The Control of Wealth In Bankruptcy

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The fixed charge for priority;
the floating charge for control.
--A saying of British bankers

This article is about the control of many billions of dollars of wealth that are caught in bankruptcy like the spoils of a fallen fortress. It introduces a model based on the concept of control that unifies at a theoretical level the twin pillars of financial default, secured credit and bankruptcy. That model also provides a unifying perspective on the academic literature of default. The model is based in substantial part on the insights available from the study of secured credit and bankruptcy systems around the world.

In the years 2000-2002, more than $760 billion of assets held by large public companies came under bankruptcy administration in the United States; private companies took billions more into bankruptcy.[1] Those amounts represent great wealth even in our immensely wealthy country. The redeployment or recapitalization of the assets of these companies will result in large realignments of wealth, power, and employment.[2] Those same companies entered bankruptcy with many billions of dollars in debt, which had also represented great wealth, much of which would disappear. That disappearance would represent a series of financial calamities for many people and institutions, calamities that would not fall evenly on every shoulder. This distribution of wealth and allocation of calamity lies at the heart of the process of recovery from financial debacle. Thus control of the recovery process represents great economic and social power.

The purpose of the recovery process is to maximize the value of the assets of the defaulting business and to distribute that value to designated beneficiaries. Control of the debtor's assets in the recovery process following a general default has an important impact on both maximization and distribution. This article provides a theoretical model whose core is the struggle between bankruptcy law and the law of secured credit for control of the recovery process.[3] The model can be introduced by

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[1] THE BANKRUPTCY YEARBOOK AND ALMANAC 2003 at 38.

[2] This article discusses only business bankruptcy cases involving corporations or other legal entities. Consumer bankruptcy presents a very different, although equally fascinating, set of financial issues.

[3] The present author made a start on this project three years ago. A Global Solution to Multinational Default, 98 MICH. L. REV. 2276, 2304-07 (2000); http://papers.ssrn.com/paper.taf?abstract-_id=259960. [hereafter "Westbrook, Solution."] In the secured credit literature, two scholars identified key aspects of the control issue long before anyone else made it a central concern. *See* Robert E. Scott, *A Relational Theory of Secured Financing*, 86 Colum. L. Rev. 901 (1986) [hereafter "Scott, Relational"]; Ronald J. Mann, Strategy *And Force In The Liquidation Of Secured Debt*, __ MICH. L. REV. 159 (1997) [hereafter "Mann, Strategy"]. Professor Mann's findings in the United States appear generally consistent with those of a recent United Kingdom study. Julian Franks & Oren Sussman, The Cycle of Corporate Distress, Rescue, and Dissolution: A Study of Small and Medium Size UK Companies (IFA Working Paper 306, 2000), http://forum.london.edu/lbsfacpubs.nsf/-

the oversimplified statement that secured credit law and bankruptcy law represent the struggle between a private and a public ordering of the recovery process. By placing control at the center of the model, it reveals secured credit law as the necessary and singular stronghold of the movement for the privatization of the recovery process because a security interest provides the institutional mechanism for control of that process. The model offered here would replace the outdated and superficial notion that the struggle in bankruptcy is merely between creditors and owners.

The last decade has seen a furious debate over privatization of the recovery process.[4] The debate has centered on a group of academic proposals that may be assembled under the rubric "contractualism." Their proponents argue that the recovery process should be governed by contracts between the debtor business and its creditors, with bankruptcy law serving as a default option for those who do not enter into bankruptcy contracts. However, these articles have proposed mechanisms for establishing priorities in distribution without explaining just how the recovery process would be managed or by whom.

Recently, some scholars have acknowledged for the first time that a central issue in the debate is control of the debtor's assets after default.[5] Yet these recent articles persist in failing to explain how control of the debtor's assets would be achieved, before or after default. In particular, none of these analyses identified any connection between privatization of the recovery process and a creditor's obtaining a security interest. This article demonstrates that none of the contractualist proposals can succeed without a security interest. Indeed, any such proposal requires the creditor to obtain a dominant security interest, which is one that covers virtually all the assets of the debtor. It then shows that widespread adoption of a privatized system depending upon dominant security interests is as undesirable as it is unlikely.

Because the vast legal literature about secured credit and bankruptcy law has largely ignored the struggle for control, the approach advanced here creates new perspectives on a host of issues that dominate the current debates in that literature. They include the role of control in the arguments about the economic efficiency of secured credit,[6] the proper analytical approach to distinguish "true-sale"

(httppublications)/2DA3FF18A16C59C080256A24003DF562 (site last visited 7-20-03) [hereafter "Franks & Sussman"].

[4] CR

[5] Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 Stan. L. Rev.751 (2002) [hereafter "Baird & Rasmussen, End"]. *See also* Douglas G. Baird and Robert K. Rasmussen, *Control Rights, Priority Rights, and the Conceptual Foundations of Corporate Reorganization*, 97 Va. L. Rev. 921 (2001) [hereafter "Baird & Rasmussen, Control Rights"]. *See also* David A. Skeel, *Creditors' Ball: The "New" New Corporate Governance in Chapter 11*, __Penn. L. Rev. __ (forthcoming 2003).

[6] *See generally*, Saul Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 YALE L.J. 49 (1982) [hereinafter "Levmore, Monitors"]; James J. White, *Efficiency Justifications for Personal Property Security*, 37 Vand. L. Rev. 473 (1984); Homer Kripke, *Law and Economics: Measuring the Economic Efficiency of Commercial Law in a Vacuum of Fact*, 133 U. Pa. L. Rev. 929, 941 (1985) [hereafter "Kripke"]; F.H. Buckley, *The Bankruptcy Priority Puzzle*, 72 Va. L. Rev. 1393

securitizations from security interests,[7] and the uses and abuses of "bankruptcy-remote vehicles."[8] It is the author's larger project to apply the model to a number of these areas. However, this article is introductory and limited to addressing the functional disabilities of the contractualist project.

Part I of this article provides an overview of the theory and the model. The law governing a debtor's financial default has two central elements: priority rights and control. While priority determines the order in which value will be distributed to claimants, control concerns the management of the debtor's assets during the recovery process following default. The two laws that together govern the recovery process—Article 9 of the Uniform Commercial Code and Title 11 of the United States Code (Bankruptcy)—incorporate rules about both priority and control, but the conflict between them—and consequently the nexus that unites them at the theoretical level—is control. Part I explains why the elaboration of more and better methods of recovery have made control of the recovery process the principle battleground between private and public governance of that process and therefore between their respective strongholds, secured credit and bankruptcy.

Part II outlines a model of secured credit.[9] The model establishes the roles of priority and control in the law of secured credit. Although they are closely related, they have distinct economic and legal functions. Because these distinctions have been blurred in the vast literature about secured credit, this article must develop some new terminology to describe the functioning of its model. The result is to identify clearly the place of control in the secured credit model and to permit its juxtaposition with the control function in bankruptcy law. Although this article is not about the efficiency *vel non* of secured credit, the model does show the relevance of the control function to the literature on that subject and thus connects the model to the prior debates in the secured-credit field.

Part II distinguishes ordinary secured parties from dominant secured parties, the latter being those with all-encompassing security interests. It explains why

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(1986); Robert E. Scott, *A Relational Theory of Secured Financing*, 86 Colum. L. Rev. 901 (1986); Paul M. Shupack, *Solving the Puzzle of Secured Transactions*, 41 Rutgers L. Rev. 1067 (1989); James W. Bowers, *Whither What Hits the Fan?: Murphy's Law, Bankruptcy Theory, and the Elementary Economics of Loss Distribution*, 26 Ga. L. Rev. 27 (1991); Randal C. Picker, *Security Interests, Misbehavior, and Common Pools*, 59 U. Chi. L. Rev. 645 (1992); George G. Triantis, *Secured Debt Under Conditions of Imperfect Information*, 21 J. Legal Stud. 225 (1992); Richard L. Barnes, *The Efficiency Justification for Secured Transactions: Foxes with Soxes and Other Fanciful Stuff*, 42 Kan. L. Rev. 13 (1993); Barry E. Adler, *An Equity-Agency Solution to the Bankruptcy- Priority Puzzle*, 22 J. Legal Stud. 73 (1993); David Gray Carlson, *On The Efficiency Of Secured Lending*, __ Va. L. Rev. 2179, 2179-80 (1994) (hereafter "Carlson, Efficiency"); Mann, Secured Credit, *supra* note xx.

[7] *See, e.g.*, Jonathon C. Lipson, *Enron, Asset Securitization And Bankruptcy Reform: Dead Or Dormant?*, 11 J. Bankr. L. & Prac. 101(2002); Edward Janger, *Muddy Rules For Securitizations*, 7 Fordham J. Corp. & Fin. L. 301 (2002).

[8] Cite needed.

[9] CR secured credit discussion.

priority is central to ordinary secured parties, while control is merely an additional value, albeit an important one. By contrast, control has a much greater value for a dominant secured party. Part II also explains how the nature and effect of control is quite different, although equally important, prior to default and following default. A further sharp distinction is drawn between control in the context of enforcement of a single debt and control following a general default.

Part II goes on to introduce the interaction of the secured-credit model with the bankruptcy model by identifying the elements of control as an additional value for a dominant secured party, including the "bankruptcy veto." Finally, it describes the British model of secured-creditor management of a general default, an approach that has dominated British commercial life for over a century as a standard substitute for bankruptcy management. The British model has given dominant secured parties both priority *and* control, but has been ignored in the American theoretical literature.

Part III introduces the bankruptcy model. It explains the role of control and priority in bankruptcy and explains why control is the more basic concept. In principle, bankruptcy law can accommodate any form of priority or no priority, but control is its *sine qua non*. The discussion also questions the ancient chestnut that "bankruptcy is equality," drawing on comparative law to show that most bankruptcy regimes may be viewed as existing for the very purpose of enforcing inequalities in the form of priorities. One of the most prominent of those inequalities, found in most bankruptcy laws around the world, is priority for secured creditors. On the other hand, without control of substantially all of the assets of the debtor bankruptcy law cannot perform its principal functions in the management of the recovery process. As the British experience shows, the only serious rival to bankruptcy as a manager of that process is the dominant secured party.

Part IVA describes "contractualism" and summarizes the various proposals that fall within that rubric, including "automated bankruptcy," "complete-system" bankruptcy, and the waiver approach. Part IVB explains why contractualism is a dysfunctional theory unless wed to a regime based on a dominant security interest. The reason is that contractual bankruptcy creates a host of difficulties that cannot be resolved except through linking those schemes to a dominant security interest. The difficulties faced by contractualism are largely the same problems that arise from giving a priority to a secured creditor and protecting that priority in a default. Because these difficulties have been largely resolved by the secured-credit regime in the United States and some other countries, the creation of a new body of law to solve the same problems would be unnecessary and inefficient. Yet, if contractualism must be linked to secured credit, it must be assessed as no more than an aspect of the case for management of the recovery process by a secured creditor.

Part V explores two of the major theoretical difficulties with the secured-credit model of default control. The first difficulty is the problem of transactional efficiency. The case for the efficiency of secured credit is unresolved, incomplete, and problematic, especially as concerns a dominant security interest. The second difficulty is the "incentive problem," a term that describes the secured creditor's disincentives to maximizing value for the benefit of other claimants.[10]

Part VI describes the evidence available from the debate in the British literature over the effects of secured-creditor management. In Britain, the system based on secured-creditor management has dominated commercial lending for over a century, but has been under increasing attack in recent years for reasons similar to the objections to secured-creditor control discussed in Part V. That critique has recently resulted in a remarkable development: the abandonment of secured-creditor management in favor of a system that steps significantly in the direction of Chapter 11 bankruptcy in the United States. Part VI argues that the British experience offers substantial empirical support for the existence of serious difficulties in secured-creditor management of a general default. That conclusion is strongly supported by the fact that the private receivership system is also being eroded or abandoned in other Commonwealth countries, although it had been dominant in those countries for most of the twentieth century. Canada is the leading example. Part VI concludes with an outline of the empirical work that is needed to test the analysis offered here.

