secured Lending," 80 Va. L. Rev. 2179 (1994).

paper.[24]

We show that under a rule according full priority to secured claims the terms of the loan arrangement negotiated between a borrower and its secured creditor are unlikely to be efficient. The problems we focus on are due to the fact that, under such a rule, the creation of a security interest has distributional consequences. In particular, under the rule of full priority the creation of a security interest diverts value to the secured creditor from unsecured creditors that cannot "adjust"

The view that full priority is socially desirable is shared by many writing outside of the law and economics literature. See, e.g., Kripke, "Law and Economics: Measuring the Economic Efficiency of Commercial Law in a Vacuum of Fact" 133 U.Pa.L.Rev. 929 (1985) (full priority increases the supply of credit); White, "Work and Play in Revising Article 9," 80 Va.L.Rev. 2089 (1994) (widespread and longstanding use of security interests demonstrates that they are socially desirable); Harris and Mooney, supra note 7 (full priority required by freedom of contract and property rights principles).

[23] The term "creditors' bargain" was introduced by Dean Jackson to describe the set of bankruptcy rules which creditors would have bargained for had they been able to negotiate among themselves ex ante. See Jackson, "Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain," 91 Yale L. J. 857, 860 (1982). Jackson believed that the hypothetical bankruptcy rules creditors would have bargained for ex ante would be the set of rules that were most efficient. Since Jackson reasoned that the most efficient bankruptcy rules were those which gave creditors as much of their non-bankruptcy entitlements as possible, he concluded that creditors would have bargained among themselves for rule that generally gave each creditor the rights it would have had outside bankruptcy. The "creditors' bargain" thus became shorthand for the view that efficiency requires that secured claims be accorded the same priority in bankruptcy as they are accorded under state law.

[24] Both the "creditors' bargain" view and our analysis of the treatment of secured claims in bankruptcy focus on the division of value among creditors in bankruptcy. A similar but distinct issue is the optimal division of bankruptcy value between creditors (as a group) and shareholders. Under the currently prevailing rule of absolute priority, all creditors are to be fully paid before equityholders receive anything in bankruptcy. In practice, however, the rule of absolute priority is frequently violated. See, e.g., Lopucki and Whitford, supra note 17; Eberhart, et al., "Security Pricing and Deviations from the Absolute Priority Rule in Bankruptcy Proceedings," 45 J. Fin. 1457 (1990); Franks and Torous, "An Empirical Investigation of U.S. Firms in Reorganization," 44 J. Fin. 747 (1989). Although our analysis applies whether or not absolute priority is respected in bankruptcy, for simplicity we assume throughout that creditors as a group are fully paid in bankruptcy before equityholders are entitled to any residual value.

the size of their claims to take into account the existence of the security interest.[25] The possibility of using security interests to divert value from these "non-adjusting" creditors distorts the debtor's choice of contractual arrangements with its creditors, giving rise to certain efficiency costs that we systematically analyze.[26]

Our analysis does suggest that the loan arrangement between a lender and the firm under the rule of full priority would clearly be efficient in a hypothetical world in which the use of a security interest does not have distributional consequences. Assume that when a security interest is created,

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[25] The use of security interests under a rule of full priority to divert value is recognized even by those who defend the rule of full priority. See, e.g., Buckley, supra note 22, at 1418-1419. Through Part V we assume that the use of security interests giving a creditor a secured claim with full priority over unsecured claims makes certain unsecured creditors worse off. In Part VI, we relax this assumption and consider the case where a security interest under full priority may make "non-adjusting" creditors better off.

[26] To our knowledge, this paper provides the first systematic analysis of how full priority distorts a debtor's choice of contractual arrangements with its creditors, leading to the efficiency costs we identify. However, this paper is not the first to make the point that the rule of full priority has adverse efficiency consequences. It has long been recognized that according full priority to secured claims may permit inefficient projects to be financed or, under certain conditions, lead a firm to continue operating when it should be liquidated. See White, "Public Policy Toward Bankruptcy: Me-First and Other Priority Rules," 11 Bell J. Econ. 550 (1980) (full priority may cause firms to overinvest and continue operating inefficiently); Jackson and Scott, "On the Nature of Bankruptcy: An Essay in Bankruptcy Sharing and the Creditors' Bargain," 75 Va.L.Rev. 155 (1989); (full priority may encourage eve of bankruptcy misbehavior by firm's secured creditor); Hudson, "The Case Against Secured Lending," 15 Int'l Rev. L. & Econ. 47 (1995) (full priority may allow firm to continue operating inefficiently). We discuss these particular efficiency problems in Section V.A. when considering the overall desirability of according less than full priority to secured claims. However, our analysis, unlike the analyses presented in these papers, seeks to identify the distortions and efficiency costs that occur under full priority whether or not the firm is in financial distress, and whether or not full priority permits inefficient project to take place.

Jackson and Scott, supra, have also suggested that full priority may be inefficient if creditors' risk preferences are such that they would prefer the risk of default to be shared by all creditors. Cf. Roe, "Commentary on "On the Nature of Bankruptcy": Bankruptcy, Priority, and Economics," 75 Va. L. Rev. 219 (1989) (assessing Jackson's and Scott's risk-sharing theory). In contrast to our more general analysis, which applies even under the standard assumption that commercial parties are risk neutral, their analysis relies on particular assumptions about the distribution of risk preferences among creditors.

the amount owed to all other creditors is adjusted in such a way so as to reflect the impact of the transaction, including the effect on these other creditors of giving the lender a secured claim with full priority in bankruptcy. Under these circumstances, the creation of the security interest under full priority could never impose a negative externality on the other creditors and the security interest could therefore not be used to divert value from these other creditors. Consequently, the security interest would be chosen only if it were efficient. In this hypothetical world, efficiency would thus require giving full priority to the secured claim in the event of bankruptcy.

But the real world is one in which not all creditors can adjust their claims in response to the creation of a security interest giving another creditor priority rights in bankruptcy. Substantial groups of creditors are clearly "non-adjusting" with respect to security interests created in favor of other creditors. Creditors that cannot take the existence of a security interest into account in setting the size of their claims against borrowers include (1) tort creditors; (2) the government (as tax collector and regulator); (3) "rationally uninformed" contractual creditors whose claims are simply too small to justify the cost of taking the security interest into account when contracting with the borrower; and (4) any creditor that extends credit on fixed terms before a decision is taken whether to create a particular security interest, and is thus unable to adjust its claim to take into account whether in fact that security interest has been created.

It should be emphasized that the analysis we offer does not assume that the two categories of voluntary non-adjusting creditors are, in the aggregate, "victimized" by the creation of a security interest giving another creditor a secured claim. It would not affect our conclusion if all voluntary creditors extended credit on terms which reflected perfectly the expected risk of loss arising from the presence of secured claims so that, on average, there were no transfer of value from these creditors. Nor does our analysis depend on the existence of tort or government claims; the problems

we identify would still occur in a world without involuntary creditors, albeit to a lesser degree. Our analysis relies only the fact that, with respect to every borrower, there invariably will be non-adjusting creditors that do not adjust the size of their claims against the borrower when the borrower creates a security interest in favor of another creditor. As the paper demonstrates, the failure of these non-adjusting creditors to adjust their claims to the creation of security interests turns out to have important efficiency implications.

The existence of non-adjusting creditors means that a borrower and a creditor may use a security interest to transfer bankruptcy value from non-adjusting creditors. The fact that security interests may be used to transfer value under a full priority rule implies that security interests may be used even when they give rise to inefficiencies. In particular, we show that the rule of providing full priority to secured claims may cause excessive use of security interests, encourage firms to take too few precautions or undertake inefficient investments, distort the choice between the use of security interests and covenants in loan contracts, and reduce the incentive of secured creditors to ensure that borrowers comply with all of their contractual and statutory obligations.

Accordingly, we believe that the efficiency case for the rule of full priority is at best problematic. We therefore present as candidates for replacing the rule of full priority two different bankruptcy priority rules that would reduce or eliminate the inefficiencies we identify by according only partial priority to secured claims. The first partial priority rule considered--the "adjustable priority rule"--would provide non-adjusting creditors with their pro rata share of all of the bankrupt debtor's assets —- regardless of whether those assets are subject to security interests. Under the second partial priority rule--"the fixed-fraction priority rule," a fixed percentage of the assets backing secured claims would be added to the pool of assets available in bankruptcy to pay unsecured claims.

Neither of the partial priority rules presented is superior to the rule of full priority in all

respects. Moving to any partial priority rule would involve certain efficiency costs. However, our preliminary analysis does suggest that the efficiency costs of a partial priority rule are likely to be relatively modest and that, on balance, there is likely to be a version of the partial priority rule that is superior to full priority from the standpoint of efficiency. Our analysis also considers the validity of other possible objections to the adoption of a partial priority rule. We show that a partial priority rule would be consistent with considerations of fairness as well as with considerations of contractual freedom. After examining certain enforcement problems that might arise under a partial priority rule, we also conclude that such a rule could be feasibly implemented.

The adoption of a partial priority rule might appear radical in light of the long history of the principle of full priority in U.S. bankruptcy law[27] and the widely held view that the rule is desirable.[28] It is widely recognized, however, that under the existing regime secured creditors do not expect that their secured claims will always be fully paid.[29] Thus, the adoption of a legal rule providing explicitly that secured claims will not be paid in full need not profoundly change the actual legal environment in which secured creditors do business.

Notwithstanding the fact that secured claims now are not always given full priority in bankruptcy, the notion that a secured creditor should be entitled in bankruptcy to the value of the collateral securing its claim (up to the amount of the claim) is so deeply ingrained in current thinking about the subject that it is worthwhile, before proceeding with our analysis, to offer an intuitive explanation as to why a rule according full priority to secured claims is actually inconsistent with a fundamental and naturally appealing principle of bankruptcy law: that like creditors are entitled to

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[27] See Baird and Jackson, supra note 3.

[28] See supra note 22 and accompanying text.

[29] See supra note 19 and accompanying text.

like treatment in bankruptcy.[30] Under the bankruptcy rules of most countries, including the United States, like creditors must share pro rata in the assets available to be distributed to them.[31] Consequently, a borrower is not permitted to give the claim of one creditor priority in bankruptcy over that of a similarly situated creditor. For example, an unsecured creditor ("C1") may not contract with the borrower for its claim to have priority in bankruptcy over that of another unsecured creditor ("C2").[32] Were the borrower to contract with C1 for such an arrangement, the contract would be completely disregarded if the borrower ever entered bankruptcy.[33] Indeed, the only way for C1 to subordinate C2's claim is by negotiating a subordination agreement with C2 under which C2 promises to pay C1 as much of what C2 receives in bankruptcy as is necessary to make C2 whole.

However, while the debtor may not give C1's claim priority over that of another creditor by simple contract, under a rule of full priority it may do so simply by creating a security interest in favor of C1 that C1 then perfects. Since the general rule is that the debtor may not give C1's claim priority over that of a single other creditor, it would appear peculiar that by complying with a few mechanical procedures the debtor and C1 can arrange to have C1's claim given priority over the claims of all unsecured creditors without their consent. This is the discontinuity on which our work focuses. As our paper will demonstrate, there are economic reasons why such a discontinuity --at least to full extent permitted under current legal principles--is undesirable.

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30 See Jackson and Kronman, supra note 22, at 1147; Warren, "Bankruptcy Policy," 54 U. Chi. L. Rev. 775, 791 (1987).

31 See generally International Corporate Insolvency, supra note 1.

32 See Rogers, supra note 7, at 994.

33 See Rogers, supra note 7, at 994.

To be sure, there would appear to be a clear difference between a simple contract between the debtor and C1 providing priority to C1's claim over that of C2 and a security interest created by the debtor that leads to the same outcome. In order for the security interest to give C1's claim full priority over that of C2, C1 generally must perfect the security interest by recording it in a public registry.[34] It might therefore be argued that a security interest and a simple contract giving C1's claim priority over that of C2 are not really alike: other creditors may be able to learn about the security interest, while it would be difficult to discover the existence of a simple contract.

However, notwithstanding the notice provided by the perfection of C1's security interest, non-adjusting creditors - including creditors which extend credit on fixed terms before the security interest is created, and thus have no opportunity to learn about its existence - do not adjust the size of their claims to take into account the creation of that security interest. And, as we will show, whenever a full adjustment does not occur, a rule permitting the debtor to confer full priority on C1's claim by creating a security interest has undesirable efficiency consequences.

The paper is organized as follows. Part II considers the efficiency implications of loan arrangements, and in particular the efficiency consequences of the security interests and covenants that make up such arrangements. We also show in Part II that security interests may be inherently inefficient. Part III introduces the distinction between adjusting and non-adjusting creditors, demonstrates that many creditors are "non-adjusting," and shows that the presence of non-adjusting creditors may lead to the inefficient use of security interests when secured claims are accorded full priority in bankruptcy. Part IV describes the five types of efficiency costs that arise under the rule of full priority. Part V discusses the two partial priority rules that would reduce or eliminate these distortions. Part VI considers various possible objections to adopting a partial priority rule and

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[34] See supra note 9 and accompanying text.

assesses the overall desirability of such a rule. Part VII concludes the paper.

II. THE EFFICIENCY CONSEQUENCES OF SECURITY INTERESTS AND COVENANTS

Before we analyze how the rule of full priority distorts loan contracts between commercial borrowers and their creditors, and identify the various efficiency costs generated by these distortions, it is necessary explore why the loan arrangements between firms and their creditors have efficiency implications in the first place.

As this Part will explain, a firm may have an incentive to act inefficiently once it borrows money from a creditor. Since inefficient behavior by the firm will increase the creditor's risk of loss, the creditor may incorporate into the loan contract a security interest and/or other provisions ("covenants") that will reduce the firm's ability to act inefficiently during the period of the loan. Although any security interest or covenants issued by the firm will make shareholders worse off by limiting their freedom of action, the shareholders may nevertheless agree to these restrictions if they cause the creditor to reduce its interest rate sufficiently to make the shareholders--on balance--better off.

To the extent a security interest (or set of covenants) incorporated into the loan contract reduces the firm's ability to act inefficiently, the security interest (or set of covenants) will yield an efficiency benefit. However, as this Part also explains, the use of a security interest or set of covenants will give rise to efficiency costs. If the efficiency costs of using a security interest (or set of covenants) are greater than the efficiency benefits, the security interest (or set of covenants) will be inefficient. Since the efficiency benefits and costs of a particular security interest are likely to be different than the efficiency benefits and costs of a set of covenants that might have a similar effect on the firm's ability to act inefficiently, in some cases a security interest may be efficient, but not as efficient as

a comparable set of covenants (and vice versa). Indeed, we will show in this Part that the actual behavior of creditors demonstrates that security interests are often inefficient or less efficient than a set of covenants. Thus the decision to include or exclude a particular security interest or set of covenants from a loan contract will have efficiency consequences. And, as we will explain in Part IV, some of the efficiency costs of full priority arise because the rule causes commercial borrowers and their creditors to incorporate inefficient security interests into their loan arrangements and to not adopt even highly efficient covenants.

A. The Loan Contract Between Firm and Creditor

Our analysis will focus on the paradigmatic case of a hypothetical corporate borrower ("D") and a hypothetical creditor ("C") that is in the business of lending money, such as a bank, finance company, or insurance company.[35] We assume that C's claim is sufficiently large that the parties may find it worthwhile to negotiate a loan contract. The loan contract between C and D may (but may not) contain a security interest and/or "covenants."[36] The loan contract will promise payments of interest to C that will reflect C's risk of loss and the various costs it expects to incur in connection

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[35] Although our analysis focuses on the case of a hypothetical corporate borrower, it is applicable to any entity that is engaged in commercial activity, such as a partnership, trust, or proprietorship.

[36] We use the term "covenant" to describe an obligation by D to C that benefits all of D's creditors to the extent they are not protected by a security interest. For example, a contractual term in the loan agreement requiring that D insure, maintain, and allow the inspection of collateral subject to C's security interest would not be considered a covenant (but rather an element of the security interest), while a restriction on dividend payments would be considered a covenant. A covenant may be either negative, such as a prohibition on D from undertaking specified investments or issuing dividends to shareholders, or positive, such as a requirement that D maintain a certain net worth. See generally Smith and Warner, "On Financial Contracting," 7 J. Fin. Econ. 117 (1979).

with the loan,[37] which in turn will depend on the extent to which the parties incorporate a security interest and covenants into the loan agreement.[38]

The arrangement negotiated between C and D will also implicitly incorporate mandatory state rules that govern the relationship between commercial borrowers and their creditors, including the rule determining the treatment of secured claims in bankruptcy.[39] We will focus on the effect of different bankruptcy priority rules on all aspects of the loan arrangement that C and D negotiate, including the use of security interests and covenants and the choice of interest rate.

It is assumed throughout the analysis that the option to create a security interest giving C full priority in specified assets of D, while potentially beneficial to C and D, is not critical to the transaction. That is, we assume that C will extend credit to D even if its secured claim does not receive full priority in bankruptcy, although in such a case the interest rate may be higher and more covenants may be adopted. In Part VI, where we consider the overall desirability of partial priority, we extend the analysis to the case in which without full priority certain loan transactions--and the activities they are intended to finance--will not take place.

B. Efficiency

As explained, we focus on the effect of different bankruptcy priority rules on the arrangement

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[37] See generally, Black, "Bank Funds Management in an Efficient Market," 2 J. Fin. Econ. 323 (1975).

[38] We assume that C does not seek to further protect itself through arrangements with parties other than D, such as by requiring guarantees from D's shareholders. However, it would not affect our conclusions if C and D's shareholders negotiated such an arrangement.