Part VII of this article summarizes the elements of the model and introduces some of its implications. In particular, it does a preliminary analysis of the position presented in the recent articles from Professors Baird and Rasmussen,[11] using this model to identify the strengths and weaknesses of their approach.

Because of the serious objections to contractualism and secured-creditor control, Part VIII concludes that the system of public, judicial control of the recovery process should continue to be the preferred alternative. It suggests that the considerable movement in the direction of United States secured-credit law and United States bankruptcy law in other countries, both developed and developing, reflect the strength of the existing American system, although some of the reforms in other countries may be worth serious consideration for adoption in the United States. Part VIII suggests that further progress in the field will require theories that unify secured credit and bankruptcy scholarship. It closes with the hope that more scholars will drink at the well of comparative scholarship in the commercial field and elsewhere.

As the foregoing discussion suggests, much of the argument in this paper rests upon lessons drawn from the study of secured-credit and bankruptcy regimes in other countries. Nearly every market economy in the world has such regimes,

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[10] There is a third problem, the policing of state secured-credit law, a job which history has left to bankruptcy law. That point is related in turn to the problem of a "carve-out" to serve the interests of stakeholders other than secured parties. Carve-out will be the subject of another paper. A carve-out has recently been adopted in the United Kingdom. *See* Vanessa Finch, *Re-Invigorating Corporate Rescue*, __ J. Bus. L. __ , text following n. 63 (forthcoming 11/03) [hereafter "Finch, Invigorating"].

[11] *See* Baird & Rasmussen, End, *supra* note xx; Baird & Rasmussen, Control Rights, *supra* note xx.

although they vary enormously. Study of these foreign laws rewards the student richly with an appreciation of the underlying policies that shape these laws, their relationship to national cultures, and the influence now exerted by globalization. While commercial laws in the United States are among the best in the world, there remains a great deal for Americans to learn from others.

Part I. Control

Understanding the reconceptualization of the theory of secured credit and bankruptcy law around the concept of control requires some new perspectives and new terminology concerning phenomena that are familiar and often discussed in both fields. The result is a bit like looking at the famous ink blot and seeing faces instead of the vase. It takes some retooling to achieve that result. For that reason, it may be helpful to begin with a brief summary statement of the overall theory.

After a business enters general default,[12] the traditional picture of the recovery process comprises three conceptually simple steps: seizure of the debtor's assets, sale of the assets--generally piecemeal "on the courthouse steps"--and distribution of the proceeds. The process of seizure and sale requires the taking and exercise of control. The distribution of proceeds rests upon a system of priorities: who stands where in the line in front of the distribution table. Thus recovery raises issues of control and issues of priority. With this simple model in mind, the vast and sophisticated literature of secured credit and bankruptcy law has focused almost exclusively on questions of priority rather than the problem of control of the *process* by which seizure, sale, and distribution are achieved.[13] In the context of that model, control of the process of sale is relatively simple and uncontroversial, while questions of priority in distribution are at the center of most disputes.

The contemporary process of recovery is likely to be very different. Although the redeployment of assets by piecemeal liquidation in a Chapter 7 bankruptcy proceeding is still frequent, in current practice the recovery process often means sale of a business as a going-concern or financial restructuring of the business (reduction of debt and extension of time for payment) in a reorganization. In the United States, both of these methods of recovery are most often accomplished in a Chapter 11 bankruptcy proceeding.[14] The resulting proceeds are often obtained over a period of years and distributed in the form of equity in the debtor, new bonds, and various other securities of considerable complexity depending in turn on the outcome of complex sales and other restructuring transactions. In these circumstances, control of the process of recovery has become at least as important as rules of priority. But for

[12] "General default" means the debtor has defaulted on all or most of its obligations, by contrast with failure to pay or perform a particular debt or other obligation.

[13] CR.

[14] They may also be done outside of bankruptcy, but even then the process of achieving an agreement often turns on the outcomes projected in a Chapter 11 proceeding.

the most part the theoretical literature has not reflected these developments and has kept priority at center stage.

The reason that control of the process of recovery has become so important is that the methods mentioned above often require more time and more complex management, both operational and financial, than a simple piecemeal liquidation. At the same time, the range of possible values, from a low value in a simple liquidation to a high value obtained from a creative merger, has become much greater as well. Closely related is the fact that key decisions in this more complex environment turn importantly upon evaluation of risk and a willingness to accept risk. As explained below,[15] the consequence is that parties with varying priorities will have quite different interests in the management of the recovery process and therefore strong incentives to try to control it for their benefit.

Traditionally, the control of the recovery process rested in the trustee in bankruptcy. However, outside of bankruptcy a secured creditor had its own unilateral method of control and sale.[16] Even when a bankruptcy proceeding began, a straight forward liquidation might not justify pre-emption of secured creditor control by the bankruptcy trustee, so the collateral might be "abandoned" to the secured party.[17] However, as reorganization bankruptcy became more prominent in the United States--sooner and more extensively than anywhere else in the world--bankruptcy law changed to impose bankruptcy control on secured creditors as well. The secured creditor retained its priority rights as before, but control of the recovery process extended to its collateral along with all the rest of the debtor's assets. Secured creditor autonomy, free of bankruptcy-law control, remains the norm in many countries who still have piecemeal liquidation as the centerpiece of their recovery paradigm, but the worldwide trend toward reorganization regimes in bankruptcy has led in many countries, as it did in the United States, to depriving secured creditors of their control of collateral in favor of bankruptcy control.[18]

Because United States bankruptcy law recognizes and enforces the priority of secured credit with little deviation, there is no conflict and no particular theoretical connection between secured credit and bankruptcy law as to priority. There is, however, a profound conflict between them as to control of a debtor's business. In that very conflict lies the fundamental connection between them. The model of the recovery process based on that struggle lies at the heart of the analysis presented here.

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[15] CR.

[16] CR.

[17] Bankruptcy Code ("BC") §554.

[18] *World Bank Principles and Guidelines for Effective Insolvency and Creditor Rights Systems* [hereafter "WB Principles"]; UNCITRAL Working Group VI (Security Interests), 2d sess., Dec. 17-20, *Draft legislative guide on Secured Transactions* (2002).

Part II. The Secured Credit Model

A. Priority and Control

Little of the literature concerning secured credit under Article 9 of the Uniform Commercial Code has carefully distinguished its two central elements, priority and control. Very many articles and books discuss the doctrine and policy of Article 9 and its relationship to the Bankruptcy Code.[19] A great deal has been written about the transactional (ex ante) impact of secured credit on the efficiency of the credit system.[20] But the theoretical building blocks of secured credit and the relationship between goals and methods within its structure have been largely ignored. This article does not join the debate as to the efficiency of secured credit and in any case a full discussion of that subject would be a large project for an entire article. What follows is an outline of the priority and control elements in secured credit sufficient to serve present purposes. The key requirement is to understand control of the recovery process as a valuable element of a security interest distinct from priority in distribution, a point virtually unexamined in the secured-credit literature.

In this model, both priority and control are shown to be essential to secured credit law *outside of bankruptcy*. As the later discussion of secured credit efficiency theory will demonstrate, however, priority has been the centerpiece of that literature and control largely ignored.[21] Only two scholars in that long debate have fully recognized the importance of some of the aspects of control discussed in this section. Professor Scott almost twenty years ago presented a model of the relationship between secured creditor and debtor that emphasized the benefits of one type of control.[22] More recently, in a series of articles Professor Mann has offered powerful empirical and analytical arguments that control is a distinct, and distinctly valuable, attribute of security outside of bankruptcy.[23]

As we will see, once bankruptcy is filed, it largely negates the control aspect of secured credit, while leaving intact the priority function. That may be one of the reasons scholars have failed to see the importance of secured-creditor control,

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[19] The classic work remains GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY (1965) [hereinafter GILMORE, SECURITY INTERESTS]. A search of the Westlaw "journals" data base uncovers over 1000 articles discussing article 9 and bankruptcy from 1990-2003 (" 'Article 9' w/p bankruptcy and da(aft 1989)").

[20] CR.

[21] *See, e.g.*, the article that started it all, Thomas H. Jackson & Anthony T. Kronman, *Secured Financing and Priorities Among Creditors*, 88 YALE L.J. 1143 (1979) [hereafter "Jackson & Kronman"]. CR efficiency text at Part V.

[22] It was the type of control called "asset constraint" in this article. CR.

[23] *See, e.g.*, Mann, Strategy, *supra* note xx. His focus was also on the period prior to a general default, although less exclusively.

despite the important clue presented by Professor Scott and the evidence provided by Professor Mann. Yet it is the tension over bankruptcy's effect on the control aspect of security that creates the theoretical link between the two bodies of law at the most fundamental level.[24]

The first purpose of a secured-credit regime is a workable system to permit a debtor to sell a post-default priority in certain collateral to a creditor, thus achieving what are thought to be socially useful purposes.[25] Priority for this purpose simply means the right to be paid first, in full, from the proceeds of disposition of the designated collateral. To achieve that goal, a secured-credit regime has three requirements. The first is to assure the creditor priority in the proceeds of sale of the collateral in case of a default, because certainty in that regard is crucial to generation of its economic benefits.[26] Yet priority in, say, yesterday's newspapers would not be satisfactory. So the second requirement is to maximize the value of the collateral. No matter how great its value, however, the collateral will not serve the first goal unless it is available following default, so the third requirement is to assure the availability of the collateral at the time of default.

These three requirements must be viewed in the context of three dichotomies of central importance in secured credit. The first divides the period prior to a default from the period following default. The second is between an "ordinary" security interest and a "dominant" security interest. The third dichotomy is between a single default and a general default. These categories are important because the nature and effect of the secured party's control of the debtor's assets is different on each side of these paired categories.

1. Pre-Default/Post-Default

A secured party's control of a debtor's assets is crucial both before and after a default, but the character and effect of that control change radically from the pre-default to the post-default situation. Prior to default, the central function of secured credit is to satisfy its third requirement, preserving the availability of the collateral in case of a future default. There is no legal difficulty vis a vis the debtor. Article 9 swept away some ancient formalisms, so only a written agreement is required.[27] However, promises by the debtor to preserve the collateral are of little value standing alone. There is no point suing the debtor who ignores the promises and conveys the assets to a buyer for value in good faith or gives a security interest to a new secured

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[24] It is instructive that the two lender-control articles recently published do not emphasize the role of security. CR that discussion in Part VI.

[25] Traditionally, the benefit was thought to be a reduction in borrowing costs and an increase in the availability of credit, although the efficiency of secured credit in delivering these results from the perspective of the credit system as a whole is hotly disputed. Part VA, *infra*.

[26] Same CR.

[27] UCC 9-203. The lender must give value, of course, and the debtor must have rights in the collateral in which the interest is granted. *See generally*, GILMORE, SECURITY INTERESTS §10.2 (297-301).

party. The debtor often has no assets left, so a judgment against it is only suitable for framing. To preserve the collateral there must be a right to recover the property from a transferee. That is, there must be a right traditionally called "in rem," which means that it is good as against third parties, even those acting in good faith and giving value.[28] It must also extend throughout the relevant market to be good against the bankruptcy trustee.[29] That result—ensuring the collateral remains with the debtor or is readily recoverable from transferees--we may call "asset constraint."