[39] Other background rules that might bear on the relationship between C and D include fraudulent conveyance law, dividend restrictions under corporate law, and various reporting requirements under state and federal law. See generally R. Clark, Corporate Law (1986).

negotiated by C and D. In evaluating the desirability of the arrangement between C and D, our perspective is that of efficiency.[40] From the standpoint of efficiency, the arrangement will be desirable to the extent that it increases social wealth. That is, the efficient arrangement is the one that maximizes the value captured by D, C, and all other parties affected by the arrangement, which we assume to be D's other creditors.[41]

However, C and D will have an incentive to shape the arrangement — which may or may not include a security interest — in the way which maximizes their private joint gains. As we will see in Parts III and IV, the arrangement they will find privately optimal is unlikely to be the arrangement that is socially optimal. Our aim in those Parts will be to systematically analyze the ways in which the rule of full priority for secured claims increases the divergence between the socially desirable arrangement and the one that is best for them.

C. The Problem of Firm Misbehavior

As explained, the loan contract between C and D will affect social wealth primarily by reducing D's ability to engage in inefficient activities following the extension of credit. Although it is by now well understood that the owners of a firm will often have an incentive to act inefficiently once the firm borrows money, some simple numerical examples are provided to make this point concrete.[42]

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[40] This is the perspective that has been adopted by most of the commentators examining the full priority rule. See supra note 22.

[41] We adopt the assumption standard in the literature that externalities from arrangements between a debtor and a creditor impinge only on other creditors. The analysis we offer would also apply if these arrangements do not systematically differ in their effects on parties other than creditors.

[42] Readers who are familiar with the concept of debtor opportunism and the various forms debtor opportunism takes may wish to proceed directly to Section D.

Assume that D has $10 of assets (and no liabilities) when it borrows $10 each from C and another creditor C2, its only creditors. In return for the funds, D promises to pay each creditor $11 at the end of the year. Subsequently, the owners are faced with a choice between two projects, X and Y. Project X promises a 50% chance of yielding $44 by the end of the year, and a 50% chance of yielding $22. By the end of the year, Project Y will yield $48 with 50% probability and $4 with 50% probability. Since Project X has an expected value of $33 and Project Y has an expected value of $26, from the standpoint of efficiency it would be desirable for the owners of D to pursue Project X.

Now consider the incentives facing D's owners. At the end of the year, creditors' claims must be paid before the owners get the residual value of D, if any. If the owners pursue Project X, the residual value available to them at the end of the year will be $22 if the project succeeds, and $0 if the project fails.[43] Thus the expected value to the owners of Project X is $11.[44] The residual value from Project Y will be $26 if the project succeeds, and $0 if the project fails, providing the owners with an expected return of $13. The owners will therefore choose Project Y because its expected value to them is greater. Note that by choosing Project Y instead of Project X, D's owners reduce the expected value of the creditors' claims by $9, while only increasing the expected value of their interests by $2.

The more general problem illustrated by this simple example is that the objective of a firm's

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[43] The payoff from Project Y will be $44 if it succeeds and $22 if it fails. In either case, D will pay $22 to C and C2, the amount owed under the loan contracts. As a result, the owners of D will be left with $22 if the project succeeds and nothing if it fails.

[44] The expected value of the project is simply the payoff under each contingency multiplied by the probability of that contingency occurring: i.e., .5(22) + .5(0) = 11.

owners, which is to maximize the expected value of their residual interest in the firm[45] does not take into account the effect of the firm's activities on it's creditors.[46] As a result, the firm's shareholders will be willing to pursue activities that increase the expected loss facing creditors, if by doing so they can increase the expected value of their interest in the firm. Such debtor "opportunism" or "misbehavior" will be inefficient if, as in the example above, the expected value of creditors' claims decreases by more than the increase in the expected value of the owners' claims.[47]

The particular type of debtor opportunism illustrated in the example--the choice of a risky but inferior project that shifts value from creditors to shareholders--is sometimes described as "overinvestment."[48] A firm's owners will often prefer higher-risk, higher-return projects since they will capture all of the additional return if the project succeeds. Creditors as a group will generally be made worse off by higher-risk, higher-return projects because such projects increase the likelihood

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[45] Although it is not necessary for our analysis, we assume, for ease of exposition, that those controlling D always seek to maximize equity value. This assumption is realistic with the respect to all but large publicly traded firms, where there is a separation of ownership and control. However, even managers of these firms will have an incentive to increase the value of equity unless it is not privately beneficial for them to do so.

[46] Both private and public owners are indifferent to the effect of D's activities on its creditors because, under the rule of limited liability, they need not make D's creditors whole if D is unable to pay its debts.

[47] "Opportunistic" behavior that reduces the value of creditors' claims is not always undesirable from the perspective of efficiency. If the "misbehavior" increases the value of shareholders' claims by more than it reduces the value of creditors' claims, the "misbehavior" will increase social wealth and therefore be efficient.

[48] This type of "misbehavior" and its different forms are also sometimes referred to as "risk alteration," "asset substitution," or "variance enhancement." See generally Smith and Warner, supra note 37, at 118; W. Klein and J. Coffee, Jr., Business Organization and Finance, 306-38 (4th Ed. 1990).

that the firm will fail and their claims will not be fully paid.[49]

The shareholders of a firm may also act opportunistically by engaging in "asset dilution"--taking assets out of the firm where they will be out of reach of creditors if the firm fails.[50] Although both corporate and commercial law place some limits on the ability of a firm to distribute value to its shareholders when the firm is insolvent,[51] those controlling the firm nevertheless retain substantial discretion in deciding whether or not to transfer corporate assets to shareholders. Since a firm's creditors are generally made worse off when assets are removed from the firm,[52] asset dilution may be inefficient.

Continuing the previous example, suppose that D's owners are now pursuing Project Y, the inefficient project that is expected to make them best off. At some point before the project is completed, the opportunity arises to remove $1.50 in cash from D. Assume further that if $1.50 in cash is removed from D, Project Y will yield $2 (instead of $4) if it fails and $46 (instead of $48) if it succeeds. The expected value of Project Y will thus be reduced by $2. Since removing the $1.50 will lead to a net loss of $.50, the asset dilution will be inefficient. Nevertheless, D's owners will choose to remove the assets because by doing so they end up with $1.50 in cash and claims on D worth $23, while otherwise they would have claims on D worth only $24.

Yet another form of debtor opportunism, "claim dilution," is the dilution of existing creditors'

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49 See Triantis, supra note 22, at 237.

50 See Smith and Warner, supra note 36, at 118.

51 See generally Clark, supra note 39.

52 See Triantis, supra note 22, at 235. The removal of assets from a firm will make creditors worse off by (1) reducing the amount of assets which will be available to them in the event the firm defaults and perhaps (2) increasing the probability of default.

claims by further borrowing.[53] The efficiency consequences of "claim dilution" will, of course, depend on the use to which the funds are put. The new funds may allow a project with a higher social value than the current project to go forward. In such a case, the claim dilution will be efficient (even though existing creditors may be made worse off by the presence of new claims against the firm). However, if the new funds enable the firm to engage in inefficient overinvestment or asset dilution, the claim dilution will be inefficient.

From the perspective of efficiency, the most desirable loan contract between a firm and a creditor is the one which minimizes all efficiency costs, including those arising from debtor opportunism. We now very briefly consider how security interests may, by reducing inefficient debtor opportunism and other efficiency costs, be part of socially desirable arrangements between commercial borrowers and their creditors.

D. The Efficiency Benefits of Security Interests

There is a substantial literature demonstrating that security interests may yield various efficiency benefits when incorporated into a loan contract.[54] At this point in our analysis, however, there is no need to describe any of these benefits at length. Since the purpose of this Section is merely to acknowledge that security interests may yield efficiency benefits and therefore be part of the socially optimal arrangement between commercial borrowers and creditors, it will suffice for now simply to cite some of the most important potential efficiency benefits of security interests identified in the literature.

However, it will be useful to organize these efficiency benefits into two categories: those which

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[53] See generally Smith and Warner, supra note 36, at 118.

[54] See supra note 22.

arise from bankruptcy priority being accorded to secured claims ("priority-dependent benefits") and those ("priority-independent benefits") which do not. This distinction, although not important now, will become critical in Part VI when we consider the overall desirability of according less than full priority to secured claims. At that point, we will examine more closely the priority-dependent benefits of security interests in order to weigh the efficiency costs that would result from not according full priority to secured claims in bankruptcy.

Let us turn first to the priority-independent efficiency benefits of security interests. Recall that a security interest accords special rights to the secured creditor outside of bankruptcy: a "property right" and a "priority right." The "property right" permits the secured creditor to seize the collateral from the borrower more quickly than it could as an unsecured creditor.[55] The "priority right" gives the secured creditor priority in the collateral that remains attached even if the collateral is sold, transferred, or pledged to other parties.[56] Consequently, the security interest makes the collateral virtually worthless in the hands of transferees, other creditors, and non ordinary-course purchasers because the secured creditor continues to have the right to seize the collateral if the borrower does not pay its debt even if the collateral is no longer in the borrower's possession.

These two features of security interests, which are not dependent on the priority accorded secured claims in bankruptcy, give security interests the ability to (1) reduce overinvestment by preventing the borrower from selling or pledging the collateral to raise funds for an inefficient

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[55] However, an important limit on the secured creditor's ability to seize the collateral is that it cannot breach the peace to do so. See U.C.C. Section 9-503.

[56] See, e.g., U.C.C. Section 9-312. However, if the borrower sells the collateral in the ordinary course of his business to a good faith purchaser, the security interest will not remain attached when the property is transferred to the purchaser. See U.C.C. Section 9-307.

project;[57] (2) reduce inefficient asset dilution by preventing the borrower from transferring the collateral to its shareholders, or selling or pledging the collateral to raise funds to transfer to its shareholders;[58] (3) reduce the costs associated with default by allowing the secured creditor to avoid judicial process;[59] (4) indirectly reduce inefficient behavior by increasing the expected cost to the borrower of violating covenants in the loan contract with the secured creditor;[60] and (5) reduce socially excessive "monitoring" of the borrower when it is suffering financial difficulties.[61]

If priority is accorded to secured claims in bankruptcy, security interests may (1) reduce the cost

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[57] See Smith and Warner, supra note 36, at 127; Stulz and Johnson, supra note 22, at 513; Triantis, supra note 22, at 247.

[58] See Stulz and Johnson, supra note 22, at 513; Triantis, supra note 22, at 247; Carlson, supra note 22, at 2191.

[59] See Schwartz (1981), supra note 22, at 29; Kripke, supra note 22, at 948; Leeth and Scott, supra note 22, at 381. If the borrower has more than one secured creditor, transaction costs may be further reduced by having each creditor take security interests in collateral it enjoys a specialized ability to resell. See Buckley, supra note 22, at 1425.

[60] The "property right" right reduces the cost to the secured creditor of declaring default, thereby increasing the likelihood that the secured creditor will seek to recover the unpaid balance on the loan from the borrower if it discovers a violation of a covenant. The "property right" also allows the secured creditor to seize the collateral and (if the borrower is too cash-constrained to bid for the collateral) sell it at a price below its value to the borrower. The increased likelihood that the secured creditor will call a default, and the possibility that the collateral will be seized and sold below its value to the borrower, together raise the expected cost to the borrower of defaulting on the covenants, thereby making compliance more likely. See Triantis, supra note 22, at 246; Carlson, supra note 22, at 2190. A number of commentators have also suggested that since it is more painful for a borrower to default on a secured loan than an unsecured loan, a borrower may be able to "signal" the high quality of its projects--and thereby procure credit at a lower cost--by offering a security interest to a potential lender. See, e.g., Triantis, supra note 22, at 246.

[61] If the borrower's assets are not secured, an unsecured creditors might "overmonitor" the borrower for signs of impending failure in order to grab the borrower's limited assets before other creditors and before the borrower enters bankruptcy. See Picker, supra note 22.

to secured creditors of acquiring information about the borrower;[62] (2) reduce socially excessive monitoring of borrower that have more than one sophisticated creditor;[63] and (3) increase socially insufficient monitoring of borrowers that have more than one creditor.[64] As explained, each of the efficiency benefits will be discussed at length in Part VI.

The magnitude of each of these benefits will of course vary from case to case, and may depend on the other terms of the borrower's loan contract with the creditor, as well as the terms of the borrower's loan contracts with other creditors. However, as the next Section explains, there will be instances where the use of a security interest will be socially undesirable even when the efficiency benefits it generates are substantial.

E. The Efficiency Costs of Security Interests

Although a security interest might yield, to varying degrees, some of the efficiency benefits just described, the use of the security interest will not be efficient if, all else being equal, the efficiency costs inherent in the use of the security interests (those efficiency costs that would arise even if all creditors were perfectly adjusting) exceed those benefits. Below we describe three types of efficiency costs inherent in the use of security interests that have not received as much attention in the literature as the potential benefits of security interests: "transactional costs," "enforcement costs," and "flexibility costs."

We first turn to the costs of creating and perfecting security interests, which we term

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62 See Part VI.A.

63 See Part VI.A.

64 See Part VI.A.

"transactional costs." In order to prevent inefficient misbehavior, the security interest must give the secured creditor an enforceable "property right" and "priority right" in the collateral. While the cost of drafting a security agreement that gives the secured creditor a "property right" in the collateral is trivial, complying with the procedural requirements necessary for the creditor to have a "priority right" can be quite expensive, at least with respect to personal property.[65] To ensure that the security interest is effective against third parties, the secured creditor must first ascertain that the collateral is not encumbered by any prior liens which would take priority,[66] and then "perfect" its interest — either by taking possession of the collateral or filing a financing statement in a public registry or registries — so that it will be effective against future claimants.[67] The design of the public registry system in the United States often makes both of these procedures cumbersome and therefore expensive, particularly in multi-state transactions.[68]

To be sure, if the secured creditor is satisfied with a security interest that is only 90% likely to be effective against the claims of other parties, it need not conduct the most thorough search or

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[65] Acquiring priority in real property is relatively inexpensive. See generally, Johnson, supra note 22.

[66] Prior perfected security interests in personal property will generally have priority over later perfected security interests. See U.C.C. Section 9-312.

[67] See U.C.C. Section 9-203.

[68] Under the U.S. system, prior valid liens may be filed in any number of states other than the one the collateral is currently located in. A prior valid lien may also be filed under a name other than the one currently used by the debtor. See U.C.C. Sections 9-103 and 9-402(7). For a description of these and other types of filings which are essentially undiscoverable under the present filing system, see Lopucki, "Computerization of the Article 9 Filing System: Thoughts on Building the Electronic Highway," 55 L. & Contemp. Prob. 7 (Summer 1992); McLaughlin, "Seek But You May Not Find: Non-U.C.C. Recorded, Unrecorded, and Hidden Security Interests Under Article 9 of the Uniform Commercial Code," 53 Ford.L.Rev. 953 (1985). New liens must frequently be registered in a number of different states (so as to ensure priority in the assets as they move from state to state). A description of the expense of filing in different states is found in Lopucki, supra.

file in every conceivably relevant registry. However, if the secured creditor has a large claim against the borrower it will have an incentive to invest considerable resources to increase the likelihood that its rights in the collateral remain effective against other parties. Indeed, anecdotal evidence suggests that the process of perfecting certain security interests in the U.S. can be relatively expensive.[69]

Once the security interest is created and perfected, the secured creditor will incur costs ensuring that the security interest remains effective - "enforcement costs." To ensure that the secured creditor's "property right" and "priority right" remain effective, the secured creditor must "police" the collateral to ensure that the collateral retains as much value as possible, that the collateral is not dissipated, transferred to an unknown party, or destroyed, and that the secured creditor's claim is not subordinated to that of a future claimant.[70]

The final and perhaps most important efficiency cost of a security interests is that it may restrict the borrower's ability to engage in efficient activities. To the extent the security interest remains effective, it can reduce the borrower's ability to engage in overinvestment, inefficient asset dilution, or inefficient claim dilution that would require the disposition or pledging of the collateral. Insofar

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[69] See, e.g., Alces, "Abolish the Article 9 Filing System," 79 Minn.L.Rev. 679, 690 (1995) (reporting a study finding that the typical filing cost of a secured transaction handled by a large Boston law firm was 5.52% of total legal fees for the transaction, or approximately $25,000); Bleakley, "Many Midsized Firms Still Find That Insurers and Banks Deny Loans," Wall St. J., A1, A6 (Nov. 16, 1992) (borrower reporting that it must pay "10 times as much in lawyers' fees" to put security interests into a loan agreement).

[70] The secured creditor may lose priority in personal property collateral, if, for example, the filing lapses (see U.C.C. Section 9-403), the debtor creates another security interest in the property under a new name (see U.C.C. Section 9-402(7)), or the collateral is moved to another state and made subject to a new security interest (see U.C.C. Section 9-103). The cost of policing the collateral will vary from case to case, depending largely on the nature of the assets subject to the security interest. The cost of monitoring mortgaged real property, for example, will be less than the cost of monitoring collateral in the form of accounts receivable. See generally, Johnson, supra note 22.

as the security interest prevents the borrower from engaging in activities that decrease social wealth, the security interest provides an efficiency benefit. However, the security interest may also prevent the borrower from undertaking certain projects, distributing assets to its shareholders, or borrowing additional funds where those activities would be efficient, creating what we term a "flexibility cost."[71]

The magnitude of each of these costs will of course be greater in some cases than in others. The important point for our analysis is that there are inherent efficiency costs to using a security interest, and that when those efficiency costs are greater than the efficiency benefits, a security interest will be inherently inefficient.