Article 9 has succeeded in creating a workable system of asset constraint by the use of a highly effective system of notice. The giving of notice by one of the methods prescribed under Article 9 is called "perfection," and enables the secured party to recover property from a transferee, subject only to certain carefully defined exceptions. It is efficacious because the disclosure of the interest to the world permits an inference of acceptance by subsequent commercial actors and therefore justifies subjecting them to the debtor's sale of priority and enforcement rights to the secured creditor. Article 9 provides a remarkably simple, inexpensive, and readily accessible system of notice by registration in a public office.[30] That notice permits the law to provide assurance of asset constraint to the secured party. This system sounds easy, but took centuries to achieve.[31] Indeed, many countries have yet to achieve it.[32] Any secured credit system is of little value if it cannot provide asset constraint; that point is part of the larger truth that serious difficulties are inherent in rules that permit a contract to bind third parties. Yet the system of specific notices, combined with the general notice provided by the law itself, largely resolves both problems.[33]

Asset constraint is a notably powerful and important function to have gone so long without a name.[34] Article 9 provides asset constraint by making unauthorized

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[28] Although a right good against all or most third parties is conventionally described as a property right, the point is not undisputed. Lynn LoPucki, *The Unsecured Creditor's Bargain*, 80 Va. L. Rev. 1887, 1952-54, 1921-23 (1994) [hereafter "LoPucki, Unsecured Bargain"].

[29] Westbrook, Solution, *supra* note xx, at 2283-84.

[30] It also may have some serious imperfections, but that is a subject for another discussion.

[31] The trick, of course, is to bind third parties without destroying free transferability in the marketplace, without which inefficiencies will increase costs dramatically. Article 9 has largely achieved that result, but the many important details are not the subject of this article. *See generally*, GILMORE, SECURITY INTERESTS, *supra* note xx.

[32] World Bank Principles, *supra* note xx.

[33] A system that derives its legitimacy from the autonomy values of private bargaining must create unacceptable externalities if it affects the rights of third parties without their consent. *See, e.g.*, Michael J. Trebilcock, *The Limits of Freedom of Contract* 243 (1993). Notice is the device that attempts to solve this difficulty--or at least ameliorate it--by a system that permits a claim that the third party with notice has implicitly assented. *But see* Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857 (1996) [hereafter "Uneasy"].

[34] The closest term in the literature is "hostage value," used by Professors Scott and Hill. Claire A. Hill, *Is Secured Debt Efficient?* 80 TEXAS L. REV. 1117, 1134 (2002) [hereafter "Hill, Efficient"]; Scott, Relational, *supra* note xx, at 927-28. *See also*, Ronald J. Mann, *Verification Institutions in*

transfers of collateral recoverable from the transferee, but that simple statement belies the complexity of a system of constraint that has been carefully fine-tuned over a century of experience to produce the right balance between protection of the secured creditor and the maintenance of free transferability in the market place.[35] It ensures, to a very large extent, that the collateral will still be available if there is a general default.

We will use the term "asset constraint" rather than "asset control," when referring to the period prior to default,[36] because during that period, the debtor has control of the assets. The security interest merely confers constraint on transfer to third parties. After a debtor's general default, a secured party acquires the right to direct control of its collateral, because it may seize it, by self-help or by judicial action, and proceed to realize upon the collateral with a broad discretion in the method of sale or other realization.[37] This valuable right to seize assets of the debtor and control their disposition we will call "collateral control."[38] Outside of bankruptcy, it leaves the secured party in complete control of the recovery process, with only a broad and flexible legal duty to act in a "commercially reasonable" way.[39] This distinction between pre-default and post-default control is significant to understanding the relationship between secured credit and contractualism, which requires different kinds of control before and after a general default, while bankruptcy as a system for managing the recovery process exercises control only after default.

In the next section, we will address the fact that both asset constraint and collateral control become qualitatively different in the hands of a dominant secured party. Prior to default, constraint over all assets gives a dominant secured party a pre-default check upon any substantial changes in the business activities of its debtor.[40] The post-default collateral control given to a dominant secured party gives the

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Financing Transactions, 87 Georgetown L.J. 2225, 2244 (1999). That term, however, refers to the leverage arising from asset constraint, an important, but distinct topic discussed *infra*. CR

[35] Obviously, overbroad restrictions on transfer—or, worse still, undisclosed restrictions—would seriously hamper the functioning of a market. Among other things, overbroad restrictions would cause potential buyers and other transferees to refuse trades or undervalue them because of the risk of losing the asset to a secured party.

[36] Professors Scott, Mann, and Hill have used the term "control" when referring to the legal protection granted to a secured party prior to default. Scott, Relational, *supra* note xx, at 927-28; Hill, Efficient, *supra* note xx, at 1134; Ronald J. Mann, *The Role of Secured Credit in Small-Business Lending*, 86 Geo. L.J. 1, 25 at n. 93 (1997)[hereafter "Small Business"].

[37] UCC Art. 9, Part 6.

[38] CR to discussion.

[39] UCC Art. 9, §§610(b), 627.

[40] That extended form of asset constraint we may call "business plan constraint." CR It is the sort of control or quasi-control that Professor Scott had in mind in an important article about the possible efficiencies of secured credit, although he did not establish the distinction as such. Scott, Relational, *supra* note xx, at 927-28.

secured creditor control of an entire enterprise and makes it possible for the creditor to realize going-concern value.[41]

2. Ordinary Secured Party Versus a Dominant Secured Party: Enterprise Control & Going Concern Value

The second dichotomy in secured finance is between an "ordinary" secured party and a "dominant" secured party. In a basic and simple model of a secured transaction, the ordinary secured party is one that receives a security interest in a single item of collateral, while a dominant secured party receives a security interest in all of the assets of its debtor.[42] Their priority rights are the same, but their rights to constrain and control produce importantly different effects.[43]

Suppose a debtor, General Kompute,[44] that might give a security interest in a large welding machine to a ordinary secured party or a security interest in all of its assets to a dominant secured party. In case of default, the ordinary secured party would have the right to take control of the single welding machine.[45] The dominant

[41] We will call the dominant secured party's all-embracing collateral control "enterprise control," because it gives effective control of the business. CR.

[42] There are many intermediate positions where the secured party has a substantial, but less than complete, security interest, but that is another issue that must await a fuller development of the secured credit model. It is obvious, however, that a security interest in the most valuable and operationally crucial of the debtor's assets might well amount to a dominant security interest. An example would be a typical single-asset real estate case, where the holder of a mortgage on an apartment complex may not have a security interest in the office furniture, the bank account, maintenance equipment, and so forth, but its collateral nonetheless represents so much of the total wealth of the debtor that the effect is much the same. An example that may be especially relevant to the recent "control" articles would be control of the debtor's bank account by way of setoff and cash collateral orders. CR Part V discussion of Baird and Rasmussen articles.

[43] Professor Scott is one of those who saw the importance of distinguishing among security interests with varying scope. *See* Scott, Relational, *supra* note xx. But he did not seize upon the heuristic value, as he might have put it, of the dichotomy between the secured party with an interest in a single asset and one with a blanket lien nor did he focus on the enforcement rights of secured parties. (His work may be subject to critical comment in this article to a greater extent than others, I fear, precisely because he has published so many useful insights that overlap with the analysis offered here.) In any event, his focus was on the quasi-control right he called "hostage value," which this article would characterize as an element of leverage for the secured party that arises from "asset constraint" or, in the case of a dominant secured party, "business-plan constraint." Asset constraint is the overall pre-default effect of the article 9 rules, while hostage value is one of the benefits it generates for a secured party. CR fn which mentions. Professor Hill has developed the hostage-value idea in more sophisticated and useful detail. Hill, Efficient, *supra* note xx, at 1133-35. *See also* Mann, Small-Business, *supra* note xx, at 22-25, 27.

[44] I trust there is no such company, but if there is one, it is not the company I have in mind.

[45] The classic ordinary secured party is a vendor with a purchase money security interest in an item it has sold to the debtor or is a lender who has financed such a sale. Such a creditor has no interest in control of the debtor enterprise. Indeed, if there is a default, its interest will lie in quickly separating its collateral from the rest and realizing as much as possible from its sale. Only in unusual circumstances would it have an interest in the overall fate of the debtor enterprise.

secured party would have the right to assume control of the entire enterprise, because of its right to seize and sell all of its assets. While the dominant secured party might not have technical control of the debtor company as such,[46] it would effectively control the entire business, from the office lease to the drill presses to the accounts receivable and inventory. One highly important consequence is that it could sell the business as a "going concern."[47]

When the ordinary secured party sold its welding machine, it would probably get only "liquidation value," the value typically obtained at a liquidation sale. It is established that liquidation value is routinely well below market value.[48] Because of the sophisticated procedures available to a secured creditor under Article 9,[49] if the ordinary secured party tried hard (for example, by advertising widely and waiting for the right buyer) it might obtain a price closer to market value for that single asset, but no more. By contrast, the dominant secured party's control of all of the assets of the enterprise would mean that it would have the opportunity to obtain "going concern" value at an Article 9 sale, which may be much greater than market value (and therefore much, much greater than liquidation value), because a living business--with established customers, knowledgeable employees, and so forth--may well bring a higher price as a unit than sale of each asset separately, even in the unlikely event that those separate sales would obtain market value for each asset. It is generally conceded that going-concern value is the highest possible value for assets and much to be desired.[50] The highly flexible Article 9 sale provisions make it legally possible

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[46] The right to sell assets, and conserve them in the meantime, is not the same as ownership of a company, but does confer considerable control, absent bankruptcy

[47]. Referring to the British system, Mokal cites as key this power, the ability of a dominant secured party ("main creditor") to keep the assets of the debtor together, contrasted with the inability of an ordinary secured party (a "fixed" chargeholder). The reason is that it protects "synergies," by which he means something like what this article calls going-concern value. *See* Rizwaan J. Mokal, *The Floating Charge—An Elegy*, in COMMERCIAL LAW AND COMMERCIAL PRACTICE at n. 30 (Oxford Sarah Worthington ed. forthcoming 2003) (hereafter "Mokal, Elegy").

[48] *See* Matter of Hoskins, 102 F.3d 311, 312 (7th Cir. 1996). *See* Kathryn R. Heidt & Jeffrey R. Waxman, *Supreme Court's Rash Decision Fails to Scratch the Valuation Itch,* 53 Bus. Law. 1345, 1346 (1998).

[49] UCC, Article 9, Part 6.

[50] James S. 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, 975 (1983) (stating that a central assumption of the reorganization sections of the Bankruptcy Code is that a business will be worth more as going concern rather than liquidation value of its assets); Lucian Arye Bebchuk, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775, 776 (1988); Robert C. Clark, *The Interdisciplinary Study of Legal Evolution*, 90 YALE L.J. 1238, 1252 (1981). Actually, there may occasionally be higher values. For example, there may be an additional value for a buyer-competitor in being able by an asset purchase to eliminate a competitor without successor liability and some of the other risks of a corporate acquisition. Professors Baird and Rasmussen in a recent article argue that few American companies have any going-concern value by the time of bankruptcy, but do not deny that any such value is likely to be the best obtainable. Baird & Rasmussen, End, *supra* note xx. They offer no empirical support for their claim about the availability of going-concern value in fact.

for the dominant secured party to make a going-concern sale.