F. Comparing Security Interests and Covenants

We begin our comparison of security interests and covenants by observing that there are intrinsic limits to the ability of a security interest to prevent inefficient behavior. First, there are a number of legal and practical reasons the security interest may simply fail to be effective against third parties.[72] And if the security interest fails to give the creditor an effective "priority right" in the collateral, the collateral may be used for inefficient asset dilution or sold to finance an inefficient investment.

Furthermore, even if the secured creditor retains an effective "priority right" in the collateral,

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[71] See, e.g., Triantis, supra note 22, at 248; Buckley, supra note 22, at 1439; Carlson, supra note 22 at 2190.

[72] A security interest may fail to effectively give the secured creditor a "priority right" because (1) it is legally defective at the time it is created, (2) it later becomes subordinated to the security interest of another creditor, (3) third parties are unaware that the secured creditor has priority in the collateral or (4) the collateral is difficult to identify and trace so that it can easily by disposed of by the borrower.

the security interest can at most prevent the borrower from acting inefficiently in ways that would require the sale, transfer, or pledging of the collateral. A security interest cannot prevent the borrower from using the collateral to engage in overinvestment, or from using other assets for that purpose.[73] Nor will a security interest prevent the borrower from inefficiently transferring other assets to its shareholders.

In contrast, creditors and borrowers may draft covenants in such a way that they reach almost every aspect of the borrower's activities. A creditor and a borrower may negotiate covenants to directly or indirectly restrict the borrower's investment activities, to bar the creation of certain security interests, to limit dividend and other payments to shareholders, or even to require the borrower to remain in the same line of business.[74] For example, if it were believed that any asset dilution by the borrower would hurt the creditor more than it would benefit shareholders, a covenant could be drafted that barred the borrower from making any payments to shareholders. Achieving a similar result solely with security interests would require subjecting all of the borrower's current and after-acquired property to security interests, which in turn would generate significant flexibility costs.

To be sure, there are efficiency costs inherent in the use of any set of covenants, and these costs may often be substantial. The fact that the borrower has agreed to a set of covenants as a condition for obtaining a loan does not ensure that it will continue to abide by them. At some point the borrower may find that it could benefit from violating the terms of its loan agreement with the creditor. To deter such a breach, the creditor must convince the borrower that the creditor is likely to discover such a violation and then punish the borrower--either by ruining its reputation, thereby

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[73] See Buckley, supra note 22, at 1438.

[74] See generally Smith and Warner, supra note 36.

reducing the borrower's future access to credit markets, or by calling a default and suing for repayment, or both. To make such threats credible and deter breach, the creditor must periodically check to see if the borrower is continuing to comply with the covenants, incurring "enforcement costs." These enforcement costs may be high if the borrower can easily conceal its transactions with related or friendly parties. The parties may also incur "transactional costs" drafting the covenants. Finally, since it will be impossible for the covenants to specify all contingencies in advance, covenants may be overinclusive and generate their own flexibility costs.[75] Thus there will be many cases where a set of covenants is inherently inefficient, or efficient but less efficient than a comparable security interest, taking into account all of the borrower's arrangements with its creditors.

However, the critical point is that there will be situations where even an efficient security interest is less efficient than an appropriate set of covenants.[76] In these cases, the use of the security interest will be socially undesirable.

G. Evidence That Security Interests Are Often Inefficient

On the basis of the analysis just presented, it should be clear that there are cases where a security interest is inherently inefficient or less efficient than a set of covenants. The data on secured lending by sophisticated creditors is in fact consistent with that conclusion.

Sophisticated creditors are frequently observed choosing not to incorporate security interests into

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[75] See Triantis, supra note 22, at 240.

[76] See Triantis, supra note 22, at 258.

their loan agreements.[77] Indeed, these lenders frequently negotiate a "negative pledge covenant" with borrowers that severely restricts the borrowers' ability to borrow on a secured basis.[78] As will be explained shortly, such covenants would not be adopted unless they were efficient. The widespread use of negative pledge covenants in loan contracts therefore indicates that there are many circumstances in which it would be inefficient for borrowers to create the security interests prohibited under the covenant. Consequently, the prevalence of negative pledge clauses demonstrates that security interests are often inefficient.

To see why a negative pledge covenant would be adopted only if it were efficient, consider the effect of such a covenant on the borrower's shareholders and the negative pledge creditor. A negative pledge covenant reduces the value of the shareholders' interests in the borrower by constraining the borrower's freedom of action. Thus such a covenant would not be adopted unless

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[77] The most direct evidence that sophisticated creditors do not always take security interests is that many companies borrow from sophisticated creditors on an exclusively unsecured basis. See Leeth and Scott, supra note 4, at 379 (reporting 1983 National Federation of Independent Businesses study that 40% of the small businesses with commercial bank loans did not provide collateral). See also Lopucki, supra note 7, at 1925 (reporting Federal Reserve statistics on lending by commercial banks to the effect that 58% of $41.2 billion in short term loans were unsecured and 35% in long term loans were unsecured); Berger and Udell, "Collateral, Loan Quality, and Bank Risk," 25 J. Mon. Econ. 21 (1990) (reporting that 30% of commercial and industrial loans are unsecured).

[78] Negative pledge covenants are incorporated into most unsecured term loans originated by banks, insurance companies, and other institutional lenders. See McDaniel, "Are Negative Pledge Clauses in Public Debt Issues Obsolete?" 38 Bus. Law. 867, 872 (1983). The use of negative pledge covenants is also widespread among publicly traded firms. See Lehn and Poulsen, "Contractual Resolution of Bondholder-Stockholder Conflicts in Leveraged Buyouts," 34 J. L. & Econ. 645 (1991) (reporting that 50% of investment grade public bond issues and 46% of junk bond issues contained restrictions on the ability of the borrower to issue secured debt). A recent study found that, in a sample of public debt issues rated A or higher, over 90% of the issues restricted the borrower's ability to incur future secured debt. See Iskandar-Datta and Emery, "An Empirical Investigation of the Role of Indenture Provisions in Determining Bond Ratings," 18 J. Banking & Fin. 93, 97, 99 tbl. 2 (1994). Indeed, it is the only restriction found in many debentures. McDaniel, supra, at 870.

it increased the value of the negative pledge creditor's claim by an even greater amount, enabling the negative pledge creditor to reduce the interest it charges the borrower sufficiently to make shareholders--on balance--better off with such a covenant. Assuming that all of the costs and benefits of such a provision were captured by the negative pledge creditor and the borrower, the use of a negative pledge covenant in a particular case would indicate that the covenant was efficient.

However, while the negative pledge creditor and the borrower bear all of the costs associated with the covenant, they do not enjoy all of the benefits. Whenever a borrower issues a covenant to an unsecured creditor, the benefits are shared by all unsecured creditors in proportion to their claims. That is, the contracting creditor does not capture all of the benefits flowing from the covenant - only its proportional share of those benefits. The remaining benefits will be enjoyed by other creditors of the borrower. Thus the use of a negative pledge covenant shows not only that the benefit of such a covenant exceeds its cost--but that the negative pledge creditor's share of the benefit alone exceeds the cost of the covenant. This in turn suggests that the efficiency benefit of such a negative pledge covenant--and therefore that the efficiency cost of the security interests its prohibits--may be substantial.

The fact that so many sophisticated creditors lend on an unsecured basis (with or without negative pledge covenants) also suggests that security interests are often inefficient. The failure of a sophisticated creditor to take a security interest in a borrower's assets means that the efficiency costs the creditor and the borrower would bear from creating the security interest are greater than the efficiency benefits they would enjoy from such a security interest and the expected value of the bankruptcy priority conferred by the security interest. One might argue that the borrowers with respect to which sophisticated creditors do not take security interests are those which are least likely to fail, and therefore that bankruptcy priority in these borrower's assets has little expected value.

Thus, the argument might go, the failure of a sophisticated creditor to use a security interest in a particular case might demonstrate only that a security interest would have been inefficient but not that the inefficiency would necessarily have been significant.

However, the widespread use of negative pledge covenants indicates that sophisticated creditors do believe that even with respect to highly rated large, publicly traded firms, the risk of failure is sufficiently high to make it worth negotiating for a contract that ensures that their claims will not be subordinated in bankruptcy. Since the use of negative pledge clauses evidences the creditors' concern about their standing in bankruptcy, it stands to reason that these creditors would place some value on the bankruptcy priority accorded by a security interest. The failure of a sophisticated creditor to use a security interest in a particular case thus does suggest that the efficiency cost of using a security interest might have been substantial.

Moreover, a recent study of financially distressed large public companies which entered Chapter 11 found that these companies issued very little or no secured debt even as they approached bankruptcy, that is, even as the expected value of priority became increasingly large.[79] To be sure, it is likely that most, if not all, of these publicly traded companies were barred by "negative pledge covenants" from issuing secured debt.[80] One might therefore infer that the failure of these firms to issue secured debt does not prove that a security interest would have been inefficient. However, companies in financial distress frequently offer their large unsecured creditors security interests in exchange for lower interest rates or other concessions.[81] Thus, even if all of the companies in the study had issued negative pledge covenants, the failure of a substantial number of these companies

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79 See Lopucki, supra note 7, at 1924.

80 See supra note 78 and accompanying text.

81 See Lopucki, supra note 7, at 1927 n. 153.

to grant security interests to their negative pledge creditors in exchange for interest rate or other concessions would still suggest that the cost to these borrowers of creating security interests would have been greater than the expected value of priority to the negative pledge creditors in the period before bankruptcy. Finally, it is worth noting that a substantial portion of small firms - which are statistically more likely to fail than larger firms[82] - borrow on a completely unsecured basis.[83] The actual behavior of firms thus indicates that even when the value of priority might be relatively high, sophisticated creditors and borrowers find they are better off not using security interests. This in turn strongly suggests that even in those cases where a sophisticated unsecured creditor does not use a negative pledge covenant the creation of a security interest would likely have been inefficient.

Our analysis and the empirical evidence indicate that the security interests may sometimes be inefficient, efficient but less efficient than a set of covenants, or more efficient than a set of covenants. The socially optimal arrangement—-the one that would maximize total wealth—-may thus contain any combination of security interests and covenants. The question we will next consider is how the rule of full priority for secured claims affects the incentive of our hypothetical creditor C and borrower D to use security interests in their arrangement.

III. The Use of Security Interests Under Full Priority

As Part II explained, the socially desirable loan contract between a borrower and a creditor may or may not contain a security interest. However, the parties will not seek to negotiate the loan contract that maximizes social wealth, but rather the arrangement that makes the two of them best

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[82] See Leeth and Scott, supra note 22, at 387-392; Altman, Haldeman, and Narayanan, "Zeta Analysis: A New Model to Identify Bankruptcy Risk of Corporations," 1 J. Banking & Fin. 29 (1977) (reporting that bankruptcy risk decreases with firm size).

[83] See Leeth and Scott, supra note 22, at 379.

off. The purpose of this Part is to show that the rule of full priority increases the divergence between the privately and socially optimal use of security interests in loan contracts.

Section A begins by showing that in a hypothetical world of full priority and perfectly adjusting creditors, there is no divergence between the privately and socially optimal use of security interests by our hypothetical creditor C and borrower D: full priority produces only efficiency gains and no efficiency costs. As Section B explains, however, the real world contains significant numbers of creditors that are not perfectly adjusting. Section C demonstrates that, in the presence of these non-adjusting creditors, the privately and socially optimal use of security interests by C and D will tend to diverge, since C and D will have an incentive to use security interests inefficiently in order to transfer value from these creditors.

A. The Easy Case for Full Priority in a World With Perfectly Adjusting Creditors

To isolate the factors that make the rule of full priority for secured claims problematic, it is worth starting with an analytical exercise: stipulating the assumptions under which according full priority to secured claims would create only efficiency gains and no efficiency costs. As will be shown, the efficiency costs of according full priority to secured claims result from the fact that these assumptions do not obtain in our world.

Consider a world in which the claims of all creditors other than C perfectly reflect all elements of the agreement between C and D. Imagine, for example, that all of the other claims arise subsequent to the transaction between C and D. Suppose further that all of the other creditors are contractual creditors which are perfectly informed about all aspects of the contract between C and D, and are able to take this information into account in shaping their contracts with D.

In such a world, the arrangement between C and D could not impose a negative externality on

other creditors. Thus C and D would never adopt an inefficient security interest in order to divert value from other creditors. Nor in such a world could the arrangement between C and D confer a positive externality on other creditors, since the other creditors would reduce the size of their claims against D to reflect the benefits flowing to them from the arrangement. Thus C and D would also have an incentive to adopt any contractual term that is efficient.

Since C and D would bear all the efficiency costs and enjoy all the efficiency benefits of their arrangement, C and D would find it in their interest to choose the socially optimal arrangement. The bargain struck between C and D would therefore tend to be efficient. Thus according full priority to secured claims — and respecting that priority in bankruptcy — could therefore only lead to efficiency gains.

B. The Presence of Non-Adjusting Creditors

In the real world, in contrast to the world assumed in Section A, the use of a security interest giving C's secured claim full priority may make C and D better off by transferring bankruptcy value from creditors which cannot adjust the size of their claim against D to take into account the existence of the security interest. These non-adjusting creditors, which are described below, range from involuntary tort creditors to voluntary creditors that extend credit to D on fixed terms before C and D negotiate their loan contract and therefore cannot take the arrangement between C and D into account when fixing those terms.

1. Private Involuntary Creditors

It is by now a familiar point in the bankruptcy and secured debt literature that according full

priority to secured claims permits a firm to divert value from tort creditors.[84] Thus it is natural to begin our discussion of non-adjusting creditors by considering the case of tort creditors that have unsecured claims against a firm in bankruptcy. Such claims will arise if private parties are injured by the firm and have claims that exceed the firm's insurance coverage limits when the firm goes bankrupt.

While most firms purchase insurance,[85] the insurance they purchase may not cover all tort claims. Insurance companies typically impose limits on the scope and amount of coverage under their policies.[86] In addition, shareholders have an incentive to underinsure because they do will not reap all of the benefits of the insurance they purchase.[87] Consequently, firms generally choose low insurance coverage limits and are often not insured for certain types of risks.[88] When private tort claims against the firm do arise, there is thus the possibility that they will become unsecured claims against the firm in bankruptcy. And, while uninsured tort claims do not often surface in bankruptcy, when they do turn up they can be substantial.[89]

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[84] See, e.g., Shupack, supra note 22, at 1094-1095 .

[85] See generally Mayers and Smith, "On the Corporate Demand for Insurance," 55 J. Bus. 281 (1982).

[86] See Hansmann and Kraakman, "Toward Unlimited Shareholder Liability for Corporate Torts," 100 Yale L. J. 1879, 1889 (1991); Lopucki, supra note 7, at 1907.

[87] See Hansmann and Kraakman, supra note 86, at 1889.

[88] See Hansmann and Kraakman, supra note 86, at 1899.

[89] In 2 of 43 large reorganizations studied by Lopucki and Whitford, tort claims — in one case for personal injury, and in the other for patent infringement — amounted to more than 2/3 of the unsecured claims against the bankrupt company. See Lopucki, "Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies, " 141 U. Pa. L. Rev. 669, 738 & nn.226-27 (1993). See also Lopucki, supra note 7, at 1906, n. 81 (describing other cases in which the tort liability of bankrupt firms was significantly in excess of the applicable insurance coverage).

The claims of these tort creditors cannot be adjusted to reflect the existence of a security interest. Even if the size of the claim is fixed after the firm creates a security interest, so that in principle the security interest could be taken into account, the size of the claim will be determined by a court without regard to the firm's financial structure. Thus it is widely recognized that a firm may make tort creditors worse off by providing a secured creditor with priority in bankruptcy with respect to the firm's assets.[90]

Indeed, the problem of tort creditors in bankruptcy has been attracting considerable attention in the law review literature.[91] Some commentators have urged that tort creditors be fully compensated when the corporate tortfeasor goes bankrupt, either through a program of mandatory insurance or by making shareholders liable for corporate torts.[92] Others have suggested that tort creditors be given priority in bankruptcy over secured claims.[93]

To the extent that any of these reform proposals are adopted, security interests could not subordinate the value of tort claims, and the problem of tort creditor non-adjustment would be

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[90] See Lopucki, supra note 7, at 1898; Hansmann and Kraakman, supra note 86, at 1884; Shupack, supra note 22, at 1094-1095. We assume that the injuries sustained by tort creditors either do not arise out of a contractual relationship with the borrower or are sustained by voluntary non-adjusting creditors. To the extent the tort creditors happen to be adjusting creditors, they can, at least in principle, adjust the terms of their arrangement with the borrower to reflect the possibility that any tort claims arising out of the relationship will be subordinated to secured claims.

[91] See, e.g., Hansmann and Kraakman, supra note 86; Leebron, "Limited Liability, Tort Victims and Creditors," 91 Colum. L. Rev. 1565 (1991); Painter, "Tort Creditor Priority in the Secured System, Asbestos Time, the Worst of Times," 36 Stan. L. Rev. 1045 (1984).

[92] See, e.g., Hansmann and Kraakman, supra note 86 (proposing unlimited shareholder liability for corporate torts); Shavell, "The Judgment Proof Problem," 6 Int'l Rev. L. & Econ. 45 (1986) (proposing mandatory insurance).

[93] See, e.g., Painter, supra note 91, at 1071-73; Leebron, supra note 90, at 1643-49; Heidt, "Cleaning Up Your Act: Efficiency Considerations in the Battle for the Debtor's Assets in Toxic Waste Bankruptcies," 40 Rutgers L. Rev. 819 (1988).

eliminated.[94] But as long as tort creditors are not fully paid when a tortfeasor firm goes bankrupt or given superpriority over secured claims, tort creditors will continue to be non-adjusting with respect to the creation of security interests.