As a consequence, if the ordinary secured party sells the welding machine at auction after giving such notice as it thinks satisfies the Article 9 requirement,[51] it may get, say, $10,000 for it, versus a market price for such a used machine of, say, $18,000.[52] If it is willing to advertise extensively, make phone calls to other companies who use such machines, and wait until the best offer is obtained, it might get the full market value of $18,000. On the other hand, the dominant secured party may be able to sell General Kompute (that is, all of its assets as a package) to Cross-Town Kompute, which has been anxious for a second location for years and would be delighted to retain the employees who know the eccentricities of each machine and greet customers by name. The dominant secured party may obtain a full going-concern value for the business, much more than the sum of the amounts it could get by selling each asset.[53] Thus the spread of values for the assets might be, say, $100,000 total from a liquidation sale of each asset; $180,000 market value after much time and effort in selling each asset; or $300,000 for sale as a going concern. There is no guarantee that a going-concern sale can be made, but it is possible in a substantial number of cases and increased payoffs like those in this example would not be surprising. That going-concern sales by secured parties are quite plausible is empirically demonstrated by the English experience described below.

Because the distinction between ordinary secured parties and dominant secured parties has been so generally ignored in the literature,[54] we need a term to distinguish the effects of the two types of collateral control. The post-default collateral control given to a dominant secured party we may call "enterprise control," because it gives the secured creditor control of an entire enterprise and makes it

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[51] UCC 9-611-14.

[52] Unhappily, we have little empirical data on these points and must rely on the experience of people in the field.

[53] The statement in text must be qualified because in some cases (perhaps in many cases) the managers or owners of a business may be crucial to obtaining going-concern value for the business. For example, a manager may be careless about financial discipline, but may have a level of credibility and technical respect among customers that makes him or her essential to the business. Because personal services may not be legally commandeered in our society, even a dominant secured party cannot realize going-concern value in such a business without obtaining the cooperation of key personnel.

[54] A recent well-documented article discusses the allocation of going-concern value between secured and unsecured creditors and makes a number of useful points analytically, but puts no importance on the distinction between ordinary and dominant secured parties. Omer Tene, *Revisiting the Creditors' Bargain: The Entitlement to the Going-Concern Surplus in Corporate Bankruptcy Reorganizations*, 19 Bankr. Dev. J. 287 (2003). Professor Shupack identified the importance of the emergence of blanket liens under Article 9, but did not develop the point. Shupack, Puzzle, supra note xx. Professor Scott was almost unique in emphasizing the importance of the "blanket lien," but focused almost exclusively on pre-default control of the debtor's business. CR discussion of Scott. Professor Hill has usefully discussed the emerging notion in financial circles, especially in the United Kingdom and the Commonwealth, of "whole-business securitization," but that approach depends on the British receivership system—that is, control by the dominant secured party. CR that discussion.

possible for the creditor to realize going-concern value.[55] The distinction between the two types of secured parties is crucial because there is such a sharp difference between the nature and value of an ordinary secured party's mere collateral control and the enterprise control exercised by a dominant secured party.

3. Single versus General Default

Following default, the law's central goal is maximizing collateral value. There is a key distinction here between a single default—only the secured party's debt is not being paid—and a general default in which the debtor is not paying its debts generally. In the first situation, the secured credit regime is simply a highly privileged mechanism for enforcing a particular debt, much superior to the slow and uncertain business of getting a judgment and sending out the sheriff to seize such property as can be discovered. Most systems around the world give a secured creditor some advantage in debt enforcement, but the United States system is among the most helpful to secured creditors.[56] Part 6 of Article 9 permits the secured creditor to use self-help, without the need to go to court. It may seize the collateral and sell it under a very flexible regime of reasonableness, paying itself from the proceeds.[57] With or without self-help, the special enforcement right given to a secured creditor in most legal systems, a right that we may call "collateral control," is a very valuable one, although its independent value has been largely ignored in the literature. In jurisdictions like the United States that permit self-help repossession and sale, collateral control is even more valuable.[58]

The shift from enforcement of a single debt to the general-default context may radically change the rights of the secured creditor because bankruptcy negates collateral control.[59] As explained below in Part II, the reason is that control of the debtor's business lies at the heart of bankruptcy law and is its *sine qua non*. Therefore, in principle bankruptcy must negate a secured party's collateral control.[60] The distinction between priority rights and collateral control is crucial for the secured creditor in a debtor's general default, because bankruptcy law honors one and negates the other.

In a general default, a security interest is simply a privately bargained priority

[55] Enterprise control is, of course, the cognate of the pre-default business constraint. CR

[56] The receivership system is even more generous, but the North American system, found in the United States under Article 9 and in Canada under the Personal Property Securities Acts, is the next best for the secured creditor. For an expert discussion of the latter, *see* Jacob S. Ziegel & David L. Denomme, THE ONTARIO PERSONAL PROPERTY SECURITY ACT (2d ed. 2000).

[57] UCC 9-612. For certain collateral, like accounts receivable, it may simply collect the accounts from the debtor's customers without any court intervention. UCC 9-607.

[58] The text refers to the value of control independent of priority alone.

[59] B.C. §362(a).

[60] This assertion is correct despite the fact that in a number of countries around the world secured creditors are not restrained by the bankruptcy stay. *See* CR.

in bankruptcy that was sold by a debtor to a creditor. The sale was part of a larger transaction in which the priority was presumably exchanged for a lower interest rate and better terms in connection with an extension of credit to the debtor. It is the only privately bargained priority permitted under the United States Bankruptcy Code.[61] Although our priority for a security interest is more absolute than that found in many other countries, the security-interest priority is recognized to varying degrees in the general-default laws of many jurisdictions.[62] Most of the issues in secured credit law in the United States, including perfection under Article 9 and adequate protection under the Bankruptcy Code, relate primarily to the institutional apparatus necessary to protect the priority of the holder of a security interest in the circumstance of a general default. But its collateral control is generally lost.[63]

Thus the distinction between a single default and a general default is important because of the difference in the secured party's collateral control rights. In enforcing a single debt outside of bankruptcy, the secured party has complete control of the recovery process as to the assets constituting its collateral. If it is a dominant secured party, it has control as to the entire enterprise. However, in a general default the debtor and other creditors hold an option to remove the secured party's control by filing a bankruptcy proceeding, an option often exercised in the United States. Once bankruptcy is filed, the secured party loses its collateral control.

In summary, priority represents the right to be first in line for payment from the disposition of collateral after default. Control is the right to control the collateral in some sense both before and after default. The importance of control is that it protects priority.

Asset constraint is the secured party's power to recover its collateral from a transferee. In the hands of a dominant secured party, asset constraint amounts to "business-plan constraint," a negative power to prevent unapproved major changes in

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[61] That statement should perhaps be qualified, if one concedes that subordination is a sort of reverse priority. Section 510(a) makes contractual subordination clauses enforceable in bankruptcy, so it may be said to be a form of privately-bargained priority. On the other hand, such clauses do not constitute a general subordination of a claim, but only subordination to certain other creditors, so they do not constitute a priority in the full sense of the word.

[62] World Bank Principles, *supra* note xx, P3 and accompanying text; UNCITRAL, Security, supra note xx, Addendum at 5, 26. *See also*, Rolf Serick, *Securities in Movables in German Law* 108 (1990)(primarily by a retention of title theory for both suppliers and lenders); American Law Institute, Transnational Insolvency Project, INTERNATIONAL STATEMENT OF MEXICAN INSOLVENCY LAW App. E, III.D.2 (forthcoming 2003) [hereafter "ALI Mexican Statement"]

[63] In a routine liquidation, the secured creditor may regain its collateral control. If the trustee in bankruptcy is selling off assets piecemeal, it will often be efficient to release bankruptcy control of collateral back to the secured party to permit that party to realize upon its sale. BC §554. On the other hand, where rescue or sale of the business as a going concern is a possibility (for example, in a Chapter 11 reorganization), the debtor in possession or trustee in bankruptcy is unlikely to relinquish control. Whether the court will return control to the secured party under section 362 depends largely on the court's view of the prospects for reorganization and the required protection of the secured party's priority. CR.

the debtor's business. More direct control of the collateral arises after default. Collateral control is the right outside of bankruptcy to seize the collateral and control the recovery process, including sale or other disposition of the collateral. For a dominant secured party, collateral control becomes enterprise control, because the dominant secured party can sell the entire business and obtain going-concern value. For both types of secured party, however, a general default may sharply reduce collateral control because another party may exercise the bankruptcy option, which would negate collateral control while preserving priority.

Asset constraint prior to bankruptcy is a valuable right that has received little attention in the economic analysis of secured credit. Collateral control is a distinct additional value that has also been largely ignored. Because bankruptcy operates only after a general default, it is in that context that control becomes the center of conflict between secured credit and bankruptcy law and thus constitutes the basic nexus between them at a theoretical as well as an operational level.

B. Benefits of Enterprise Control to a Dominant Secured Party

The two most important benefits a dominant secured party gains from enterprise control are the opportunity of realizing going-concern value after default and a possible veto over a bankruptcy proceeding.

A dominant security interest offers debtor and creditor a substantial potential payoff, absent bankruptcy. The ordinary secured party must lend based on its estimate of the future value of its one item of collateral.[64] If the item's estimated depreciating value at sale will at all times be in excess of the declining balance on the loan, the creditor's analysis is complete.[65] It will determine the amount of its loan and price it as a function of being fully secured up to the sale value.[66] By contrast, the dominant secured party is in a position to lend on the basis of being secured by the going-concern value of the debtor's enterprise, over which it will take full control in case of default.[67] That higher value may permit the lender to lend more money at a

[64] The text is not inconsistent with the elementary proposition that all lenders are interested in the debtor's capacity to pay the loan without any need for enforcement. Shupack, Filing, at 790. The text refers to the secured party's analysis of its lending position qua secured party, that is, with sole reference to the value of its collateral as part of its lending package.

[65] Note that this estimate would be higher if there were no prospect of bankruptcy, because the creditor could assume that in case of default it would be able to enjoy its collateral-control right to manage the sale of the collateral. In reality, the possibility of bankruptcy means the estimate of value by the ordinary secured party will depend in material part on the likelihood of bankruptcy and the consequent loss of its collateral-control right.

[66] That is, it will apply its secured-loan pricing and risk standards to the loan to the extent of the value of the collateral. If it is willing to lend more, it will apply its unsecured price and risk standards to the remainder above the projected collateral value.

[67] The description in the text is shorthand. All lending is done on the basis of discounted probabilities--at least in theory. The actual value of a dominant secured party's security will the going-concern value discounted by the improbability of obtaining the going-concern value. More fully, where going-

lower, secured rate of interest. That is, it may lead to an increase in capital availability and a reduction in costs. That result is arguably desirable for debtor and creditor as well as for society generally, other things being equal. Given the large gap between going-concern value and other values, the enterprise control given to the dominant secured party has the potential to be substantially more valuable to the parties than the mere collateral control granted to the ordinary secured party. Its institutional implications are also important, because the realization of going-concern value is a principal justification for Chapter 11.[68]

As we have seen, however, bankruptcy negates collateral control. To that extent, the value of enterprise control must be discounted[69] by the risk of a bankruptcy filing following default. Yet that risk may be reduced, and the value of enterprise control enhanced, by a bankruptcy veto. A possible veto over the maintenance of a bankruptcy proceeding is a second added value arising from enterprise control. The bankruptcy veto arises from the fact that enterprise control may prevent the funding of a bankruptcy proceeding and make the likely results of bankruptcy unattractive to the debtor and other potential filers of a bankruptcy petition, unless the secured creditor, for its own purposes, desires such a proceeding.[70] The ability to sidestep bankruptcy control and enjoy the benefits of

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concern value is X, the piecemeal-sale market value of the assets is Y, and liquidation value of the assets is Z, there will be a composite value equal to the discounted probability of obtaining X+ the discounted probability of obtaining Y+ the discounted probability of obtaining Z. Assuming a fairly good probability of obtaining going-concern value, the composite value will be higher than either Y or Z, permitting the lender to lend more or to lend at a lower interest rate.