2. Government Claims

Although tort claims against bankrupt firm may in some cases be substantial, on aggregate they are not as significant as the claims of the second group of involuntary creditors: federal, state, and local government agencies.[95]

Firms are required to make periodic payments to federal, state, and local governments for corporate income taxes, withholding taxes on employees' salaries, social security contributions, sales tax, property tax, excise tax, and customs duties.[96] When the bankruptcy petition is filed, at least some of these taxing authorities will be creditors of the firm for taxes due but not paid. In fact, tax claims against bankrupt firms are usually substantial, especially in the case of closely-held firms.[97]

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[94] It should be noted that the problem of non-adjustment would not be eliminated under a mandatory insurance system that permitted the insurer to reach bankruptcy assets as an unsecured creditor in order to recover payments made to the firm's tort victims. In such a case, mandatory insurance would simply substitute one set of non-adjusting creditors (insurers) for another (tort creditors). While such a substitution might be desirable for risk-spreading reasons, it would not address the problems we identify in this paper.

[95] It might be argued the federal government should not be seen as an involuntary creditor because the federal government could always change the bankruptcy rules to favor itself, or choose not to assert any claims against firms in the first instance. Whether or not the government is considered an involuntary creditor is irrelevant for our purposes. What matters for our analysis is that the government is currently a non-adjusting creditor because (1) it asserts claims against firms which do not take into account the particular financial structures of those firms and (2) those claims may be subordinated through the issue of security interests.

[96] See 11 U.S.C. 507(7).

[97] See Baird, supra note 14, at 915.

In addition, the government may have environmental, pension-related, and other non-tax claims against a bankrupt firm. Although these claims will not, unlike tax claims, be present in every bankruptcy, they may be substantial when they do arise.[98]

The size of the government's claims against a firm are set by statute without regard to the firm's capital structure and, in particular, without regard to any security interests the firm may have created that subordinate the government's claims to those of the secured creditor. Thus the government is non-adjusting with respect to the creation of security interests by the firm. That is, when a firm and creditor must decide whether to create a security interest, the firm will treat its obligations to the government--like its obligations to tort creditors--as fixed.

3. Voluntary Creditors with Small Claims

As just explained, involuntary creditors are not able to adjust the size of their claims against a borrower when it creates a security interest in favor of another creditor because their claims are fixed by law. But the fact that a creditor voluntarily contracts with a firm does not necessarily make that creditor adjusting with respect to a security interest created by the firm. Many of a firm's voluntary creditors will be customers,[99] employees,[100] and trade creditors that have relatively small claims against the firm. Even though these creditors may, in principle, be able to take the existence of a security interest into account in contracting with the firm, the small size of their claims will generally make it rational for them not to do so.

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[98] See Lopucki, supra note 7, at 1897.

[99] Customers may be owed money for payments made toward purchases of goods or services. For example, ticketholders had substantial unsecured claims against Braniff Airlines when it went bankrupt. See Lopucki, supra note 7, at 1897, n. 41.

[100] See 11 U.S.C. 507(3) and (4).

The cost to any creditor of adjusting its terms with a firm to reflect accurately its risk of loss in connection with lending to that particular firm will be substantial. Simply determining the extent of a firm's secured debt will be quite difficult.[101] And even if a creditor with a small claim could costlessly acquire information about the firm's secured debt, the creditor would still be required to estimate the firm's likelihood of insolvency, its insolvency value, and the extent of its unsecured debt in order to estimate its risk of loss.[102] Finally, a creditor which had undertaken such an investigation would face the additional cost of contracting specialized terms with the firm.

While at any given time the amount of credit these parties extend collectively to the firm may be quite large, the amount owed to each of these creditors individually — and thus the expected loss faced by each creditor — is typically small. Thus the benefit to these creditors of acquiring information and negotiating special terms with the firm each time they extend credit will be minimal. Even trade suppliers, which are more commercially sophisticated than employees and customers, are believed to have neither the time nor the expertise to evaluate individual firm risk.[103] Indeed, trade creditors are observed charging uniform interest rates to all customers that purchase on credit,[104] indicating that when they extend credit to a customer they do not set the interest rate to take into account the particular risk of loss associated with lending to that customer.

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[101] For example, although public registries identify the class of assets subject to a security interest, they do not indicate the size of the loan secured by the collateral. See generally, Baird, "Notice Filing and the Problem of Ostensible Ownership," 12 J. Legal Stud. 53 (1983).

[102] While reporting services such as Dun & Bradstreet do compile financial information about firms, the information they provide is often of limited use. The services do not report on all firms, the U.C.C. filing information on which they rely is itself not complete (see supra note 101), and there is no public source of information on the unsecured debt of most firms.

[103] See Roe, supra note 26, at 225; Hudson, supra note 26 at 56.

[104] See Triantis, supra note 19, at 90.

It is important to emphasize that the failure of creditors with small claims to take into account a borrower's arrangements with other creditors does not imply that they will always be undercompensated for bearing the risk that other creditors of the borrower will have priority claims in bankruptcy. It is possible that trade creditors set terms that compensate them for the average risk of loss they face in lending to all of their customers. However, whether or not these creditors are adequately compensated for their risk of loss is not relevant for our analysis. Our analysis assumes only that voluntary creditors with small claims do not adjust their terms to reflect whether or not a particular security interest has been created.

The following example will make this point more concrete. Suppose that trade suppliers with small claims know that each loan period there is a 50% chance that our hypothetical firm D (as well as other firms in its industry) will mortgage all of its assets. Suppose further that the trade creditors also know that the unsecured creditors of a fully mortgaged firm will be paid nothing if the firm goes bankrupt, while the unsecured creditors of other firms receive on average 4 cents on the dollar in bankruptcy (which is in fact the average amount received be unsecured creditors in bankruptcy when payment is made).[105] Finally, assume that the trade creditors typically extend $10,000 of credit to each firm per loan period and that the probability that any firm will fail is 1% per loan period. Thus the risk of loss associated with extending $10,000 of credit to a firm that has mortgaged all of its assets is $100 (the probability that the firm will fail multiplied by the amount that will be lost in the event of failure, i.e., 1% of $10,000) while the average risk of loss associated with lending that amount to the other type of firms is $96 (1% of $9600). Since there is a 50% chance that any particular firm will be fully mortgaged, the risk of loss associated with lending $10,000 to any firm is thus $98.

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[105] See supra note 15.

If the trade creditors were perfectly informed, they would charge firms that had mortgaged all of their assets $4 more in interest per loan period (.04% of $10,000) than they would charge the other firms to reflect the increased risk of loss they would face from lending to fully mortgaged firms. However, the transaction costs involved in determining the extent to which a particular firm has mortgaged its assets make it rational for these creditors not to check the arrangements of each borrower, but rather to charge an interest rate that reflects the average risk of loss of lending $10,000 to companies like D. When D decides whether to pledge all of it assets, it thus knows that creditors with small claims will not increase the interest they charge D if it decides to do so. In fact, there is a 50% probability that D will find that it is worthwhile pledging all of its assets--perhaps in part because it can reduce its interest expense by "selling" some of the bankruptcy value otherwise belonging to trade creditors to a secured creditor. In such a case, creditors with small claims that charge D an interest rate reflecting an expected risk of loss of $98 will be undercompensated for the risk of loss associated with lending to D. However, there is also a 50% chance that D will not find it worthwhile to pledge all of its assets--notwithstanding the fact that by doing so it can sell the bankruptcy value otherwise belonging to trade creditors to a secured creditor in exchange for a lower interest rate. In such a case, creditors charging D the average interest rate will be overcompensated for the risk of loss from lending to D.

4. Prior Voluntary Creditors

We have just seen that voluntary creditors with small claims will generally find it rational to be non-adjusting with respect to the security interests created by a borrower. In addition, any creditor, including one with a large claim, will always be non-adjusting with respect to a particular security interest if it extends credit on fixed terms before the borrower makes a decision whether or not to

create that security interest. To the extent the terms set by the creditor are fixed, such a creditor, no matter how commercially sophisticated, will not be able to adjust with respect to any security interest subsequently created by the borrower.

To be sure, a prior creditor could require that the borrower covenant not to grant security interests during the term of the loan. Indeed, as Part II explained, institutional creditors frequently negotiate a negative pledge covenant restricting their borrowers' ability to issue secured debt.[106] The question might arise as to why, if security interests may be so inefficient, such contractual arrangements are not always used. However, there are a number of situations in which a negative pledge covenant will not be used even if the borrower is likely to issue an inefficient security interest.

Consider first the case of an unsecured creditor lending to typical U.S. firm--a small closely held company. The owners of such a company may be able to have their company borrow from the owners' families, friends, or business associates with little risk that the unsecured creditor will discover the borrowing.[107] The company might then later grant the "informal" lender a security interest giving the lender's claim priority over that of the unsecured creditor.[108] When it discovers the breach, the unsecured creditor's only recourse will be to call a default, sue for repayment, and then begin the lengthy judicial process required before the creditor can seize the company's assets

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[106] See generally Smith and Warner, supra note 36.

[107] See Schwartz (1989), supra note 22 at 244-5; Lopucki, supra note 7, at 1928, n. 157. In contrast, unsecured creditors lending to a large publicly traded firm will learn about any material change in the borrower's financial condition because the borrower's managers will face civil or criminal liability if they fail to publicly report such changes.

[108] See Equitable Trust Co. v. Imbesi, 412 A.2d 96 (Md. 1980) (holding that a mortgagee had priority in property encumbered by borrower in violation of a covenant).

to satisfy the debt.[109]

Since the unsecured creditor of a small private company may well not discover the violation of a negative pledge covenant for quite some time, and once the breach is discovered further time will elapse before the company actually pays a price for breaching the covenant, the owners may not be deterred from breaching the covenant, especially if they believe they have much to gain from doing so. As a result, an unsecured lender might not offer a lower interest rate in exchange for a negative pledge covenant from a small private company or any company whose transactions are very difficult to monitor. The firm will therefore be free to create security interests that are inefficient and the unsecured creditor will set its interest rate to reflect the risk that the firm will in fact do so.

Next consider the case of an unsecured creditor lending to a borrower whose other creditors are non-adjusting. As we explained in Part II, a portion of the benefits of any negative pledge covenant adopted by an unsecured creditor and a borrower will flow to non-adjusting creditors and thus not be captured by the contracting parties. Since the unsecured creditor and the borrower will bear all of the costs but not enjoy all of the benefits of a negative pledge covenant, it will not be in their interest to adopt one if their share of the benefits does not exceed the costs associated with the covenant, even if the covenant is both enforceable and efficient.

Finally, consider the case of on an unsecured creditor lending to a borrower that anticipates issuing both efficient and inefficient security interests. For such a borrower, a negative pledge covenant would not be socially desirable if the aggregate efficiency loss from preventing the creation of efficient security interests would be greater than the aggregate efficiency benefit from preventing the creation of inefficient security interests. In that case, even if the negative pledge covenant were

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[109] The unsecured creditor could also attempt to damage whatever is left of the company's reputation at the time the breach is discovered.

enforceable and the contracting parties would capture all of the costs and benefits of the provision, it will not be in their interest to adopt it.

One might also question why, if security interests are so inefficient, sophisticated unsecured creditors do not build an adjustment mechanism into their contracts with borrowers which allow them to reset the interest rate if the borrower subsequently creates a security interest. Unlike a negative pledge covenant, an adjustment mechanism negotiated between an unsecured and a borrower would not confer a benefit on any other creditors. Thus, an adjustment mechanism would be more likely than a negative pledge covenant to be adopted if it were efficient.

However, although sophisticated creditors with large claims might find such mechanisms worthwhile in principle, it is believed that such an arrangement would not generally be practical.[110] The appropriate adjustment factor for each security interest would depend on numerous parameters, such as the likelihood of the borrower's insolvency, that would be realized only at the time the security interest is created. It would therefore be extremely difficult to specify the appropriate schedule of interest rate adjustments in advance.[111]

Moreover, such a contractual provision--like a negative pledge covenant--might be difficult to enforce against smaller companies that are easily able to conceal a financing transaction and that may well lack the funds to pay the adjustment once the transaction is discovered. Thus even if an appropriate adjustment schedule could be costlessly specified in advance, there may be situations where a sophisticated creditor would not reduce the interest rate it charged a borrower in exchange

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[110] See, e.g., Kanda and Levmore, supra note 22, at 2112.

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

for such an adjustment mechanism.

In any event, even if some prior sophisticated creditors with sufficiently large claims did adopt such an interest rate adjustment mechanism, other prior creditors would be non-adjusting with respect to the creation of subsequent security interests by the borrower. Thus the borrower would still have an incentive (albeit a reduced one) to create security interests even if they were not efficient.

It should be emphasized that although prior voluntary creditors may not be able to adjust to the creation of a security interest by the borrower, we are not assuming that they are exploited by the borrower. We are in fact willing to assume that prior creditors anticipate the risk that subsequent security interests will subordinate their claims in bankruptcy and charge accordingly. The only assumption on which our analysis depends is that the terms negotiated by almost all prior creditors, however set, are fixed by the time the borrower and a potentially secured creditor negotiate their loan transaction. Thus when the borrower and the potentially secured creditor shape their arrangement, the use of a security interest giving the creditor a secured claim with full priority-- compared to not using such a security interest — may make the borrower better off by allowing it to "sell" to the creditor bankruptcy value that would otherwise be enjoyed by these prior non-adjusting creditors.

C. Full Priority and the Decision to Create a Security Interest

We now consider how, under the rule of full priority for secured claims, the presence of non-adjusting creditors affects the decision of a borrower and a potentially secured creditor about whether to create a security interest. The effect of full priority on the arrangement chosen by the borrower and the creditor is easily seen in the context of the following numerical example.

Suppose that our hypothetical firm D has three different pieces of heavy equipment which it is contemplating pledging to C. Suppose further that D has other creditors, some of which are

adjusting and some of which are non-adjusting. With respect to each piece of equipment, the creation of a security interest would impose a direct loss of $4 on non-adjusting creditors. The creation of a security interest encumbering the first two pieces of equipment would yield a benefit of $6 to C and D, taking into account the higher interest rate that adjusting creditors (i.e., subsequent creditors with claims sufficiently large to take these security interests into account) would charge D if the security interests are created. The creation of a security interest with respect to the third piece of equipment, however, would yield a benefit of only $2 to C and D (again taking adjusting creditors' reactions into account). Thus, a security interest would be efficient with respect to the first and second pieces of equipment but not with respect to the third.

In this example, D will choose to create security interests covering the first and second pieces of equipment, because each security interest will yield a benefit to C and D of $6. In addition, D will create a security interest with respect to the third piece of equipment because such a security interest will yield a benefit to C and D of $2 even though it is inefficient. The presence of non-adjusting creditors thus causes C and D to act inefficiently by encumbering the third piece of equipment in favor of C.

Let us now turn to the question of whether non-adjusting creditors are actually "hurt" by these security interests. Consider first the case in which all of the non-adjusting creditors are involuntary. If all of the non-adjusting creditors are, for example, tort creditors, the creation of each security interest will reduce the value of these creditors' claims by $4. Thus the three security interests will affect a transfer of $12 from the involuntary creditors to C and D. Since the tort creditors do not have the opportunity to set the size of their claims to reflect the possibility of this transfer, they are actually "hurt" by the creation of the security interests.

The second case to be considered is one in which all of the non-adjusting creditors are voluntary

creditors. We are willing to assume that these voluntary creditors, which we will suppose are commercial banks, believe at the time they extend credit to D that D is likely to encumber, or is likely to have encumbered, all three pieces of equipment. In such a case, the banks will choose terms that compensate them for the anticipated transfer of $12. When C and D negotiate their loan contract, D will do what is expected and encumber all three pieces of equipment. Because the banks will be compensated for subordination by the higher interest rate paid by D, they will not be "hurt" by the creation of the security interests. Thus the efficiency costs arising from the creation of the security interest covering the third piece of equipment will be borne entirely by D's equityholders in the case where all of D's creditors are voluntary and well informed.

In the case where all of a borrower's creditors are voluntary and well informed, it might be argued that the borrower would be better off if it simply contracted in advance not to create a security interest that it knew would be inefficient. But such an argument assumes that the borrower would know that a security interest it may create sometime in the future would be inefficient, a highly implausible assumption. If one instead were to make the more reasonable assumption that it is very difficult to know in advance whether a particular security interest will be efficient, it would not be in the borrower's interest to make such a commitment. Furthermore, even if the borrower knew in advance that a particular security interest would be inefficient, a commitment not to create that security interest might not be credible to unsecured creditors under a variety of circumstances and therefore might not induce them to lower their interest rates.

One could also argue that in the case where all of the borrower's creditors are voluntary and well informed, the borrower would be reputationally constrained from creating a security interest that is inefficient. However, even well informed creditors are unlikely to know whether a particular security interest is efficient or inefficient. Moreover, since firms like the borrower will tend to act

similarly, the borrower's use of security interests is not likely to be unconventional or unanticipated. The borrower's reputation will therefore be no better or worse than those of its competitors. And, even if creditors would know that a particular security interest would be inefficient and the creation of that security interest would be unconventional, reputational considerations will not prevent the borrower from creating a security interest if the benefits from doing so are sufficiently great.[112]

Now let us consider the third (and most realistic) case in which some of D's non-adjusting creditors are voluntary and others are involuntary. In such a case, the creation of an inefficient security interest might be in D's interest if it transfers enough bankruptcy value from the involuntary creditors to make D better off (taking into account the increase in interest rates charged by voluntary and well informed creditors). Under these circumstances, even if D knew in advance that a particular security interest would be inefficient and it could make a credible commitment not to create that security interest, it would not be in D's interest to do so.