[68] H.R.Rep. No. 595, 95th Cong., 2d sess. 220, reprinted in 1978 U.S.C.C.A.N. 5963, 6179 ("The premise of a business reorganization is that assets that are used for production in the industry for which they were designed are more valuable than those same assets sold for scrap."); Lucian Arye Bebchuk, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775, 776 (1988) (recognizing "reorganization is […] especially valuable when (i) the company's assets are worth much more as a going concern than if sold piecemeal, and (ii) there are few or even no outside buyers with both accurate information about the company and sufficient resources to acquire it."); Robert C. Clark, *The Interdisciplinary Study of Legal Evolution*, 90 YALE L.J. 1238, 1252-54 (1981) (stating, "[w]henever the going-concern value of an insolvent debtor's business exceeds its piecemeal liquidation value, and the receivership preserves that excess value, there is a net gain for creditors and society.").

[69] Of course, the risk of bankruptcy also reduces the value of collateral control for an ordinary secured party.

[70] In a fair number of reported cases a secured party has agreed to a "carve-out" of value from its collateral. *See, e.g.*, *In re Debbie Reynolds Hotel & Casino, Inc.*, 255 F.3d 1061 (9th Cir.2001). *See also* L. King, 4 Collier on Bankruptcy, 506.05[6], at 506-134 (15th ed. rev.2000). Because UCC section 315 and BC section 552 give the secured party a broad right to the proceeds of its collateral, a dominant secured party will ordinarily have a security interest in all the cash flow of the business, leaving nothing to pay attorney and trustee fees and other expenses of the bankruptcy unless the secured party agrees to use of its proceeds for that purpose. *See, e.g.*, *In re Hotel Syracuse, Inc.*, 275 B.R. 679 (Bankr. N.D. N.Y. 2002); *In re Nuclear Imaging Systems, Inc.*, 270 B.R. 365 (Bankr. E.D. Pa. 2001); *In re Suntastic USA, Inc.*, 269 B.R. 846 (Bankr. D. Ariz. 2001). If the secured party refuses, there may be no funds available to pay professionals and basic expenses, making a bankruptcy filing pointless. The existence of the cases where carve-out was agreed necessarily implies other cases--one would think a substantial majority of those involving a dominant secured party--in

enterprise control over the recovery process may represent a substantial additional value to the secured creditor, materially adding to the benefit associated with potential sales at going-concern value.[71] Neo-classical theory would suggest that this increase in value would be shared between debtor and lender in the same way as the other enhancements obtained by the secured party by virtue of a dominant security interest.[72] The benefit comes with certain difficulties discussed below.[73]

C. British System

Partly for historical reasons,[74] this way of looking at the position of a dominant secured party has been obscured in the United States. By contrast, it is the classic and typical picture of secured lending in Britain. Britain provides an empirical example of the consequences of a system in which a dominant security interest is typical and a dominant secured party retains control even in a general

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which the secured party would have no interest in a bankruptcy proceeding, would refuse a carve-out, and would therefore leave the proceeding unfinanced and unsustainable. The rich literature and caselaw on this subject references primarily section 506(c) of the BC, which gives a priority in collateral proceeds to the reasonable costs of preserving and disposing of collateral in a bankruptcy case, but only to the extent that the secured party is benefited. *See, e.g.*, Steve H. Nickles, & Edward S. Adams, *Tracing Proceeds to Attorneys' Pockets (and the Dilemma of Paying for Bankruptcy)*, 78 Minn. L. Rev. 1079 (1994) (discussing cases and suggesting reforms). Nickles and Adams criticize the cases for having been unwilling to interpret this provision more broadly in favor of paying bankruptcy costs. The cases most often are found under the heading "carve-out," which refers to a situation in which the secured creditor agrees that a certain amount of the proceeds of its collateral may be used to pay attorney's fees and other costs of a bankruptcy. This solution requires, of course, the consent of the secured party. The arguments that Nickles and Adams, two knowledgeable scholars, make in favor of requiring payment of bankruptcy costs from collateral are closely related to those made *infra* for a bankruptcy trump of the bankruptcy veto. CR.

[71] Of course, the bankruptcy veto would have substantial value even where the debtor does not have a going-concern value because elimination of bankruptcy control would leave the dominant secured party in complete control of the recovery process.

The benefits of control are not limited to the bankruptcy situation. *See, e.g., Gau Shan Company, Ltd. v. Bankers Trust Co.*, 956 F.2d 1349 (6th Cir. 1992), in which the debtor tried to block a suit by the creditor in Hong Kong. It's key argument was that the creditor had an English-style floating charge and therefore could block the debtor from access to the courts by exercising its rights, making it impossible to respond properly to the Hong Kong suit. A similar result might be obtained in the United States if a dominant secured party argues that its all-embracing security interest includes any cause of action the debtor might have against the secured party.

[72] Part VA, *infra*.

[73] CR to incentive problem and veto problem.

[74] A striking characteristic of Article 9 is that it makes "blanket" liens readily obtainable and enforceable without establishing any different rules for the holders of such liens. The literature neither suggests such differentiation nor explains why it is unnecessary. Few things are more obvious than the dramatic difference in the positions of ordinary and dominant secured parties, but the difference is ignored like the Purloined Letter. EDGAR ALLAN POE, The Purloined Letter, in THE PURLOINED POE, Ch. 1 (John Muller, J. & William Richardson, eds., 1988). The reason is the failure to take account of the centrality of the concept of control. Also contributing may have been the existence of many middle cases, secured creditors with multiple security interests but not blanket liens, a point not addressed in this article.

default.[75] Since the late Nineteenth Century, Britain has had a security system known as the "floating charge." The word "charge" means security interest. The scope of the floating charge is roughly equivalent to a "blanket lien" in United States terminology; that is, it is a security interest over all of the assets of the debtor. The charge is called "floating" because it does not restrict the power of the debtor to deal in its assets freely until there is a default. At the point of default, it is said to "crystallize," giving the secured creditor instant and virtually complete legal control over all the debtor's assets. Through a "debenture," which serves some of the functions of the American security agreement, the secured creditor has the right after default to appoint a "receiver" with no intervention or supervision by a court. A legal fiction makes the receiver, who is now called an "administrative receiver,"[76] the agent of the company, not the secured party, so the secured creditor is not liable for the receiver's acts.

The creditor-appointed receiver, who is invariably an accountant, then proceeds to liquidate the debtor. In theory, the receiver should make every effort to sell the business as a going concern and thus to realize going-concern value.[77] If no buyer is found for the business as a whole, the receiver proceeds to an asset liquidation with broad powers to choose the methods of sale. As a matter of course there is no court involvement—or supervision—of any kind. Often no bankruptcy proceeding[78] is filed at all. If there is a need to resolve issues beyond the sale of the assets, then a voluntary or involuntary liquidation might follow the receivership.[79]

[75] My British friends will find the following description painfully simplistic to the point of error, but I eschew all nuance in an effort to be clear to a United States audience. For far fuller and better discussions of the floating charge, *See, e.g.*, REPORT OF THE INSOLVENCY LAW REVIEW COMMITTEE, INSOLVENCY LAW AND PRACTICE, [1981] CMND. 8558, 9 [hereafter the "Cork Report"]; Roy Goode et al., Debtor-Creditor Regimes, in World Bank, Building Effective Insolvency Systems 1, 2-3 (1999); Ian Fletcher, The Law of Insolvency 373-424 (3d Ed. 2002); Vanessa Finch, Corporate Insolvency Law 234-69 (2002); R.M. Goode, Legal Problems of Credit and Security at 46-51, 76-77 (2d ed. 1988) [hereafter "Goode, Security"].

[76] Perhaps to keep foreigners confused, the private receiver, appointed out of court by the secured party, is called an "administrative receiver," while the court-appointed manager of an attempted reorganization is called an "administrator." (Now if we can only learn how to pronounce "Leiscester.")

[77] Cork Report, *supra* note xx, at xx.

[78] I will use the term bankruptcy per United States usage, although in Britain (and most of the English-speaking world) the term for a corporate bankruptcy is an "insolvency proceeding." The word bankruptcy is used in Britain and elsewhere to mean the bankruptcy of a natural person. Am. L. Inst., Transnational Insolvency Project, PRINCIPLES OF COOPERATION IN TRANSNATIONAL INSOLVENCY CASES AMONG MEMBERS OF THE NORTH AMERICAN FREE TRADE AGREEMENT at 1 n.2 (2003) [hereinafter "ALI Statement"]. Although the analysis in this article is limited to business debtors that are legal entities, I will use "bankruptcy" in the service of clarity for an American audience.

[79] Gabriel Moss, *Comparative Bankruptcy Cultures: Rescue or Liquidation? Comparison of Tends in National Law—Britain*, 23 BROOK. J. INT'L. L. 115, 121 (noting, "In Britain, most rescues of businesses have involved the sale of the business to other entities, while the insolvent rump of the corporation has, generally speaking, gone into liquidation.").

An example would be the happy, if perhaps rare, instance in which there is a surplus after the secured party is paid in full from the sale of the assets and there is need for a bankruptcy proceeding to distribute the remaining proceeds according to the statutory scheme.[80]

The creditor who holds the floating charge in this system almost always has a "fixed" charge as well, often over most, if not all, of the debtor's assets.[81] It is the fixed charge that provides priority in distribution, because the floating charge is subordinate to a number of "preferences" (priorities), including tax claims.[82] Thus the British bankers' saying that introduces this article: the fixed charge for priority, the floating charge for control.[83] For our purposes, the most important point is the separation of the two functions of a security interest, one that is rarely so obvious in United States practice and therefore often ignored.[84]

This sort of lending arrangement is typical in Britain, while the "blanket lien" is only one of a number of lending patterns in the United States and not necessarily the most frequent.[85] In Britain, banks, especially the four dominant "clearing" banks, employ the floating charge routinely,[86] although apparently it is not so often found where the debtor is a major company. Thus Britain presents a "natural experiment" for observation of the effects of a lending system that depends primarily on dominant security interests.

English accountants report that they are fairly frequently successful in selling businesses intact and thus obtaining going-concern values.[87] They do not quantify these reports and one may wonder about how often going-concern values are actually achieved. Nonetheless, there is no reason to doubt the honesty of their reports that such sales are made. The English experience certainly demonstrates that such sales can be achieved by dominant secured parties exercising a fully realized enterprise

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[80] As the quotation that leads this article suggests, the lender often takes "fixed charges," on specific assets. A fixed charge is similar to a security interest of the sort found in North America. It has several advantages, including the fact that the charge is not subordinated to certain other priority creditors, as a floating charge may be. *See* Goode, Security, supra note xx, at 52.

[81] A "fixed" charge is more or less the same as a security interest in United States law.

[82] *Id*. *See* Mokal, Elegy *supra* note xx.

[83] The explanation for the combination of fixed and floating charges is complex and its detail would take us too far out of our way. *See generally*, Goode, Security *supra* note xx; Mokal, Elegy, *supra* note xx; Finch, supra note xx.

[84] It must be said, however, that the distinction has often been ignored in the British literature as well. *See* Mokal, Elegy, *supra* note xx.