Thus whether or not all of the non-adjusting creditors are compensated for the increased risk of loss due to the creation of the three security interests in this example, what these creditors charge D will not be affected by its actual arrangement with C--either because they extend credit before the transaction with C or they extend credit after the transaction and do not verify their belief that D has created the security interest in favor of C. Thus, if C and D adopt a security interest which provides C with priority in some of D's assets, the security interest may transfer value from these creditors. We will now turn to examine the implications for efficiency of the presence of non-adjusting creditors.

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[112] See, e.g., Triantis, supra note 22, at 239; Jackson and Kronman, supra note 22, at 79 n.31.

IV. THE EFFICIENCY COSTS OF ACCORDING FULL PRIORITY TO SECURED CLAIMS

In this Part we systematically examine the five types of efficiency costs that arise under the rule of according full priority to secured claims. These efficiency costs, which we believe have generally been overlooked so far both in the bankruptcy literature and the literature on secured debt, are described below in the context of the hypothetical loan transaction between C and D.

A. Excessive Use of Security Interests

The first efficiency cost arising from the rule of full priority is that security interests will be used even if they are inherently inefficient. That is, C and D may adopt a security interest that gives C and D a larger slice of the pie by redistributing bankruptcy value from non-adjusting creditors even though the security interest at the same time reduces the size of the total pie.[113]

To make this point concrete, suppose the creation of a security interest in favor of C would not affect D's behavior but would create transactional costs of $10 for C and D. Thus, the security interest would reduce the size of the pie by $10. Suppose further that (with or without the security interest) there is a 1% likelihood that D will fail, and that in the event of such failure the effect of the security interest, under the rule of full priority, would be to provide C with $2000 of bankruptcy assets that would otherwise be available to non-adjusting creditors. Thus the security interest, under full priority, would create an expected transfer of $20 from non-adjusting creditors to C. Although the security interest would decrease the size of the total pie available to all parties, it would increase the portion of the pie enjoyed by C and D by $10. As a result, C and D will choose to create the security interest even though it is inefficient.

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[113] This is a special case of the general point that whenever an arrangement creates a negative externality from a social perspective it will be used excessively.

B. Distortions in the Level of Precaution and Choice of Investments

The first efficiency cost of full priority--the excessive use of security interests--may occur whether or not the adoption of the security interest affects D's behavior before or after the loan transaction. But the most important efficiency consequences of full priority are those connected with D's behavior. As this Section explains, the ability of D to give C a security interest that subordinates the claims of unsecured creditors may affect D's behavior even before C and D negotiate their loan contract.

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

Under the rule of full priority, however, D may give C a security interest that protects the value of C's loan from the dilutory effect of tort claims. Consequently, if C is given a security interest it will not charge a higher interest rate if D fails to take precautions and there are more tort claims against D are expected. Since D will not face the prospect of paying C a higher interest if there are likely to be more tort claims against it, D will have less incentive to invest in precautions if it knows

that it can grant C a security interest giving C's secured claim full priority.[114]

In essence, the rule of according full priority to secured claims exacerbates the problem created by limited liability, which has recently attracted considerable academic attention.[115] As that literature has explained, limited liability allows shareholders to avoid internalizing the full costs imposed on tort victims by limiting the victims' claims to the amount of the borrower's assets in bankruptcy. This leads firms to underinvest in precautions and overinvest in risky activities that externalize harm to other parties. According full priority to secured claims allows shareholders to avoid internalizing even more of the costs in the manner we have just described.

C. Distortions in the Choice Between Security Interests and Covenants

The two efficiency costs have just identified — the excessive use of security interests and the increased distortion in D's choice of precautions and investments before C extends credit — are present whether or not full priority affects D's behavior after the arrangement is negotiated. Now we will focus on the effect of full priority on the elements of the arrangement between C and D that affect D's activities once credit is extended. As this Section explains, full priority may distort C's choice between a security interest and a more efficient set of covenants for controlling inefficient behavior by D after the loan transaction, as the following numerical example illustrates.

Consider the situation in which C and D will choose either a set of covenants or a security interest (but not both) to reduce D's ability to engage in inefficient asset dilution after C extends

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[114] The use of security interests under full priority to permit the borrower to bear less of the claims of unsecured creditors is well recognized by both those favoring and those critical of the rule of full priority. See Lopucki, supra note 7, at 1898; Buckley, supra note 22, at 1417.

[115] See, e.g., Hansmann and Kraakman, supra note 86; Leebron, supra note 91; Painter, supra note 91.

$10,000 of credit to D. The security interest will give C priority in $9,000 of D's assets. Assume that D also owes a non-adjusting creditor another $10,000, and that whether the security interests or the set of covenants is adopted, D will fail with a probability of 1%. Both the set of covenants and the security interest will cost C and D $10 in transactional and enforcement expenses. If the covenants are adopted, and D fails, C and the non-adjusting creditor will each be paid $8,000 (for a total of $16,000). If the security interest is used, and D fails, C will receive $9,000 in bankruptcy and the non-adjusting creditor will receive nothing. Finally, suppose that the covenants and the security interest will directly reduce the expected value of shareholders' interests in D by $30 and $20 respectively (before taking the interest rate charged by C into account). If the covenants were adopted, the expected value of creditors' claims would be $70 greater, and the expected value of shareholder's claims would be $10 less, than if the security interest were used. Since the expected value of all claims against D would be $60 greater if the covenants were used, the set of covenants would be more efficient than the security interest. However, the expected value of C's claim would be $10 higher and the expected value of the shareholders' claims would be $10 higher (before taking C's interest rate into account) if the security interest were used. Thus C and D will find it in their interest to adopt the security interest even though it is less effective at preventing inefficient asset dilution than the set of covenants.

D. Suboptimal Use of Covenants

We have just seen that the rule of full priority for secured claims may cause C and D to adopt a security interest where a set of covenants would have been more efficient. Now we turn to a related but distinct problem- that, given that C and D have adopted a security interest (which may or may not be efficient), full priority makes it less likely that C and D will also include in their

arrangement a set of covenants that would be socially desirable for them to adopt.

As was explained in Part III, in a perfect world in which the terms of other creditors fully reflect the consequences to them of all of the elements of the arrangement between C and D, the two parties would have an incentive to adopt any covenant which is efficient because they would capture all of the resulting benefits. In our world, however, non-adjusting creditors would capture part of the benefits and bear none of the costs of any set of covenants negotiated between C and D. Consequently, even if the set of covenants were efficient when its total benefits are taken into account, it would not be privately beneficial for C and D to adopt if the benefits accruing to C (and any other adjusting creditors) are outweighed by the cost to D.[116]

While this problem — that C and D will have an insufficient incentive to adopt efficient covenants — is generally true whenever there are creditors whose claims do not fully reflect the agreement between C and D, the problem becomes even more severe if C and D adopt a security interest under the rule of full priority. In such a case, C's risk of loss will be reduced and therefore the benefit to C of an additional set of covenants will be even smaller.[117] C is thus even less likely under a rule of full priority to adopt a covenant that is highly efficient.[118]

The following numerical example illustrates how full priority exacerbates the problem of the suboptimal use of covenants. Continuing with the example used in the previous Section to illustrate

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[116] See Triantis, supra note 22, at 242.

[117] If C's loan is fully secured, and there is sufficient excess collateral to fully cover C's collection costs and any unpaid interest, then its risk of loss will approach zero. Cf. Hudson, supra note 25, at 52 (observing that a bank with a secured loan will have no incentive to use its knowledge of the debtor optimally because it is fully protected from risk of loss).

[118] The point that a creditor which takes security is less likely to "monitor" the debtor through other contractual restrictions is well understood in the literature. See Jackson and Kronman, supra note 22, at 1153; Buckley, supra note 22, at 1440; Triantis, supra note 22, at 244.

the distortion between security interests and covenants, assume that C and D have adopted the inefficient security interest because it makes them better off than the more efficient set of covenants. Recall that as a result of adopting this security interest, there is a 1% chance that D will fail during the loan period, and in such a case C will be paid $9,000 of the $10,000 it is lending D, while a non-adjusting creditor which has already lent D $10,000 will be paid nothing. Now C and D must decide whether to adopt a second set of covenants designed to prevent D from engaging in various inefficient projects.

Suppose that these covenants would reduce the likelihood of D failing from 1% to .5%, further reduce the expected value of shareholders' claims by $5 (before taking into account the effect of the second set of covenants on the interest rate charged by C), and impose an additional $5 of enforcement costs on C and D. Since the non-adjusting creditors will lose $10,000 if D fails and C will lose $1000 if D fails, reducing the probability of failure by .5% would increase the expected value of creditors' claims by $55 (.5% of $11,000). Thus the second set of covenants would be efficient because they would cost C and D $10 and yield an expected benefit of $55. However, since under full priority C's security interest ensures that C will lose only $1000 if D fails, the benefit to C of such a set of covenants would be only $5 (.5% of $1000). Since the covenants will cost C and D $10 and yield a benefit to them of only $5 under full priority, it will not be in their interest to adopt the covenants even though they would be efficient.

Let us now consider what would happen if the security interest did not give C full priority in the collateral, and C was forced to share some of D's bankruptcy assets with the other creditor. In particular, let us suppose that in bankruptcy C's secured claim would be reduced by 20%, and the rest of its claim would be treated as an unsecured claim. In such a case, C would be given 80% of the $9000 in collateral securing its claim - or $7200. C would then have an unsecured claim for

$2800 (the balance of its claim) and would share pro-rata with the non-adjusting creditor in the remaining $1800 of bankruptcy value. Thus C would be paid an additional $394 (2800/12800 X $1800), for a total of $7594. Under such a rule, C would lose $2406 if D went bankrupt, and therefore reducing the likelihood of D's failure by .5% would increase the value of C's claim by approximately $12. Thus under such a rule C and D would find it in their interest to adopt the set of covenants because it would increase the expected value of the claims of C and D's shareholders by $2 ($12 - $10).

E. Suboptimal Enforcement Efforts

We have just seen that full priority may distort C and D's choice between security interests and covenants, and may cause C and D to forego the use of desirable covenants once even a security interest is adopted. However, there may be cases where creditors' use of covenants does not appear affected by the use of security interests. For example, a bank may use the same standardized loan contract whenever it extends credit to a particular class of borrowers whether or not it also takes a security interest. There may also be lenders which may or may not take a security interest when they extend credit, but in either case do not employ covenants. One might infer from such practices that the priority accorded security interests does not affect the monitoring arrangement employed by these lenders. However, as this Section explains, such an inference would be unwarranted.

In discussing the effect of full priority on the use of covenants in loan arrangements, we did not touch on the level of C's enforcement efforts - the activities undertaken by C to ascertain that D is continuing to comply with its contractual commitments. However, as was explained in Part III, D's incentive to comply with the covenants it has issued may well depend on the level of C's enforcement efforts. That is, the less C monitors D's compliance with these commitments, the less likely it is

to detect a breach, and the more likely it will be that D will find the expected cost of breach to be less than the expected benefit of breach--and therefore violate the covenants. To the extent the covenants bar D from engaging in inefficient activities, the level of C's enforcement efforts will therefore have efficiency implications.

Even in the absence of priority, C will engage in less than the optimal amount of enforcement activity since some of the benefit of this activity will flow to other creditors, yet it (and D) will bear all of the costs. But C will have even less of an incentive to engage in enforcement activities to the extent C is protected from risk of loss by a security interest giving C's claim full priority in bankruptcy--just as it will have less incentive to adopt even covenants that are highly efficient (as the previous Section demonstrated). As a result, D may be more likely to violate a covenant and act inefficiently under a rule of full priority if C has a security interest.

Thus, even if full priority does not lead to fewer covenants being adopted by C and D, it may well degrade the effectiveness of the covenants they do adopt--and lead to efficiency problems--by reducing C's incentive to monitor D's compliance with those covenants. The fact that some creditors may use the same covenants whether or not they also take a security interest therefore does not imply that the actual level of monitoring of borrowers--and the borrower's willingness to act inefficiently--is not affected by full priority.

Now let us consider the situation in which C lends on both a secured and unsecured basis and but never includes covenants in its loan agreements. As we indicated in Part II, all contracts between commercial borrowers and their creditors implicitly incorporate the various mandatory rules that govern the relationship between debtors and creditors, such as fraudulent conveyance law and corporate law limitations on payments to shareholders. These mandatory state rules give creditors certain rights against borrowers which C may exercise against D even though these rights are not

explicitly incorporated into the agreement between C and D. However, if C has a security interest providing it with full priority in its collateral it will have little incentive to enforce these mandatory rights even if doing so would be efficient. Thus the enforcement distortion we identify may be present even if C and D do not explicitly adopt any covenants into their loan arrangement.

V. Possible Alternatives to the Rule of Full Priority

In Part IV we demonstrated that a rule of full priority for secured claims leads to certain inefficiency costs. Accordingly, in this Part we present two rules that would reduce or eliminate the efficiency costs associated with full priority by providing only partial priority to secured claims.[119] Although neither of these partial priority rules is superior in every respect to the rule of full priority, they are worth considering as alternatives to full priority in light of the significant efficiency problems with that rule. The first partial priority rule presented, which we refer to as the "adjustable priority rule," would not provide secured claims with priority over the claims of non-adjusting creditors. This approach, if properly implemented, would eliminate all of the efficiency costs associated with full priority that were identified in our analysis. Under the second partial priority rule, which we refer to as the "fixed-fraction priority rule," a fixed fraction of the collateral backing secured claims would be made available to pay the claims of unsecured creditors. Both of these rules would have the effect of turning part of a secured creditor's claim into an unsecured claim, leaving all secured creditors at least partially unsecured.[120] However, the fixed-fraction priority rule,

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[119] It should be noted that these partial priority rules are intended to eliminate or reduce only the efficiency distortions in loan contracts that arise as a result of full priority. Complete elimination of all of the distortions in the loan contracts between commercial borrowers and creditors would require that all non-adjusting creditors be paid in full.

[120] Recall that the secured claim, is the lesser of (1) the amount of the claim and (2) the value of the collateral securing the claim. A secured creditor which took a security interest in assets worth more than the

unlike the adjustable priority rule, would reduce but not completely eliminate the inefficiencies associated with full priority.

Before examining these rules more closely, it should be emphasized that neither of these rules would completely eliminate the priority accorded to secured claims in bankruptcy. Rather, the partial priority rules would affect only the degree to which the secured creditor enjoys priority in its collateral when the debtor enters bankruptcy. The priority-dependent benefits of security interests, which we will examine in Part VI, would thus be at least partially preserved under either rule. Moreover, neither of these priority rules would have any effect on the secured creditor's "property right" and "priority right" outside of bankruptcy. That is, neither alternative would require modifying Article 9 of the U.C.C. or the state laws governing transactions in real property. Thus all of the priority-independent efficiency benefits connected with security interests would be completely maintained under either rule.

A. The Adjustable Priority Rule

As we have seen, a significant problem with the rule of full priority is that it allows a borrower to transfer value from creditors whose claims are not adjusted to reflect the terms of the borrower's relationship with a secured creditor. This transfer of value in turns leads to the various efficiency costs described in Part IV. The adjustable priority rule, which would deny a secured claim priority over the claims of creditors which were non-adjusting with respect to the underlying security interest(s), would be a natural alternative to the full priority rule because it would go directly to the root of the problems that arise under full priority.

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amount of the loan would therefore have a secured claim no greater than the amount of its loan. Thus by turning part of the secured claim into an unsecured claim, the partial priority rules ensure that every secured creditor will be partially unsecured.

One might question whether a bankruptcy court could in fact identify those creditors of a debtor which were non-adjusting with respect to a particular security interest in order to enforce such a rule. We will address the feasibility of implementing the adjustable priority rule below. For the moment, however, let us assume that the court is able to identify a debtor's non-adjusting creditors to see how the rule would work under optimal conditions.

Suppose that our hypothetical firm D goes bankrupt with $150 in assets and outstanding debt of $300, $100 of which is owed to C, $100 of which is owed to an adjusting unsecured creditor, and $100 of which is owed to a tort creditor. Assume further that $100 of the assets are subject to a security interest held by C.

In the absence of any priority, the $150 in assets would be divided on a pro rata basis with each creditor receiving $50.[121] Under the rule of full priority, and assuming that all unsecured creditors share pro rata in the remaining assets, C will receive $100 and the remaining $50 in assets will be divided equally between the other two creditors. The result under full priority is that $25 of bankruptcy value is transferred from each unsecured creditor to C, the secured creditor. C thus benefits under the full priority rule at the expense of both the adjusting contractual creditor — which (since it is adjusting) has been compensated with a higher interest rate for the increased risk of loss due to C's security interest — and the tort creditor — which has not received such compensation.

Under the adjustable priority rule, the claim of the non-adjusting tort creditor would not be subordinated to C's secured claim. The tort creditor would thus receive the $25 to which it would have been entitled even if C's secured claim had been accorded full priority over the tort creditor's

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[121] For ease of exposition, we assume in our examples that all unsecured creditors are treated equally in bankruptcy. Under U.S. bankruptcy law, however, certain "priority" unsecured creditors - such as the government and employees of the debtor - are entitled to have some or all of their claims paid before those of general unsecured creditors. See supra note 13.

claim, and another $25 representing the amount which would have been transferred from the tort creditor to C had full priority been respected. In this case, the total amount received by the tort creditor--$50--is exactly the amount which the tort creditor would have received if C's security interest had been entirely disregarded and the distribution of D's bankruptcy value had been purely pro rata.