[85] *See* Paul M. Shupack, Preferred *Capital Structures And The Question Of Filing*, 79 Minn. L. Rev. 787 (1995) (some empirical data) [hereafter Shupack, Filing]. There are few empirical data to help us on this point, but the statement in text would command considerable agreement in the field.

[86] Cork report at 9. The United Kingdom Insolvency Service, "A Review of Company Rescue and Business Reconstruction Mechanisms," at 9 (1999) [hereafter "British Review"].

[87] A recent study confirms that conclusion. Franks and Sussman, *supra* note xx; Cork Report, *supra* note xx.

control. Although the receiver system no doubt facilitates this process, there is no reason in principle that dominant secured parties cannot achieve the same results under the very flexible provisions of Article 9 and no reason to doubt that they have done so.[88]

Part III. The Bankruptcy Model

Much less development is needed in describing a basic model of bankruptcy for the purpose of establishing the centrality of control and its relationship to priority, because there is a considerable consensus on some central points. It has long been understood that bankruptcy is a collective proceeding to be used primarily, if not exclusively,[89] when a debtor has entered general default, and that bankruptcy's central purpose is the maximization of the value to be distributed to its designated beneficiaries. It can be argued that other purposes are also important, or even central, to the bankruptcy function,[90] but the maximization of distributions to beneficiaries is a consensus goal.[91] On the other hand, we find a considerable debate about the choice of beneficiaries. Especially in the business context—the only sorts of cases considered in this article--some argue that only creditors should be regarded as beneficiaries of the process,[92] while others would find a place for employees, entrepreneurs, and even communities.[93] But each disputant would want to maximize

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[88] *Cf. Bezanson v. Fleet Bank-Nh*, 29 F.3d 16- (1st Cir. 1994) (Secured creditor got something like going concern value, but for its own benefit, although the deal was ultimately unsuccessful). There may be reason to wonder, however, if they have often done so at the point of the "official" Article 9 sale. *Id. See* CR re bidding in and re carve-out.

[89] A bankruptcy filing by a debtor not in general default is likely to be dismissed. The courts have made it clear that bankruptcy is not ordinarily to be used in single-creditor disputes rather than general defaults. *See, e.g., In re Better Care, Ltd*., 97 B.R. 405, 419 (Bankr. N.D. Ill. 1989) Furthermore, a filing by a debtor who is not in general default is unlikely because it will often lack the incentive to risk control of its business to resolve a single-creditor dispute. Bankruptcy is a blunt instrument for debt enforcement and legal systems should not rely on it for that purpose. WB Principles, *supra* note xx, P2, §45.

[90] Jay L. Westbrook, *The Globalization of Bankruptcy Reform*, 1999 N.Z. L.Rev. 401, 404-10. (seven purposes for bankruptcy, beginning with social control).

[91] *See, e.g.*, THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 7-19, 22-27 (1986) [hereinafter JACKSON, LOGIC]; Max Radin, *The Nature of Bankruptcy*, 89 U. PA. L. REV. 1, 3-9 (1940) (explaining that since Henry VIII, the time of the earliest bankruptcy statute, there was always some method by which all the creditors were compelled to accept their disposition of their claims against the bankrupt's property; this collective action to maximize value has always been the central agreed function of bankruptcy); Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 STAN. L. REV. 311, 319-23 (1993); Douglas G. Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren*, 54 U. CHI. L. REV. 815, 822-24 (1987); Randal C. Picker, *Security Interests, Misbehavior, and Common Pools*, 59 U. CHI. L. REV. 645, 647 (1992).

[92] JACKSON, LOGIC, *supra* note xx.

[93] The long-ago debate between Professors Warren and Baird remains fresh in this regard. Elizabeth Warren, *Bankruptcy Policy*, 54 U. Chi. L. Rev. 777 (1987); Douglas G. Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren*, 54 U. Chi. L. Rev. 815 (1987). *See also*,

value for its favored beneficiaries.

After the identification of beneficiaries comes the establishment of priorities. Every bankruptcy system establishes priorities in distribution.[94] These priority schemes vary greatly from one country to another. There is a pattern at the top, because three groups are favored in most systems: employees, secured creditors, and governments.[95] Even as to those privileged creditors,[96] however, the national schemes vary greatly in their generosity to each group. For example, employees are given only a modest priority in the United States,[97] but have a dominant position in Mexico per its constitution.[98] By contrast, secured creditors have a nearly absolute priority in their collateral in the United States, but are subordinated to other interests in a number of countries.[99]

Elizabeth Warren, *Bankruptcy Policymaking in an Imperfect World*, 92 MICH. L. REV. 336 (1993) [hereafter "Warren, Policymaking"].

[94] WB Principles, *supra* note xx; UNCITRAL Guide, *supra* note xx. *See generally* Jay L. Westbrook, Universal Participation in Transnational Bankruptcies, Making Commercial Law, Essays in Honour of Roy Goode 419 (Ross Cranston ed., 1997); Jay L. Westbrook, *Universal Priorities*, 33 Tex. Int'l L.J. 27 (1998).

[95] *Id*. *See also* 1 J. DALHUISEN ON INTERNATIONAL INSOLVENCY AND § 1.06 (1986) (in many countries there are general preferences in bankruptcy for secured creditors, employee claims, and governments); Jacob S. Ziegel, *Preferences and Priorities in Insolvency Law: Is There a Solution?* 39 St. Louis L.J. 793, 796 (1995) (maintaining that many countries follow the U.S. practice of providing priority to secured creditors in bankruptcy); Barbara K. Morgan, *Should the Sovereign Be Paid First? A Comparative International Analysis for the Priority of Tax Claims in Bankruptcy*, 74 AM. BANKR. L.J. 416 (2000) (internationally government claims are among the highest in bankruptcy priority).

[96] The favorable distribution rights that are called "priorities" in the United States are often called in English "privileges" in descriptions of civil-law systems. *See, e.g.*, Mexican Statement, supra note xx, at sec. IV.F(1)(c)-(d) (referring to singularly privileged creditors);"Ley de Concursos Mercantiles y de Reforma al Artculo 88 de la Ley Organica del Poder Judicial de la Federacion", D.O., May 22, 2000 (Mexican Bankruptcy Law); Draft Legislative Guide on Insolvency Law, U.N. General Assembly Working Group V, 28th Sess., U.N. Doc. A/CN.9/WG.V/WP.63/Add.1(2003). They are also called "preferences" in some systems.

[97] 11 U.S.C. §507(a)(3)-(4) (wages earned within 90 days of bankruptcy up to $4,000 per employee, plus limited amounts of employee benefits).

[98] ALI Mexican Statement, *supra* note xx, sec.IV.F(1).

[99] Interestingly, the United States priority is nowhere explicitly stated in the Code. Germany is only one of a number of countries to provide for surcharges on collateral, reducing the secured party's return from the collateral. *See* Kenneth N. Klee, *Barbarians at the Trough: Riposte in Defense of the Warren Carve-Out Proposal*, 82 CORNELL L. REV. 1466, 1477-78 (1997) (describing rule recently adopted in Germany). Other countries subordinate secured parties to other creditors. See, e.g., Goode, Security, *supra* note xx at 52 (United Kingdom); ALI Mexican Statement, *supra* note xx, sec. IV.F(1); WB Principles, supra note xx. Interestingly, the United States priority is nowhere explicitly stated in the Code. Germany is only one of a number of countries to provide for surcharges on collateral, reducing the secured party's return from the collateral. *See* Kenneth N. Klee, *Barbarians at the Trough: Riposte in Defense of the Warren Carve-Out Proposal*, 82 CORNELL L. REV. 1466, 1477-78 (1997) (describing rule recently adopted in Germany). Other countries subordinate secured parties to other creditors. *See, e.g.*, Goode, Security, *supra* note xx at 52 (United Kingdom); ALI Mexican Statement, *supra* note xx, sec. IV.F(1); WB Principles, *supra* note xx.

The only real constant as to priorities in bankruptcy regimes around the world is the omnipresence of priorities, which is the same as saying there is a universal absence of equality of distribution. Equality of distribution (in the common law tradition, "equity is equality") is often said to be a central tenet of bankruptcy law in every country.[100] However, the exceptions do not prove that rule, but swallow it.[101] A tenet that lacks a single observation cannot be taken seriously. It is true that bankruptcy has as a major purpose equality of distribution to all those within a legal "class" of creditors. That is, those with equal rights should receive equal treatment. As a statement of priority, that point is trivial. Presumably, all law aims to treat similarly situated persons similarly. But as a statement of control, it has content. To understand its content, it is necessary to understand the role of control in the collective process that is bankruptcy. In brief, control is necessary to enforce any system of priority, including a system of equality (an absence of priority).

Every bankruptcy system includes a moratorium (stay) that can effectively block creditor access to some or all of the debtor's assets. The moratorium often restrains lawsuits and other actions to collect debt as well.[102] Along with the moratorium, bankruptcy systems routinely give control of the debtor's assets to the designated controller of the bankruptcy process,[103] although with great variation in the legal doctrines that produce that result.[104] On the basis of these two legal

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[100] JACKSON, LOGIC, *supra* note xx, at 29 (stating the principle is "perhaps the most common—and uncontroversial—of bankruptcy's policies."); Charles Seligson, *Preferences Under the Bankruptcy Act*, 15 VAND. L. REV. 115, 115 (1961) (stating, "[e]quity is equality. That maxim is a theme of bankruptcy administration--one of the cornerstones of the bankruptcy structure."); James W. Bowers, *Groping and Coping in the Shadow of Murphy's Law: Bankruptcy Theory and the Elementary Economics of Failure*, 88 MICH. L. REV. 2097, 2101-02 (1990); Warren, Policymaking, *supra* note xx, at 353-61. *But see* Jay L. Westbrook, *Choice of Avoidance Law in Global Insolvencies*, 17 BROOK. J. INT. L. 499, 508-09 (1991) (only applies within a class, so not important except in the context of non-discrimination against foreigners).

[101] This point has recently become recognized in the British literature. *See* Rizwaan J. Mokal, *Priority as Pathology: The Pari Passu Myth*, 60 C.L.J. 581 (2001). *See also* Look Chan Ho, On Parri Passu, *Equality and Hotchpot in Cross-Border Insolvency*, xxx.

[102] In many countries, however, the stay is not automatic as it is in the United States. Instead, the responsible court is given the power to issue orders restraining seizure of assets and other conduct. *See, e.g.*, Junichi Matsushita, *The Summary of the Bill for the Law on Recognition and Assistance of a Foreign Insolvency Proceeding*, THE JAPANESE ANNUAL OF ANNUAL OF INTERNATIONAL LAW 31, at 334 (No.43, 2000); ALI Mexican Statement, *supra* note xx, sec.II.F(1).

[103] For example, in the United States the controller is the trustee in bankruptcy or debtor-in-possession. 11 U.S.C. §1104. In several other countries, the controller is an administrator or the old management subject to the supervision of a court-appointed official. See, e.g., ALI Mexican Statement, *supra* note xx, at II.C., IV.B. (conciliador; sindico); ALI Canadian Statement, *supra* note xx, at I.C.7., D. 1, E. 3. (trustee; monitor)

[104] Some systems contemplate creation of an estate to which the debtor's property is conveyed by the law. *See, e.g.*, American Law Institute, TRANSNATIONAL INSOLVENCY PROJECT, International Statement of Mexican Insolvency Law XX (2003 forthcoming) ("masa" or estate assumes all of the debtors property). Other systems conceive that the debtor's assets become the property of the trustee. *See e.g.* Canadian Statement, *supra* note xx, I.C.e. Virtually all limit the debtor's power to convey or otherwise control those assets. WB Principles, *supra* note xx, Principle 11.

preliminaries, the controller can marshal assets, manage an ongoing business, seek bids for assets, bring avoiding actions, and, ultimately, distribute proceeds or otherwise benefit the chosen beneficiaries of the process.

The key point is control. If individual creditors were allowed to seize the debtor's assets, an orderly liquidation or reorganization would obviously be impossible. That is, employees, secured creditors, or the state, favored in most systems, might well lose value to unsecured commercial creditors in the rush for assets. The control provided by the moratorium or stay ensures that these competitors are restrained, while other doctrines[105] ensure that the bankruptcy regime will control the liquidation or recapitalization of the debtor's assets and the distribution of resulting value to the preferred beneficiaries.[106] It has long been recognized that the collective proceeding that is bankruptcy is required to maximize value,[107] but it is equally true that the control imposed by bankruptcy law is essential to enforcing the inequality of distribution—that is, priorities—mandated by each legislature. A recent study by a Spanish scholar makes a persuasive historical case for understanding the role of bankruptcy as a system for enforcing priorities and defeating a general or overall equality of distribution.[108]

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[105] The most important additional rules for enforcing priority systems are (i) the vesting of control of the debtor's assets in someone equivalent to our trustee in bankruptcy and (ii) the avoiding powers, which recapture assets that were transferred before bankruptcy.

[106] For this reason, the very absence of control identifies some of the beneficiaries chosen by a particular regime. For example, in some countries the opening moratorium does not apply to labor (employee or union) claims. *See, e.g.*, Mexican Statement, *supra* note xx, Chapter II. In others, secured creditors and their collateral are exempt from its reach. *See, e.g*., Canadian Statement, *supra* note xx, at I.C.d (in liquidation cases). The practical effect of their exemption may be to maximize the value of their recoveries, while lowering the overall recovery for beneficiaries generally. It is not coincidental that the same creditors exempted from the stay in a particular system are invariably favored within a bankruptcy proceeding as well. ALI Mexican Statement, *supra* note xx, II.F.1, IV.F.1 (labor claims).

ALI Canadian Statement, *supra* note xx, I.C.6 (secured claims). It would be a serious conceptual error to think of these claimants as excluded from the bankruptcy process in such a system, because that process, starting with the moratorium that restrains their competitors from seizing the debtor's assets ahead of them, is designed specifically to benefit them. Their exemption from the stay is the next best thing to an advance distribution of assets. It is for that reason that their exclusion from the stay's coverage is not inconsistent with the assertion that control is essential to any bankruptcy regime. A striking example of the effect of exclusion in our law, recently enacted, is the exemption from the stay for certain financial contracts, which amounts to a substantial priority for certain creditors, even though they are often unsecured under state law. Bankruptcy Code §§362(b)(6-7), (17); 555-56; 559.

[107] JACKSON, LOGIC, *supra* note xx, at 5.

[108] Jose Maria Garrido, Tratado de las Prefencias del Credito (2000). Professor Garrido describes a tension between the pro rata rule of the *ius mercantile* and the priority-heavy "concurso" schemes of government systems in Italy, Spain, and elsewhere in Europe as bankruptcy law was developing in the 17th Century. He suggest that the purpose of changes in the insolvency laws in that period was to protect the property of impecunious nobles. Necessary to that end were the creation of priorities and control of the entire process by a publicly appointed administrator. *Id*. at 232-33. [Translation to English by Jonathon Pratter (Tarleton Law Library) and Gloria E. Avila-Villalha, on file with the author].

In a model of bankruptcy based on the goal of enforcement of priorities, equality of distribution still has a role, but only to enforce equality (generally understood as pro rata distribution) within a given priority class. Just as bankruptcy control is necessary to ensure the priority of employees as a group, for example, that control also ensures that each employee will share pro rata in the enjoyment of that priority, rather than having favored employees, lucky employees, or more aggressive employees do better than the rest. It is in that sense that equality of distribution is an important goal of bankruptcy.

The necessary conclusion is that bankruptcy exists to enforce a set of priorities, but can be used to enforce any set of priorities that might be chosen by policymakers. The only thing that is essential to bankruptcy is that the bankruptcy regime get control of the debtor's assets and be able to dispose definitively of its liabilities, so the assets can be safely sold or recapitalized and the value distributed to the chosen beneficiaries.[109] Bankruptcy could in theory be used to enforce a priority system of non-priority— that is, complete equality—although it does not appear that even one such system is extant. Thus priority is the usual goal of bankruptcy, but no particular choice of priority is necessary. On the other hand, control is the *sine qua non* of any bankruptcy system.[110]

At this point, it is necessary to introduce the idea of neutrality, a concept never identified in the literature about bankruptcy, but almost as central in many bankruptcy systems as control. This concept deserves an article of its own, but can only be briefly introduced here and modestly elaborated in Part V. If equality is not the necessary centerpiece of a bankruptcy priority regime, it can be argued that neutrality occupies that position. The core idea is this: if a bankruptcy involves competing interests, then control may be exercised either impartially or with partiality to one interest or another. If the policymaker recognizes both interests as worthy of protection, then its policy requires neutrality in the default manager.[111]

To get an initial idea how this point applies in the context of secured credit, suppose that Congress has decided to accept without reservation the claim that secured credit is the most efficient form of credit in every instance.[112] On that basis, it enacts a bankruptcy system that has only dominant secured parties as

[109] In a reorganization, debts may be restructured by being reduced and extended in payment or the company or its assets may be sold as a unit to pay some or all of the debts. In a restructuring, value is created by effectively recapitalizing the assets at the restructuring "price" because the new capital structure is thought to be sufficiently reduced that the assets can provide a sufficient return on the restructured investment. Often that process requires new loans or new equity investments as well. Thus the usage "recapitalization of assets."

[110] As noted earlier, this statement includes the notion that pervasive control from which favored creditors are excepted is perfectly consistent with bankruptcy as a system of priority enforcement. CR earlier footnote.

[111] It may be that the importance of neutrality has been ignored because it was too obvious, like speaking in prose.

[112] CR.

beneficiaries.[113] In such a system, the manager of the default has only to ensure that the dominant secured party gets the maximum possible recovery. Then its work is done. Although the British Parliament and courts never explicitly adopted such a rule, it has been argued that the receiver system frequently operated as if that were the rule.[114] And that system made sense once a decision was made to protect a dominant secured party (there, the floating-charge holder) at all hazards. If there is only one beneficiary, the management of the general default should be in the hands of that beneficiary or its agent, which will then act in the beneficiary's best interests.[115]

On the other hand, Congress might have decided instead to have a system that encourages the market to decide on the appropriate combination of secured credit, unsecured credit, and equity financing for each business. That would be a fair description of the present system in the United States. In such a system, the Congressional objective of maximizing value for each class of beneficiaries would require a neutral manager charged not merely with distribution of proceeds according to a set of priorities, but first and foremost with managing the default and arranging the deployment of assets so as to produce the maximum return for each class.[116] Such a task is formidable and probably cannot be achieved fully, but it would be the ideal objective of a neutral manager in response to the Congressional policy.[117]

Even under the present system, an exception can be posited, in principle, to the proposition that bankruptcy neutrality is essential to the management of a general default. The exception is the case in which there is a valid dominant security interest that is undersecured. That is, even assuming a near-absolute secured-credit priority

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[113] If Congress included ordinary secured parties holding interests in a variety of assets of the debtor, then those interests would be in potential conflict and the result would not be a single-beneficiary class.

[114] CR.

[115] *Cf.* Schwartz, Priority, *supra* note xx. In such a system, a necessary premise would be that virtually all the working capital for the business would be supplied by the entrepreneur and the secured party, a point of considerable interest we will not explore further here.

[116] The Code explicitly requires neutrality in a trustee's lawyer and other professional advisors to the estate. Code §327 ("disinterestedness"). Although the Code does not require neutrality of the trustee in so many words, the caselaw has long imposed on a trustee in bankruptcy fiduciary duties to all those interested in the estate. Collier, Revised 15h Edition, xxx.

[117] The task would be difficult because the beneficiary classes would have conflicting interests. For example, the first priority class might be paid in full with a very low risk, low return management and deployment of assets, while a lower priority class might be better served with a little more risk on the hope of a little more return. CR present n. 222. This point deserves an article of its own, which it will not get here. It should be noted, however, that a Congressional decision to give top priority to class A is not the same as a decision that the default manager should maximize returns for that class while ignoring the rest of Congress' beneficiaries. *Cf.* Lipson, *supra* note xx. It is the distinction between those two ideas—priority versus management—that explains the apparent anomaly that Congress is obviously very concerned with debtors and unsecured creditors, yet gives no explicit priority to either. It wants to protect the priority of certain creditors, while hoping to maximize value for lower-priority classes at the same time. As usual, it leaves the hard-to-reconcile details to the courts.

as in the United States, so that the secured party has a top priority in all the debtor's assets, it may be that the maximized value of those assets will still be less than the amount owed to the secured party.[118] In that case, it can be argued that there can be no competing priority and no need for bankruptcy. Among other things, this exception explains why almost all instances in which bankruptcy-waivers are enforced are single-asset real estate cases, a point explored below.[119] In that sort of case, the control exercised by the dominant secured party is arguably all that is necessary or perhaps appropriate.

Part IV. Contractualism and Secured Credit

A. Contractualism

A number of scholars have proposed to replace bankruptcy law with bankruptcy bargains established by contracts between debtors and creditors. They do not make much attempt to relate their work, each to the other, but it is fair to group these theories as "contractualism," understood to mean any approach that would permit important bankruptcy rules to be modified or abrogated by contract between the debtor and one or more creditors.[120] They are vague about the role of the courts or other institutions in enforcing the hypothetical bargains they imagine being struck, but presumably these bargains would establish a set of legal rules governing the recovery process or, at least, contractual waivers and exceptions to the existing bankruptcy regime. Nearly all of the proposals that have been advanced envision a bankruptcy bargain struck ex ante, at the time credit is granted.[121]

The term "proposals" with respect to contractualist writings is accurate, because none of these approaches devotes a great deal of attention to theory as such.[122] They assume for the most part that bankruptcy should have the functions that private parties, especially lenders, want it to have. Following Professor Jackson,[123] they assume it has no other functions. On the basis of a general notion of market efficiency, they further assume that a private regime bargained by the parties

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[118] Note that this statement assumes the case in which there is not a going-concern value in excess of the secured debt.

[119] CR.

[120] Professor Block-Lieb calls them "neoliberterian" theorists. Susan Block- Lieb, *The Logic and Limits of Contract Bankruptcy*, 2001 Ill. L. Rev. 503, 504 (2001).

[121] The exceptions include Steven L. Schwarcz, *Rethinking Freedom of Contract: A Bankruptcy Paradigm*, 77 TEX. L. REV. 515 (1999) (proposing enforcement of certain waivers in bankruptcy) [hereinafter, Schwarz, Rethinking]; and Edward S. Adams and James L. Bailie, *A Privatization Solution to the Legitimacy of PrePetition Waivers of the Automatic Stay*, 38 Ariz. L. Rev. 1 (1996) (Urging acceptance of waivers of the automatic stay even while acknowledging that such waivers amount to waivers of bankruptcy protection).

[122] The description that follows draws heavily upon that found in Elizabeth Warren and Jay L. Westbrook, THE LAW OF DEBTORS AND CREDITORS 1029-42 (4th Ed. 2001).