The adjustable priority rule requires only that a non-adjusting creditor's share of bankruptcy value be calculated by assuming that the secured claims with respect to which the creditor was non-adjusting were actually unsecured claims. For our purposes, it does not matter how the remaining bankruptcy value is divided among secured and adjusting unsecured creditors. One could imagine a "full priority" version of the adjustable priority rule in which secured creditors that give up part of the collateral backing their secured claims to non-adjusting creditors receive the remaining value of their collateral (up to the amount of their claim) and as much of their pro rata share of unencumbered assets as is necessary to satisfy their claims, before any adjusting unsecured creditors are paid. In this example, such a scheme would result in C receiving $100 and the adjusting unsecured creditor receiving $0.[122] That is, C would receive exactly what it would have received under full priority. One could also imagine a version in which adjusting unsecured creditors are given what they would have received under the rule of full priority, and secured creditors are paid the remaining value of the collateral backing their claims. In this example, the second version of the adjustable priority rule would result in the adjusting creditor receiving $25, and C receiving $75. Although under the first scheme C's secured claim would have "full priority" over the adjusting creditor's unsecured claim, and under the second it would not, in either case C's priority would come

[122] This result is equivalent to the one which would obtain if there were a subordination agreement between the secured and the adjusting unsecured creditor.

only at the expense of the adjusting creditor. Thus C's use of a security interest under either version of the adjustable priority rule would affect the division of bankruptcy value only among adjusting creditors. As a result, the security interest could not be used to transfer value from non-adjusting creditors.

Under any version of the adjustable priority rule, borrowers and creditors could not use a security interest to transfer value from non-adjusting creditors. Thus such a rule, if it could be implemented fully, would eliminate the inefficiencies we identified as arising out of full priority: the excessive use of security interests, the increased distortions in the borrower's level of precaution and choice of investment, the distorted choice between covenants and security interests, and the resulting reduction in the use and enforcement of covenants.

While a partial priority rule giving secured claims priority only over adjusting claims has never, to our knowledge, been proposed, a growing number of commentators has proposed that tort claims be given superpriority over secured claims in bankruptcy.[123] These proposals have been motivated by the desire to increase firms' incentives to reduce harmful externalities. As we explained in Part IV, the ability of a borrower to subordinate tort creditors' claims by issuing security interests under a rule of full priority allows it to internalize less of the cost it imposes on these parties than it would under a rule of pro rata sharing in bankruptcy. Superpriority would force borrowers to internalize even more of these costs than pro rata sharing, and presumably would lead borrowers to take even better precautions and choose even better projects than under a pro rata rule. However, even if superpriority for tort claims were the best method for addressing the problem of tort externalities,

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[123] See, e.g., Lopucki, supra note 7, at 1908; Adler, "Financial and Political Theories of American Corporate Bankruptcy Theory," 45 Stan. L. Rev. 311, 340 (1993); Leebron, supra note 91 at 1650; Roe, supra note 26, at 227; Painter, supra note 91 at 1081.

which is not clear,[124] the scheme would at best somewhat reduce, and certainly not eliminate, the efficiency problems that are caused by full priority. As explained, the efficiency costs of according full priority to secured claims arise because of the existence of non-adjusting creditors, most of which are voluntary creditors or government agencies. Thus while giving superpriority to tort claims would immunize tort creditors from the effect of priority, thereby reducing the efficiency costs we identified to the extent they are caused by the presence of tort creditors, such a scheme would not reduce the distortions and efficiency costs caused by the presence of contractual non-adjusting creditors and government claims.[125]

Although the adjustable priority rule would in principle eliminate the efficiencies arising out of full priority, one might believe that such a rule would be difficult to administer in practice. To be sure, complete elimination of the inefficiencies we identified as arising from full priority would require identifying during the bankruptcy proceeding those creditors which were adjusting and those creditors which were non-adjusting. And it would clearly not be feasible to investigate every creditor to determine whether it had in fact "adjusted" to each security interest.

However, the difficulty of separating non-adjusting creditors from adjusting creditors in bankruptcy may easily be overstated. With little effort, a bankruptcy court could identify a

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[124] See Block-Lieb, "The Unsecured Creditor's Bargain: A Reply," 80 Va. L. Rev. 1989, 1996 (1994) (questioning superpriority for tort claims on the grounds that making secured creditors liable for these claims may not be the most efficient method for reducing harmful externalities by the firm).

[125] One commentator who has advocated superpriority for tort claims has extended that proposal to deny a secured claim priority over the claims of any voluntary creditors which did not expect to be subordinated by that claim. See Lopucki, supra note 7, at 1947-1948. Since there are many "non-adjusting" creditors that expect to have their claims subordinated in bankruptcy - such as the government, trade creditors, and prior creditors with large claims - such a proposal (assuming that it could be implemented) would also not fail to eliminate the problem of creditor "non-adjustment" and the resulting efficiency problems we analyze.

substantial portion of a debtor's creditors that were non-adjusting with respect to a particular security interest: (1) those creditors that had extended credit before the creation of the security interest and lacked an adjustment mechanism in their loan contracts with the debtor; (2) all tort creditors; (3) government agencies; and (4) such creditors as employees, customers, and utilities that are not in the business of lending, are not able to take the existence of security interests into account in setting the interest rate they charge, and in fact do not negotiate any credit terms with the debtor. A "low-cost" adjustable priority rule that accorded non-adjusting treatment in bankruptcy only to these creditors would substantially reduce the efficiency distortions which we identified in Part V at very little administrative cost.

Such a low-cost adjustable priority rule could be made even more effective by according non-adjusting treatment to all creditors with claims below a fixed, low threshold--say, $5,000. Creditors with such small claims will be rationally non-adjusting even if they are commercially sophisticated since it simply will not be worthwhile to investigate the financial structure of a borrower before extending such a small amount of credit.[126] Such a bright-line rule would increase the number of non-adjusting creditors that are properly accorded non-adjusting treatment in bankruptcy, reducing further the incentive of borrowers to use security interests merely to transfer value.

One might argue that such a bright line rule might distort loan transactions by causing lenders to limit inefficiently the size of their loans in the hope of obtaining better bankruptcy treatment. However, since the likelihood that a borrower will fail is usually rather small, a creditor is likely to lose much more (either in foregone interest, as a lender, or in foregone profit, as a financing seller) by limiting the size of its loans to $5000 than it will gain, on an expected value basis, from improving its position in bankruptcy. Reliance on such small loans will also increase transaction

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[126] See supra Part III.B.3.

costs for the borrower as well as cause secured creditors and adjusting creditors to charge the borrower higher interest rates (since their position in bankruptcy will be worsened by the presence of unsecured claims below the threshold amount). Thus neither borrowers nor creditors would appear to have much incentive to shape their loan transactions in order to obtain favorable treatment under such a bright-line rule.

Even if a low-cost adjustable priority rule could substantially reduce the efficiency costs associated with full priority, one may nevertheless believe that such a rule would be undesirable because of the uncertainty it would create for secured creditors. It is therefore worth considering a partial priority rule in which secured creditors know with reasonable certainty what they will receive in bankruptcy, such as the fixed-fraction rule presented below.

B. The Fixed-Fraction Priority Rule

Under the fixed-fraction priority rule, a secured creditor would receive full priority with respect to a certain percentage of its secured claim. The collateral backing the rest of the claim would be made available to pay unsecured claims (including that portion of the secured creditor's secured claim that was made unsecured by operation of the rule). Thus under a rule giving secured creditors 80% of their secured claim, the other 20% of the collateral would be distributed to pay unsecured claims--including the unsecured claims of all secured creditors.

A variant of the fixed-fraction priority rule was in fact proposed by the German Commission on Bankruptcy Law in 1985 as a replacement for the rule of full priority in German bankruptcy law.[127] The Commission recommended that secured creditors be given only 75% of the amount of their secured claims collateralized by personal property on the grounds that personal property liens

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[127] See Drukarczyk, supra note 1, at 205.

in Germany are difficult to discover and that, as we have argued, exposing secured creditors to increased risk of loss is likely to encourage more desirable monitoring of their borrowers.[128] Three years earlier, the U.K.'s Cork Commission had proposed a more limited version of the fixed-fraction priority rule under which 10% of the property subject to floating charges (such as inventory) would be made available to pay unsecured claims.[129]

To illustrate the operation of the fixed-fraction partial priority rule, we will consider the version in which the secured creditor receives priority with respect to 80% of its secured claim. Returning to the example used to examine the adjustable priority rule, assume that when D goes bankrupt it has $150 in assets and owes $100 to a tort creditor, $100 to an adjusting creditor, and $100 to C. As in the earlier example, C has a security interest with respect to $100 of D's assets.

Under the 80% fixed-fraction priority rule, C will receive $80 of the encumbered assets. The remainder of its claim, $20, will be made unsecured and pooled with those of the other two creditors. The $70 in assets available to pay unsecured claims will then be distributed to the three creditors in proportion to their unsecured claims. Thus C would receive 20/220 of the $70 in assets — or approximately $7, and the other two creditors would share the remaining $63 in assets. In this example, the tort creditor would receive $31.5 under the 80% fixed-fraction priority rule, almost 40% less than the $50 it would receive under the adjustable priority rule, but approximately 25% more than the $25 it would receive under full priority.

Like the adjustable priority rule, the fixed-fraction priority rule also reduces the ability of creditors and their commercial borrowers to use security interests to transfer value from non-

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[128] Id.

[129] See Goode, supra note 1, at 66-67. The Cork Commission's proposal was motivated solely by distributional concerns. Id. Neither of these proposals has yet been adopted.

adjusting creditors by not allowing secured claims to fully subordinate non-adjusting claims in bankruptcy. The fixed-fraction priority rule would thus also decrease the excessive use of security interests, the distortion in investment and level of precaution, and the various distortions in the monitoring arrangements adopted by commercial borrowers and their creditors. The reduction of these distortions would depend on the percentage of the secured claim that is treated as unsecured: the larger the percentage, the greater would be the reduction in the identified efficiency costs. In the extreme case where the entire secured claim is treated as unsecured, a security interest could not be used to transfer value in bankruptcy, and the inefficiencies caused by full priority would be completely eliminated. Thus, the fixed-fraction priority rule could not completely eliminate the efficiencies we identify while at the same time giving the secured creditor priority with respect to any part of its claim.

Nevertheless, the fixed-fraction priority rule might be preferable to the adjustable priority rule since it would create less uncertainty for secured creditors and would be slightly easier to administer in bankruptcy. And, as we explain in the next Section, it would be possible to design a fixed-fraction priority rule that is definitely preferable to the de facto rule of partial priority under the existing regime.

C. The Existing Erosion of Priority

While in principle U.S. bankruptcy law accords full priority to secured claims in bankruptcy, in practice secured claims sometimes receive less than full priority. However, although we believe that a partial priority rule is likely to be superior to the rule of full priority, the existing bankruptcy regime achieves partial priority in a manner that is clearly undesirable. Erosion of full priority under the existing regime works primarily through Chapter 11. If an insolvent firm does not liquidate

immediately under Chapter 7 but rather first seeks to reorganize its capital structure under Chapter 11, a secured creditor is likely to receive less than it would have received under a rule of full priority. Although a full description of how Chapter 11 undermines the priority of secured claims is beyond the scope of this paper, it is worth describing some of the features of Chapter 11 that lead to this result.

Under black letter bankruptcy law, a secured creditor is entitled to receive interest on its secured claim during the proceeding only to the extent that the value of its collateral exceeds the amount of the claim.[130] The creditor also does not have a right to any income generated by the collateral during the proceeding.[131] Thus, the secured creditor is not compensated for the time value of its money during the Chapter 11 proceeding, which typically takes a year and a half or more.[132]

Moreover, although in principle the court must provide "adequate protection"[133] of the secured creditor's interest in the collateral throughout the proceedings, if the debtor's assets fall in value and the debtor is eventually liquidated under Chapter 7, the secured creditor may receive less than the value of its collateral as measured at the time the bankruptcy petition was filed. In fact, since keeping bankrupt businesses in operation is costly, it is common for the debtor's assets to be worth substantially less at the end of a failed reorganization proceeding.[134]

Finally, if the debtor emerges from Chapter 11, the secured creditor will generally not be allowed to take physical possession of the collateral. Bankruptcy law requires only that the secured

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130 See 11 U.S.C. 506(b).

131 See United States Savings Assoc. v. Timbers of Inwood Forest, 108 S.Ct. 626 (1988).

132 See Baird, supra note 14, at 916.

133 See supra note 12 and accompanying text.

134 See Baird, supra note 14, at 916.

creditor be paid off with a note promising cash payments with a present value of at least the value of the secured creditor's interest in the collateral.[135] However, bankruptcy judges will often choose an artificially low discount rate for the payments (in order to reduce the interest burden on the debtor emerging from bankruptcy), thus forcing the secured creditor to accept less than the full value of its secured claim.[136] It is generally believed that the cumulative effect of these rules and practices is to divert value from secured creditors to unsecured creditors and even to equityholders.[137]

Whether and to what extent the secured creditor's priority claim is undermined under the current regime thus depends on such extraneous factors as whether the debtor immediately liquidates under Chapter 7 or spends time in Chapter 11, the amount of excess value in the collateral, and the particular preferences of the bankruptcy court overseeing the case. The priority of secured claims is thus undermined in an arbitrary and unpredictable way, creating unnecessary uncertainty. Furthermore, the redistribution of value from secured creditors to shareholders under the existing regime does not generate any of the efficiency benefits that we showed would result from redistributing that value to non-adjusting creditors.

To the extent that the current ad hoc system of partial priority achieves efficiency benefits by redistributing some value from secured creditors to non-adjusting creditors in bankruptcy, those benefits (and more) could be achieved more efficiently by a fixed-fraction priority rule that reduced the amount of secured claims by a certain percentage in all bankruptcy cases, increased the amount of value available to pay unsecured claims by the corresponding amount, and then fully respected the value of the modified secured claims throughout the bankruptcy proceeding. For example, if

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135 See 11 U.S.C. 1129(b)(2)(A).

136 See Baird, supra note 14, at 915.

137 See, e.g., Weiss, supra note 19.

secured creditors currently expect to lose an average of 5% of their secured claims to unsecured creditors and 1% of their secured claims to shareholders in bankruptcy, then a fixed-fraction priority rule giving secured creditors 94% of their secured claim whenever a borrower entered bankruptcy (and making the other 6% available to pay the claims of unsecured creditors) would achieve greater efficiency benefits than the current system (by giving non-adjusting creditors more in bankruptcy) while creating less uncertainty among secured creditors before bankruptcy.

VI. Assessing the Desirability of Partial Priority for Secured Claims

Although we have seen that the rule of full priority is associated with a number of efficiency costs and that a partial priority rule would be able to reduce those costs, a final determination as to whether a partial priority rule should be adopted requires a full analysis of the desirability of partial priority. In this Part we accordingly begin such an analysis. In Section A we offer a preliminary examination of the efficiency costs associated with partial priority that suggests that the efficiency costs of a partial priority rule are likely to be modest. Section B explains that an examination of the past behavior of U.S. firms is unlikely to indicate which priority rule is most efficient. In Section C, we show that giving firms a choice between partial priority and full priority is also unlikely to answer the question of which rule is more efficient. Section D shows that full priority is not required by bargain or fairness considerations. In Section E we demonstrate that full priority is also not mandated by freedom of contract principles. Finally, in Section F, we examine certain enforcement issues that might arise if partial priority is adopted and conclude that a partial priority rule could be feasibly implemented.

A. The Efficiency Costs of Partial Priority

In Part II, we briefly cited both the priority-dependent and priority-independent efficiency benefits of security interests that had been identified in the literature. According less than full priority to secured claims would not reduce or in any way affect the priority-independent efficiency benefits of security interests. However, according less than full priority to secured claims might reduce the efficiency benefits of security interests that are priority-dependent. The reduction in these priority-dependent benefits would be an efficiency cost of weakening priority that must therefore be taken into account in determining which type of priority rule is preferable. Although a full analysis of these costs is beyond the scope of this paper, the preliminary analysis we offer below suggests that the cost associated with reducing the various priority-dependent benefits of security interests would be rather modest. Thus we believe that a rule of partial priority is likely to be a more desirable rule than full priority from the perspective of efficiency.

1. Increased Information Acquisition Costs

The first priority-dependent efficiency benefit of security interests identified in Part II is that, under a rule of full priority, a security interest allows a secured creditor to extend credit at an appropriate interest rate without expending resources to acquire information about the borrower's probability of default and the expected value of the creditor's pro rata share of the borrower's bankruptcy assets.[138] In principle, if the value of the assets subject to the secured creditor's security interest covers the amount due, accrued interest, and collection costs, the creditor need not make any calculation about its expected loss in order to extend credit to the borrower at an

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[138] See Buckley, supra note 22, at 1421.

appropriate interest rate.

Under any partial priority rule a secured creditor will be exposed to risk of loss even if its claim is fully secured. Thus the secured creditor--if its claim is large enough--will have an incentive to incur costs acquiring information about the borrower before extending credit so that it can properly set its interest rate to reflect the risk of loss from lending to that particular borrower. This in turn will increase the transaction costs associated with the extension of secured credit.

The magnitude of any increase in information acquisition costs will of course depend on the type of partial priority rule that is in place. A rule such as the adjustable priority rule would require a secured creditor to estimate the probability of the borrower's default, the amount of both non-adjusting and adjusting claims against the debtor, and the amount of the borrower's bankruptcy assets in order to set an appropriate interest rate. Under a rule such as the 80% fixed-fraction priority rule, however, a secured creditor could anticipate receiving at least 80% of its secured claim in bankruptcy. The secured creditor thus could set a reasonably appropriate interest rate by estimating only the probability of the borrower's default. The increase in information acquisition costs would thus be smaller under a rule such as the 80% fixed-fraction rule than under a rule such as the adjustable priority rule.

However, it is far from clear that giving secured creditors an incentive to determine the risk of lending to a particular borrower is, on the whole, socially undesirable. To the extent a partial priority rule would cause interest rates to more accurately reflect borrower risk, the partial priority rule would make shareholders internalize more of the cost of their own activities. As we explained in Part IV, the ability of firms to use secured debt under a rule of full priority to internalize less of the cost of their activities increases the incentive of firms to engage in risky activities and take insufficient precautions. Thus the adjustment of secured creditors' interest rates to better reflect the

risk of their borrowers' activities is likely to cause these borrowers to act more efficiently. If the increase in the cost of information acquisition is less than the efficiency gains that result from forcing borrowers to internalize more of the cost of their activities, then on balance it will actually be desirable for secured creditors to incur the increased information costs in the first instance.

2. Increased Monitoring Costs

We now turn to the last two priority-dependent efficiency benefits of security interests identified in Part II: those which relate to the coordination of contractual control ("monitoring") of a borrower which has more than one creditor. Various commentators have suggested that under full priority security interests may promote a more socially desirable level of monitoring of a borrower with more than one creditor, either by reducing excessive monitoring or by increasing insufficient monitoring. The literature appears to offer three different theories of how security interests may lead to more efficient monitoring when secured claims are accorded full priority in bankruptcy: the "relative skills," "specialization," and "focal point" theories.

In the scenario envisioned by the "relative skills" theory, a borrower has two (or more) creditors, at least one of which is less capable of monitoring the borrower's behavior. If none of the creditors are secured, each will engage in some level of monitoring, even though the monitoring performed by the least skilled creditor(s) could be more efficiently accomplished by the most skilled creditor(s). As a result, the creditors as a group will spend too much on monitoring--and that cost will be passed on to the borrower in the form of higher interest rates. The borrower may be able to coordinate more efficient monitoring of itself by giving a security interest to the least capable creditor(s); under full priority, such a move would reduce or eliminate the creditor(s)' risk of loss and their need to monitor, while shifting the risk (and the incentive to monitor) to the most capable

or informed creditor(s), reducing the borrower's overall interest expense.[139]

The "specialization" scenario also envisions a borrower with at least two creditors capable of monitoring it. If all the creditors are unsecured, there may be duplicative and therefore inefficient monitoring of the borrower, the cost of which the borrower will bear. The borrower may be able to induce more efficient monitoring by having each creditor "specialize" in monitoring the assets that it takes a security interest in. By securing each creditor, the borrower might avoid excessive monitoring, reduce the cost of monitoring by permitting each creditor to focus on certain assets rather than the overall financial health of the borrower, and permit each creditor to develop an expertise in monitoring the type of collateral it is assigned, thus reducing the interest rates the borrower must pay these creditors.[140]

Under the "focal point" scenario, the borrower again has two or more creditors that are capable of monitoring it. If all of these creditors are left unsecured, there might either be excessive monitoring of the borrower (if each creditor believes that the other creditors are not monitoring) or insufficient monitoring (if each creditor believes that the others are monitoring). The borrower can reduce the coordination problem inherent in having more than creditor by giving one creditor a security interest in the business' most important assets--its "focal point" assets--the monitoring of which would benefit all creditors by preventing the borrower from engaging in many different types of inefficient activities. The secured creditor thus monitors on behalf of all creditors, for which it is compensated by having a priority interest in the borrower's assets. The other monitors will, under this theory, charge lower interest rates because they know that the risk of misbehavior has been

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[139] See Jackson and Kronman, supra note 22, at 1154-1156; Levmore, supra note 22, at 58-59.

[140] See Jackson and Kronman, supra note 22, at 1154 n.55; Baird, supra note 101, at 57; Baird and Jackson, supra note 3, at 324-328.

reduced by the monitoring of the focal point monitor and that they are therefore not required to expend resources monitoring the borrower.[141]

The plausibility of each of these explanations for the use of security interests under full priority has been convincingly challenged in the literature[142] and we will not repeat the critiques here. Instead, we will observe that even if these theories are correct and security interests do generate an efficiency benefit under full priority by permitting borrowers to coordinate the monitoring efforts of their creditors, this benefit is not likely to be very important.

The efficiency benefit described by these theories only arises in situations where there is more than one creditor capable of monitoring the borrower. However, the empirical data on the financing arrangements of privately held firms - which make up 99% of bankruptcy filings[143] - indicate that such firms generally have only one institutional creditor (e.g., a bank or finance company) that is capable of monitoring.[144] This pattern of financing is not at all surprising. As these monitoring theories correctly emphasize, the presence of more than one monitoring creditor gives rise to efficiency costs that the borrower will have an incentive to eliminate. And there is no easier way of eliminating these coordination problem than by borrowing from only one monitoring creditor in

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[141] See Levmore, supra note 22, at 54-57.

[142] See, e.g., Schwartz (1981), supra note 22, at 11 n.28; Levmore, supra note 22, at 53; Buckley, supra note 22, at 1442-3; Schwartz (1984), supra note 22, at 1055-159.

[143] See Baird, supra note 14, at 912.

[144] See Baird, supra note 14, at 921, citing Petersen and Rajan, "The Benefits of Firm-Creditor Relationships: Evidence From Small Business Data," 49 J. Fin. 3 (1994); Scott, supra note 22 at 949 (reporting that a standard commercial finance security agreement provides that the lender will act as the borrower's "sole source of financing," and that less than 5% of a sample of small and medium sized businesses appeared to have developed a general financing arrangement with more than creditor). Larger, publicly traded firms often have more than one sophisticated creditor, but they very rarely issue secured debt. See Part II.G.

the first place. Thus even if there are cases in which security interests provide the priority-dependent efficiency benefit of coordinating the monitoring of debtors, these cases are likely to be rare. Furthermore, in such cases a partial priority rule need not significantly affect the ability of security interests to coordinate the monitoring of the borrower.[145] Consequently, a partial priority rule is unlikely to lead to significant monitoring efficiency losses.

3. Reduced Financing for Desirable Activities

We have assumed until now that whether or not secured claims are accorded full priority over unsecured claims in bankruptcy, the loan transactions we have studied would take place. However, a secured creditor is likely to charge a higher interest rate under a rule according less than full priority than under a rule of full priority to compensate itself for the reduction in the value of its bankruptcy claim. In such a case, the transaction may not go forward, and the borrower may not be able to begin operating, continue its activities, or pursue a particular project that the secured loan is needed to finance. Thus many bankruptcy commentators believe that an important priority-dependent benefit of security interests is that they permit the financing of desirable activities which otherwise could not be financed.[146]

Supporters of this view therefore may take the position that a rule of partial priority would prevent the financing of some efficient activities that a rule of full priority would facilitate. On

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[145] Although an analysis of the effect of different versions of the partial priority on the monitoring efficiencies that arise under these scenarios is beyond the scope of this paper, it is worth noting that the use of an 80% fixed-fraction priority rule is unlikely to reduce dramatically the level of a secured creditor's efforts to police the collateral subject to its security interest, see Baird, supra note 14, at 919, or reduce the incentive of a sophisticated unsecured creditor to monitor the debtor.

[146] See Kripke, supra note 22; Stulz, and Johnson, supra note 22; Harris and Mooney, supra note 7, at 2028-2037.

closer inspection, however, this problem is likely to be much less serious than it may appear. In fact, as we explain, the activities which a partial priority rule is most likely to prevent are those which are inefficient. Thus, to the extent a partial priority rule prevents firms from engaging in certain activities, the result on balance may be socially desirable.

Let us first consider the effect of the priority rule on the financing of efficient activities. Suppose that under a partial priority rule, the financing of an efficient activity with a secured loan neither imposes a negative externality nor confers a positive externality on non-adjusting creditors. In such a case, the partial priority rule will not prevent the efficient activity because the equityholders will not be prevented from capturing the full efficiency gain associated with the activity. To be sure, the equityholders will be worse off than under a rule of partial priority to the extent they are forced to pay a higher interest rate to secured creditors. But the reason the equityholders must pay a higher interest rate to secured creditors is that a partial priority rule does not allow the equityholders to "sell" as much of the firm's bankruptcy value to the secured creditors in exchange for a lower interest rate. However, under the no-externality scenario being considered, equityholders will still face a positive (albeit smaller) payoff from any efficient activity they might undertake (even without the "sale" of this bankruptcy value), and thus will still have an incentive to undertake the efficient activity.

Now suppose that under a partial priority rule the financing of an efficient activity with a secured loan transfers value from non-adjusting creditors to the shareholders (and therefore imposes a negative externality on non-adjusting creditors). The negative externality will of course be even greater under full priority. In such a case the shareholders will have an incentive to undertake it under either a partial priority or full priority rule, since they will capture the efficiency gain and benefit from the transfer of value from the non-adjusting creditors. Under the negative externality

scenario, the full priority rule would therefore offer no advantage over a partial priority rule.

Finally, consider the case in which under a partial priority rule the financing of an efficient activity with a secured loan confers a positive externality on non-adjusting creditors (that is, value is transferred from the shareholders to the non-adjusting creditors). If the positive externality on non-adjusting creditors is less than the efficiency gain, the project will be undertaken (since the shareholders will capture that portion of the efficiency gain that is not transferred to non-adjusting creditors). In such a case, the full priority rule would not be preferable to the partial priority rule.

However, if the positive externality on the non-adjusting creditors is greater than the efficiency gain from the activity, the shareholders will not undertake the activity. Under these conditions, the full priority rule may facilitate the activity — but only if full priority reduces the positive externality on non-adjusting creditors to less than the efficiency gain (so that the shareholders can capture part of the efficiency gain). In such a case, it would be desirable for secured claims to be accorded full priority in bankruptcy.

The following example is provided to make this point more concrete. Suppose that a firm is likely to fail and impose large losses on non-adjusting creditors if certain activities are not financed. However, if those activities are financed the firm is likely to survive, in which case the non-adjusting creditors will have their claims paid in full. The financing of these activities will thus confer a substantial positive externality on non-adjusting creditors. However, assume that equityholders are likely to receive very little benefit from these activities and keeping the firm alive--and thus will allow the firm to fail unless the cost of borrowing to finance the activities necessary to keep the firm alive is very low. Secured credit will be cheaper if secured claims are accorded full priority than if they are not. Thus suppose that the cost of secured credit under full priority will be low enough to induce the equityholders to pursue the activities that will benefit non-adjusting creditors, but that

the cost of secured credit under partial priority will be too high to lead to that result. Under these assumptions, it would be desirable to accord the secured claims full priority in bankruptcy. However, even those who support the full priority rule recognize that such a scenario--when a firm is likely to fail without full priority financing, and will barely survive with it--will be rather rare.[147]

Moreover, a complete comparison between the effects of full priority and partial priority on the financing of activities requires examining the effect of each rule on the financing of all activities, not just those that are efficient. For while it is true that full priority will in some cases facilitate efficient activities that partial priority would not, it is also true that full priority will facilitate some inefficient activities that partial priority would not.[148] Therefore we must also consider the effect of the different priority rules on inefficient activities.

For an inefficient activity to take place, the negative externality imposed on non-adjusting creditors must be greater than the efficiency loss (that is, the transfer from non-adjusting creditors to the equityholders must be greater than the efficiency loss borne by the equityholders). Suppose that under a partial priority rule, the negative externality is large enough so that an inefficient activity will take place. Since the negative externality under full priority will be even greater, the inefficient activity will also take place under full priority, and neither rule is superior.

Now suppose that under a partial priority rule, the negative externality is not large enough for the inefficient activity to take place. Since the negative externality under full priority will be even greater, it is possible that under full priority the inefficient activity will be financed. Thus, the full priority rule will facilitate an inefficient activity which a partial priority rule would not where the

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147 See, e.g., Triantis, supra note 22, at 248-249.

148 See Hudson, supra note 26, at 49; Ingberman, "Triggers and Priority: An Integrated Model of the Effects of Bankruptcy Law on Overinvestment and Underinvestment," 92 U. Wash. L. Rev 1341, 1372 (1994).

efficiency loss is greater than the externality created by partial priority but less than the externality caused by full priority.[149]

While this scenario may also be rare, a priori there is no reason to believe that the aggregate loss from efficient transactions that are prevented by a partial priority rule (that would be undertaken under full priority) is greater than the aggregate gain from inefficient transactions that are also so prevented. In other words, there is no basis for concluding that, on balance, it would be undesirable for the activities that full priority permits and partial priority prevents not to take place.

In fact, there is reason to believe that the aggregate loss from efficient activities prevented by partial priority is smaller than it might appear. When an efficient activity would otherwise not take place under partial priority because it would confer too great a benefit on non-adjusting creditors, those creditors may well find it in their interest to modify their contractual rights so as to reduce the size of the positive externality and permit the activity to take place. For example, consider the previous example in which non-adjusting creditors would gain from certain activities that will not be financed under partial priority because the equityholders would capture too little of the benefit of the activities. In such a case, the non-adjusting creditors might agree to reduce the size of their claims (by, for example, forgiving part of their loans) in order to induce the equityholders to undertake the project, because they will be better off receiving full payment on their reduced claims than little or no payment on their full claims. Indeed, one commonly observes lenders in workouts agreeing to reduce the size of their claims in order to increase the likelihood of eventually receiving

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[149] See White, supra note 26 (according full priority to secured claims may lead the firm to undertake inefficient investments or continue operating inefficiently when it should be liquidated); Jackson and Scott, supra note 26, at 170-171 (full priority may lead secured creditor to encourage firm to act inefficiently on the eve of bankruptcy); Hudson, supra note 26, at 57 (same).

payment on the remainder of their claims.[150] Thus, partial priority may be more likely to prevent inefficient activities than efficient ones.

B. Learning from the Past Behavior of U.S. Firms

Our preliminary analysis of the possible efficiency costs of according less than full priority to secured claims suggests that those costs - information acquisition costs, certain monitoring costs, and the loss from efficient projects which cannot be financed - are likely to be relatively modest. Indeed, some of the consequences of partial priority which might be believed to give rise to efficiency costs may in fact be desirable. As explained, partial priority may give secured creditors an incentive to use the extra information they acquire to better control their borrowers' behavior after credit is extended. Moreover, the activities that would have been financed under full priority that do not go forward under partial priority may, on balance, be undesirable. However, further work is required before a final determination can be made that a partial priority rule is preferable to full priority.

To test which priority rule is superior, one might consider investigating the actual behavior of firms to see if their behavior could shed any light on the issue. In particular, it might be hypothesized that if a partial priority rule were in fact more efficient than the full priority rule, borrowers would privately contract with their creditors to be bound by that partial priority rule. Since firms are in fact not observed establishing private partial priority rule arrangements, one might be led to think that there is no rule of partial priority that is more efficient than the rule of full priority.

However, as we explained in Part V, the de facto regime in which U.S. firms operate is not one

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[150] See Gilson, John, and Lang, "Troubled Debt Restructurings: An Empirical Study of Private Reorganization of Firms in Default, " 27 J. Fin. Econ. 315 (1990).

of full priority. As a result of the workings of Chapter 11, secured creditors do not expect to receive, on average, the full amount of their secured claims before unsecured claims are paid. Thus a U.S. firm seeking to be governed by a partial priority rule would not need to opt out of U.S. bankruptcy law.

More importantly, firms do not have the ability to opt out of U.S. bankruptcy law; the bankruptcy rules are mandatory.[151] Even if a firm preferred to be governed by another rule — i.e., another form of the partial priority rule or a de facto full priority rule--it could not choose to opt out of U.S. bankruptcy law into such a regime. Thus the failure to observe firms opting out of U.S. bankruptcy law cannot be used as evidence for or against the desirability of any particular rule.

C. Leaving the Priority Rule to Private Ordering

Since the past behavior of U.S. firms does not shed any light on the question of which priority rule is superior because U.S. bankruptcy rules have not permitted firms to opt out of the statutorily mandated regime, one might propose that U.S. firms be given a choice of bankruptcy regimes: full priority or some version of partial priority. It could be argued that such an arrangement would eliminate the need to investigate the relative efficiency of the two rules, since each firm simply could choose the regime which was most efficient given its particular circumstances.

However, if a firm were given the choice between a full and partial priority regime, it is unlikely that it would choose the partial priority regime even if that regime were efficient. As explained, many of the claims against the firm will be held by involuntary creditors, and in particular government agencies. These creditors will not adjust the size of their claims against the firm to take into account the priority regime chosen by the firm. Thus if the firm chooses a partial priority

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[151] See, e.g., U.S. v. Royal Funds Corp., 724 F.2d 12 (2d Cir. 1983).

regime, secured creditors will raise their interest rates, but involuntary creditors will not reduce the size of their claims (even though they will be better off). Unless the efficiency gain from switching from full to partial priority is greater than the positive externality that is conferred on involuntary creditors by such a move, the firm will have no incentive to opt out of full priority.[152]

Even in the absence of involuntary creditors, a firm would only choose a partial priority regime if it expected its voluntary unsecured creditors to charge lower interest rates than those which would be charged under a full priority regime to compensate the firm for the higher rates that would be demanded by secured creditors. To achieve such a reduction in interest expense, the firm would be required to inform its creditors, including those with small claims, that the firm was a "partial priority rule" firm so that they would lower their interest rates accordingly.

However, it is unlikely that many creditors--including such creditors as trade suppliers-- would charge an interest that reflected the particular regime chosen by the firm. Trade suppliers currently charge uniform interest rates to all of their customers, indicating that they do not take into account the particular characteristics of each borrower. Since the likelihood that any particular firm will go bankrupt is very low and a trade creditor's bankruptcy payment may not vary much between "full priority rule" and "partial priority rule" firms, there is no reason to believe that such creditors would charge "partial priority rule" firms a lower interest rate. Instead, creditors with small claims could be expected to continue charging a single interest rate that would presumably compensate them for the aggregate risk they face in lending to many different types of firms. As a result, firms might have little incentive to choose a partial priority regime even in a world with no involuntary creditors.

This analysis suggests that allowing firms to choose between partial priority and full priority is

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[152] See Rasmussen, "Debtor's Choice: A Menu Approach to Corporate Bankruptcy," 71 Tex. L. Rev. 51, 67 (1992) (observing that firms permitted to choose among bankruptcy regimes will have an incentive to choose the one which assigns the lowest possible priority to nonconsensual claimants).

unlikely to answer the question of which rule is socially optimal. The analysis also indicates that since firms may choose a full priority regime over a partial priority regime even if the partial priority regime is more efficient, a partial priority rule should be made mandatory rather than optional if it is likely to be the most efficient rule.

D. Fairness and Bargain Considerations

Our analysis thus far has focused on the rules of full and partial priority primarily from an efficiency perspective. From this perspective, we have shown that a rule of partial priority is likely to be preferable to the rule of full priority. But before closing it is worth considering whether the rule of full priority can be seen as required by some bargain or fairness principle.

One might take the position that giving a secured claim less than full priority in bankruptcy is inconsistent with the bargain that the secured creditor makes with the borrower and is thus unfair. In particular, one might argue that since the secured creditor had contracted for full priority and chosen its terms accordingly, the priority right that it had contracted for should be consistently respected by the law. Indeed, the legislative history to the current U.S. Bankruptcy Code states explicitly that it was the intent of Congress, in drafting the bankruptcy laws, to give secured creditors the benefit of their bargain.[153] But this fairness or bargain argument is less valid than it may appear at first glance.

Under a partial priority regime, creditors taking security interests would expect partial priority treatment in bankruptcy (not full priority) and choose their terms accordingly. Thus giving them only partial priority in the end would be perfectly consistent with their initial bargain. In the event a borrower of a secured creditor were to fail, the secured creditor would get no more and no less

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[153] See supra note 12.

than it expected to receive in bankruptcy.[154]

Indeed, given that the de facto regime has been partial priority for some time, it is reasonable to assume that secured creditors currently expect to receive on average only partial priority for their secured claims in bankruptcy, and set their terms to reflect that expectation. If a borrower enters Chapter 11 and a secured creditor's secured claim is given less than full priority, that secured creditor cannot claim that it was treated unfairly. Thus, if a formal rule of partial priority were adopted that accorded as much priority to secured claims as those claims receive today under the de facto partial priority regime, even secured creditors that extended credit before the change of regime would not be denied the benefit of their bargain.[155]

E. Freedom of Contract Concerns

Even if one believed that the adoption of a rule according partial priority to secured claims was not foreclosed by bargain or fairness considerations, one might still raise the objection that such a rule constrains freedom of contract. In particular, one might argue that not according full priority to secured claims denies a borrower the right to grant a creditor a security interest giving the creditor full priority right in the collateral. Indeed, Professors Harris and Mooney defend the full priority accorded to secured claims on just this ground.[156]

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[154] Cf. Rogers, supra note 7, at 987 (arguing that the Fifth Amendment "takings" doctrine does not apply to a secured creditor whose state law rights are modified in bankruptcy, because at the time of entering the arrangement it knew or should have known that its rights would be circumscribed if the borrower entered bankruptcy).

[155] In contrast, if all existing debt were to be subject to a de facto full priority regime, secured creditors would get a "windfall" and unsecured creditors would not get the benefit they bargained for.

[156] See Harris and Mooney, supra note 7.

However, freedom of contract arguments have force only with respect to arrangements that do not create direct externalities. When a contract directly affects only the parties to that arrangement, it is believed that in most cases the parties should be allowed to choose for themselves whatever is best for them. But when the contract directly impinges on the rights of third parties, there is no prima facie presumption of freedom of contract.

When a debtor enters bankruptcy, the bankruptcy court cannot enforce all of the contracts the debtor entered into before it went bankrupt; there are simply not enough assets available to do so. As a result, the bankruptcy system must modify the debtor's loan contracts by limiting the extent to which each creditor is entitled to repayment. This is generally accomplished by giving each creditor a right to its pro rata share of the debtor's bankruptcy assets.[157] In this setting, an arrangement between the debtor and a particular creditor that gives the creditor more than its pro rata share of the debtor's bankruptcy assets must therefore reduce, dollar-for-dollar, the amount that will be available to other creditors: that is, such an arrangement creates a direct externality on these other creditors.

Since an arrangement that allows the debtor to increase the bankruptcy share of one party must come at the expense of another, it is only natural that the law imposes restrictions on the ability of a debtor to enter into such arrangements. For example, the law does not permit a firm to sell options on its bankruptcy value to non-creditors.[158] The law also does not allow a debtor to favor some creditors at the expense of others by making preferential payments on the eve of

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[157] For discussions of the pro rata rule, see T. Jackson, The Logic and Limits of Bankruptcy 12-13, 29-32 (1986); Kanda and Levmore, supra note 22, at 2122.

[158] See Buckley, supra note 22, at 1452.

bankruptcy.[159] Nor, as we observed in Part I, does the law give any force to a contractual term between a debtor and an unsecured creditor ("C1") giving that unsecured creditor's claim priority over that of another unsecured creditor ("C2") in bankruptcy. The refusal of the law to enforce the sale of C2's bankruptcy value to C1 does not generally raise freedom of contract concerns because it is recognized that the debtor's sale of C2's bankruptcy value to C1 concerns the disposition of something of value that does not belong to either of them, but rather to a third party, C2.[160] It would be no more natural for the law to enforce such a contract than it would be to enforce a contract in which the debtor sells C2's house to C1.

However, under the rule of full priority the creation of a security interest by a debtor in favor of C1 accomplishes the same result as a contract between the debtor and C1 giving C1's claim priority over C2's claim. A security interest under full priority thus creates the exact same direct externality as a simple contract between the debtor and C1 that the law would refuse to enforce.[161] Freedom of contract no more requires that the debtor and C1 be permitted to create a security interest subordinating the claim of C2 than it requires that the law enforce a simple contract between C1 and the debtor achieving the same result. Thus, while there may be economic reasons for fully or partially respecting the priority of secured claims in bankruptcy, such a result is certainly not mandated by freedom of contract principles.

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[159] See 11 U.S.C. 547.

[160] See Lopucki, supra note 7, at 1899.

[161] See Schwartz (1994), supra note 22, at 2082 (1994).

F. Enforcement Issues

In determining the desirability of a rule according secured claims with less than full priority in bankruptcy, the ability of secured creditors to circumvent the rule must be considered. For if secured creditors can achieve the effect of full priority under a rule of partial priority, then the partial priority rule is likely to have little beneficial effect. However, as this Section explains, existing or easily implementable rules could largely prevent secured creditors from circumventing a rule of partial priority.

1. Pre-Bankruptcy "Opt Out" Activity

As we explained in Part II the "property right" and "priority right" associated with security interests give rise to a number of potential efficiency benefits. Thus, while we believe that according less than full priority to secured claims in bankruptcy is likely to be desirable, we see no reason to restrict a secured creditor's "property right" or "priority right" outside of bankruptcy. However, if a secured creditor's "property right" is maintained, and the "priority right" is modified in bankruptcy, the secured creditor will have an incentive to call a default and seize all of its collateral if it anticipates that the debtor will enter bankruptcy, so as to avoid "sharing" its collateral with other creditors. If such a strategy were to succeed, it would put the secured creditor beyond the reach of the bankruptcy system and undermine the efficiency benefits of using a partial priority rule in bankruptcy.

However, the ability of a secured creditor to "opt out" of the bankruptcy priority scheme by seizing its collateral before bankruptcy is likely to be very limited. The secured creditor would not be able to repossess unless the contract gives it the right, under the circumstances, to declare a default and seize the collateral. And, even if the creditor has the right to declare a default under the

loan contract, its ability to seize the collateral will usually be very restricted. In particular, the secured creditor may not seize the collateral if by doing so it would breach the peace.[162] Since most commercial collateral is located on the borrower's property and is thus difficult to access without the cooperation of the borrower, this breach-of-the-peace restriction makes it virtually impossible for secured creditors to engage in "self-help" repossession. As a result, the secured creditor would almost always be required to enlist the help of the judicial system in recovering the collateral, providing the borrower with ample time to file for bankruptcy.

More importantly, existing bankruptcy rules would generally make repossession by a secured creditor on the eve of bankruptcy futile. For example, Section 547(b) of the U.S. Bankruptcy Code gives the bankruptcy trustee the right to void a transfer to a creditor from the debtor within 90 days of the filing of the bankruptcy petition if the transfer would give the creditor more than it would receive in a Chapter 7 liquidation. Since in principle secured creditors are currently entitled to the full value of their secured claim in Chapter 7, this provision is not invoked against fully secured creditors which receive payments from the debtor within 90 days of bankruptcy, However, under a partial priority rule, the secured creditor would not be entitled to the full value of its claim in bankruptcy. Section 547(b) could therefore be used to recover the amount of assets the secured creditor is required to share with other creditors. Thus even in the rare case where the secured creditor could legally repossess the collateral, Section 547(b) might deter it from such a move.

To be sure, there is the possibility that a secured creditor might attempt to grab the collateral on the hope that the debtor will not enter bankruptcy in the next 90 days. The secured creditor might reason that if the debtor does not enter bankruptcy in the next 90 days, the creditor will enjoy full priority in the seized collateral (up to the amount of its claim), and if the debtor does enter

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[162] See U.C.C. Section 9-503.

bankruptcy during that time, it will be no worse off having seized the assets. It would thus appear that in the few cases where the secured creditor could declare a default and peacefully repossess the collateral, it would have an incentive to do so, and perhaps in some cases avoid partial priority treatment.

However, repossession by the secured creditor might cause sophisticated unsecured creditors to force the debtor into bankruptcy within 90 days of the repossession so that the collateral could be used, at least in part, to satisfy their claims. In fact, under current law, unsecured creditors often force a firm into bankruptcy after the firm grants a security interest to another creditor, so that they can attack the transfer of the security interest under Section 547.[163] Thus even if a secured creditor could legally repossess its collateral, it might be reluctant to incur the cost of repossession knowing that unsecured creditors would be likely to simply undo the repossession by forcing the debtor into bankruptcy and attacking the transfer under Section 547.

2. Avoiding Partial Priority Through Leasing

Secured creditors facing a rule of partial priority may seek to avoid the effect of such a rule by using arrangements that accomplish a result similar to a secured loan but which would be accorded more favorable treatment in bankruptcy. In particular, a number of commentators have suggested that any attempt to give secured creditors less than the full amount of their secured claim could be thwarted through the use of leases, which can be functionally similar to secured loans but are not treated as secured loans in bankruptcy.[164]

In a sale-leaseback transaction, a firm sells some assets to another party which then leases them

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[163] See Lopucki, supra note 7, at 1927.

[164] See, e.g., White, supra note 14, at 503.

back. A standard lease agreement requires the firm to make periodic payments on the lease to the lessor, and gives the lessor the right to repossess the assets in the event of a default by the firm. At the termination of the typical lease, the assets may be either returned to the lessor or purchased by the firm. Depending on its terms, the lease may very closely resemble a secured transaction. In both cases, the firm has use of an asset, agrees to make a stream of payments to another party, and must relinquish possession of the asset if it fails to make these payments.

Under current bankruptcy law, leased assets are not property of the debtor and therefore do not enter the bankruptcy estate,[165] meaning that their value is not available for distribution to the debtor's creditors. Instead, the bankrupt firm must either cure any existing defaults and then either assume the lease (or assign it to another party), or reject the lease and return the assets to the lessor.[166] As a result, the lessor is assured of receiving either the assets or the contracted for payments after the lessee enters bankruptcy.

If a rule of partial priority were in effect, a secured creditor would receive only a portion of the value of the assets serving as collateral for its loan. Thus firms and their sophisticated creditors would have an incentive to structure secured transactions as leases to avoid the effect of a rule of partial priority. The possibility of using leases to avoid the effect of a partial priority rule might appear to severely limit the usefulness of such a rule.

However, current law makes it somewhat difficult for an arrangement that is like a secured loan to be treated as a lease in bankruptcy. That is, an arrangement may be considered a secured loan for bankruptcy purposes even if it is labelled a "lease" by the parties. There must be a real economic difference between a lease arrangement and a secured loan for the arrangement to be

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[165] See 11 U.S.C. 541.

[166] See 11 U.S.C. 365.

recognized as a lease under bankruptcy law.[167] To be treated as a lease, for example, the arrangement must not make the lessee bear the cost of depreciation, and the arrangement must terminate before the end of the asset's life.[168]

Thus an arrangement which will be recognized as a lease in bankruptcy will not be a perfect substitute for a secured loan. And, to the extent the lease is in fact functionally different from a secured loan, it is likely to impose costs on the parties that a secured loan would not. For example, because the lessee would not bear the risk that the leased assets will fall in value by the end of the lease term, it would have less incentive to properly use and maintain them. The lessor must thus impose restrictions on the assets' use and monitor the lessee's compliance, an arrangement which would be costly for both parties.[169] If these costs, which the parties would bear whether or not the lessee goes bankrupt, exceed the expected costs to the lessor of acting as a secured lender under partial priority, then the parties would not substitute a lease for a secured loan under full priority.[170]

But even if current law permitted leases structured very similarly to secured loans to be

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[167] See White, supra note 19, at 420; U.C.C. 1-201(37).

[168] See White, supra note 19, at 420.

[169] See generally Smith and Wakeman, "Determinants of Corporate Leasing Policy," 40 J.Fin. 895 (1985).

[170] There may also be other costs to the parties of leasing. For example, if the marginal tax rate of the lessee is higher than that of the lessor, so that the depreciation is worth more if the lessee owns the property, there will be a tax disadvantage to leasing. See Smith and Wakeman, supra note 169, at 897. Furthermore, the bankruptcy treatment of leases is not entirely favorable. If the debtor decides to breach the lease, any damage claim by the lessor will be treated as an unsecured general claim that arose before bankruptcy. In addition, the bankrupt firm may assign the lease to another party, notwithstanding any anti-assignment provisions in the lease contract. Thus the lessor may find itself in a contractual relationship it would have not otherwise chosen to enter into.

accorded lease treatment in bankruptcy, so that secured creditors could easily switch to leasing in order to avoid the effect of a partial priority rule, the partial priority rule could easily be enforced by modifying the treatment of leases in bankruptcy to bring it into line with that accorded secured loans. To the extent leases are similar to secured loans, there would appear to be no economic or other justification for treating the arrangements differently in bankruptcy. That is, there is no reason why lessors could not be afforded less favorable treatment in bankruptcy than they currently receive if that were necessary to enforce a partial priority rule.

Although a complete analysis of the appropriate treatment of leases in bankruptcy is beyond the scope of this paper, it is worth noting that to the extent leases and secured loans are substitutes, leases are likely to give rise to the same type of efficiency problems identified in this paper. Indeed, the covenants issued by public companies typically place similar restrictions on borrowers with respect to both security interests and leases,[171] suggesting that the two arrangements do in fact have similar undesirable efficiency consequences. Thus, even in a world without secured lending, there might be efficiency benefits to giving lessors less favorable treatment in bankruptcy than they currently enjoy.[172]

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[171] See McDaniel, supra note 78, at 868. Indeed, the only restrictions found in the debentures of companies rated A or better are sale-leaseback restrictions and negative pledge covenants. Id.

[172] For a discussion of some of the possible benefits of according lessors with less favorable treatment in bankruptcy, see Fried, "Executory Contracts and Breach/Assignment Decisions in Bankruptcy," (mimeo., Harvard Law School, 1995).

VII. CONCLUSION

This paper has reexamined a basic principle of bankruptcy law--that secured claims should be accorded full priority over unsecured claims. The paper has taken issue with the view widely held by legal scholars and economists that economic efficiency is best served by giving secured claims full priority in bankruptcy. Our analysis has demonstrated that the rule of full priority in fact distorts contractual arrangements between commercial borrowers and their creditors, producing various efficiency costs. In particular, the paper has shown that full priority causes excessive use of security interests, reduces the incentive of firms to take adequate precautions and choose appropriate investments, and distorts the monitoring arrangements chosen by firms and their creditors.

Having identified the efficiency costs associated with full priority, we also have considered the desirability of a different approach--according only partial priority to secured claims. Our analysis of partial priority has shown that such a rule could eliminate or reduce these efficiency costs--and that such an approach is likely to be more efficient than the full priority rule. Therefore, we have put forward two particular partial priority rules--the adjustable priority rule and the fixed-fraction priority rule--which should be considered as alternatives to the rule of full priority. Our analysis has also shown that such an approach would be consistent with considerations of fairness and contractual freedom, should not be left to private ordering, and could be feasibly implemented. We hope that our work will lead bankruptcy scholars to reconsider the principle of full priority, and that the framework of analysis we have developed will prove valuable in such a reconsideration.