[123] JACKSON, LOGIC, *supra* note xx.

would produce a more efficient method of achieving those functions than would be provided by any legal regime.[124]

On the other hand, the contractualists understand that their key difficulty is to govern by contract an event—general default—that is collective and multi-party by definition. They are keenly aware that parties may not ordinarily use a contract between them to bind third parties. As a result, they devote much of their efforts to advancing proposals by which they believe the problems of third-party rights and multi-party relationships can be avoided in a system that turns on a private bargain.[125]

One group of contractualist proposals can be called "automated bankruptcy"[126] One version of automated bankruptcy assumes a tiered system of debt priority, so that upon a general default the lowest priority tier can either invest sufficient funds to pay off all higher tiers or forfeit its interest entirely. Then the next tier up the ladder has the same chance and faces the same forfeiture. If the process reaches the top tier without payment having been made, the top tier simply takes over ownership of the debtor and disposes of it as the holders of top-tier debt think most advantageous.

Another approach is potentially more elaborate than automated bankruptcy. It puts in place an entire bankruptcy system by contract. One variation on this "complete-system" approach supplies a menu of such systems, one of which is selected by a debtor at its corporate birth.[127] Creditors can then decide whether to extend credit to the debtor, given its selection of a particular bankruptcy system from the menu.[128] Some other advocates of a complete system by contract propose that each new contract adopting a bankruptcy system will automatically apply to the debtor's prior creditors, replacing the systems that were in prior contracts.[129] In this way, what might be called the "ever-green" complete-system approach seeks to avoid the objection that the menu system is too rigid. Finally, a third variation is

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[124] "Of Coase." Yet it is interesting to note that a leading contractualist, Professor Alan Schwartz, once proposed the imposition of priority for the first lender by law. *See* Alan Schwartz, *A Theory of Loan Priorities*, 18 J. Legal Stud. 209 (1989).

[125] The point in text is less true of the proponents of automated bankruptcy, discussed just below. They do discuss the problem of notice to third parties, although not at length. *See, e.g.*, Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 STAN. L. REV. 311, 338-341 (1993).

[126] The leading examples are Bebchuk, Approach, *supra* note xx, at 776, and Adler, Puzzle, *supra* note xx.

[127] Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 TEX. L. REV. 51, 118 (1992) [hereinafter, Rasmussen, Menu].

[128] This proposal allows for change in the agreed bankruptcy regime at a later time by implicit agreement of all creditors. Rasmussen, Menu, *supra* note xx (noting that, "change in the corporate charter should be allowed only with the consent of all of the creditors.").

[129] Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 YALE L.J. 1807, 1821-22 (1998) [hereafter Schwartz, Contract Theory].

more cautious. It would leave the bankruptcy system largely in place, at least in theory, but permit bargains for waiver and replacement of certain provisions, subject to limited post-hoc review by the courts under stated tests of fairness and efficiency.[130] A central focus of this last approach is advance, irrevocable waiver of the automatic stay if bankruptcy should ensue, generally given in exchange for a secured loan after the debtor is already in financial distress.

This short summary does not do justice to the extent to which these contractualist proposals have dominated debate about bankruptcy theories over the last decade. Article after article has proposed the privatization of the management of financial distress through ever more-ingenious contractual schemes. On the other hand, so preoccupied have these scholars been with the problem of third-party rights they have devoted little attention to the institutional management of a general default nor to explaining why a private system would be more efficient.[131] They have made a useful contribution to the literature because they have forced onto the table the question of privatizing bankruptcy law, one inevitable in the academic epoch of Law and Economics. In the process, their work has identified the central problems with private management of a general default. Professor Rasmussen's ingenious "menu" idea, for example, put the question of public notice at the center of things, where it belongs.[132] Professor Schwartz has seen for some time the central importance to a private system of giving an overriding priority to a single creditor.[133] Professor Schwarcz, by focusing on the phenomenon of security interests given after financial distress has arisen, has begun an exploration of the centrality of the choice of a manager of a general default.[134]

B. Secured Contractualism

The contractualists say almost nothing about secured credit. Their imagined systems of bargained bankruptcies ignore the central pillar of credit bargaining, the security interest, which is also the only privately bargained priority recognized in bankruptcy laws in the United States and around the world. The critics of the contractualists offer a number of sound arguments against their theories,[135] but largely within the same frame of reference, ignoring the relevance of the secured

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[130] *See, e.g.*, Schwarcz, Rethinking, *supra* note xx.

[131] This myopia is consistent with the economic focus of much of this literature. Economists are notoriously deficient in describing the organization of the markets about which they theorize. *See* John McMillan, Reinventing the Bazaar 8-9 (2002) [hereafter "McMillian"].

[132] *See, e.g.*, Rasmussen, Menu, *supra* note xx, at 66-68.

[133] Schwartz, Priorities, *supra* note 49, at 216 -18, 240-41.

[134] *See, e.g*., Schwarcz, Rethinking, *supra* note xx, at 585. His focus is the mid-distress workout, after a company is in financial trouble. The special analysis that is required for mid-distress security interests is another element in the author's larger project, but is beyond the present article.

[135] *See, e.g.*, Block-Lieb, *supra* note xx; Lynn M. LoPucki, *Contract Bankruptcy: A Reply to Alan Schwartz* 109 YALE 317 (1999); *See* Lynn M. LoPucki, *The Case for Cooperative Territoriality in International Bankruptcy*, 98 MICH. L. REV. 2216, 2246-47 (2000).

credit system. Yet this section will show that the existence of a highly sophisticated system of secured credit permits achievement of all the goals of the contractualists and solves the otherwise intractable problems presented by their proposals. The only conceivable form of contractualism is secured contractualism.

On the other hand, that conclusion makes the contractualist project a relatively small aspect of the debate that matters most: the costs and benefits of secured credit. The case for secured credit at the transaction (credit-extending) stage has been the subject of a long and inconclusive debate, leaving the claim of benefits from a secured credit system problematic at best. Beyond that fundamental difficulty lies a second difficult obstacle that must be overcome by proponents of secured contractualism. As we have seen, an ordinary security interest is insufficient for management of a general default. To be successful, contractualism requires a dominant security interest to support its objective of privatizing management of a general default. We will see that there are substantial concerns about giving over management of a general default to a dominant secured party and that these concerns must extend to any contractualist proposal.

The contractualist theorists envision a world in which creditors can bargain in advance for an assured position in case of the debtor's general default. A security interest provides just that result. A dominant secured creditor that exercises reasonable care in its arrangements will have a highly predictable legal environment following default, in which it will control the debtor enterprise, the disposal of its assets, and the distribution of the proceeds. Even under present law, a dominant secured party will often be able to veto a bankruptcy. There is little more that any contractualist could ask of a legal regime.

Without the support of a security interest, the contractualist proposals are crippled by intractable problems. The three most important are notice, serial contracting, and control. Bankruptcy law provides a standing notice as to the rules governing a general default, permitting credit grantors and others (for example, employees and venture capitalists) to make market decisions on that firm basis. As Professor LoPucki has explained, any contractualist approach which permits bankruptcy laws to be waived or modified must provide a method by which creditors will know that the debtor has entered into a binding agreement concerning events following its general default.[136] The other creditors must also know the contents of that agreement. Otherwise, market actors would have to price their contracts on worse-case assumptions about the agreements into which their counterparties (borrowers or traders) might have entered that would affect the actors' risks in the transaction. For the most part, contractualist theories have failed even to address this problem.[137] Yet the terms of an agreement for automated bankruptcy, for example,

[136] Cooperative Territoriality 2244-45.

[137] *See, e.g.*, Lucian A. Bebchuk, *A New Approach to Corporate Reorganizations*, 101 Harv.L.Rev. 775 (1988); Barry E. Adler, *A Theory of Corporate Insolvency*, 72 N.Y.U. L. Rev. 343 (1997). It may be that these authors had as an implicit paradigm enterprises that were public companies in the United

would be of pressing importance to a subsequent creditor considering extending unsecured credit to a debtor. If that party later discovered that the debtor had contracted for an automated bankruptcy regime in case of general default and if that regime were binding upon the subsequent creditor, that party would recover nothing unless it could organize (and contribute capital to) a "class" effort to buy out higher tiers of debt. Absent notice, any creditor would have to price its credit on the risk that such an agreement existed.[138]

Similar difficulties arise with respect to the complete-system approaches to contract bankruptcy. At the heart of such a system must be an agreement binding on third parties that a certain creditor would have the right to appoint a new manager of the debtor's business following default. The provisions of that agreement would be important to various parties, including those considering entering into joint ventures or distribution agreements with a debtor, because of the uncertainties about the competence and conflicting interests of the new manager. To avoid inefficient overpricing in reaction to these risks, a contractualist system must provide for the giving of notice.[139]

To his credit, Professor Rasmussen sees the centrality of the notice problem, providing for notice to the market through his "menu" approach. But his approach does not solve the second problem, serial contracting, which is addressed by Professor Schwartz. The difficulty arising from serial contracting is that Professor Rasmussen's proposal would lock the debtor into an unalterable choice of a bankruptcy regime at an early stage in its business life, a scheme that might be wholly unsatisfactory to its subsequent creditors and itself at a later stage.[140] However, when Professor Schwartz attempts to solve that problem with his last-to-contract or ever-green approach,[141] he is left with a somewhat bizarre system in

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States market and therefore assumed that notice and disclosure would be a function of the securities acts. The efficacy of that disclosure system, especially as to the purpose and effect of specific transactions, is far less clear than it seemed to be before Enron, et al. *See, e.g.*, Report of the Examiner, Enron Corporation, June 30, 2003 (failures to disclose true nature of loan transactions and "wash" transactions with major banks). *See also* [NYT and WSJ articles re Citigroup and Morgan settlements with the SEC, July 29, 2003].

[138] Another very serious problem is that the subsequent creditor would have to learn and understand the detailed terms of the automated bankruptcy agreement, rather than being able to rely upon the rules of a general-default system like the current bankruptcy law that serves, in effect, as a standard, boiler-plate agreement in every case. That difficulty is not resolved by linking the system to a security interest, but will not be further addressed in this article. *See* Elizabeth Warren & Jay L. Westbrook, *Contracting Out of Bankruptcy: A Factual Intervention* (draft article available from author or web site) (empirical data demonstrating potential for serious informational difficulties arising from contractualism) [hereafter "Contracting Out"].

[139] These are, of course, the same kinds of problems created by a system of secured credit with priority and control assurances for the secured party, although the contractualist problems are more complex and difficult to solve.

[140] *See* Lynn M. LoPucki, *The Case for Cooperative Territoriality in International Bankruptcy*, 98 MICH. L. REV. 2216, 2243-51(2000).

[141] Schwartz, Contract Theory, *supra* note xx, at xx; LoPucki, Contract Bankruptcy, *supra* note xx, at

which a bankruptcy scheme in the contract of a supplier of copy paper to the debtor might be held binding on J.P. Morgan Chase as the debtor's principal lender. Any proposal that creates a hard-to-change contractual scheme (menu) or that separates the bargaining process from a major supplier of the credit that will be at risk (ever-green) is unworkable on its face.[142]

Furthermore, in an ever-green contractualist system with successive amending contracts, there would inevitably be ambiguities as to which contract was the controlling one. How would disputes of this sort be resolved and who would control the enterprise while they were being resolved? These issues would involve a thousand points of important detail. The details themselves need not detain us. The point here is that if there is to be legal enforcement of these contracts, especially in the context of third-party rights and multi-party proceedings, all sorts of provisions would have to be developed, adopted into law, be found wanting in various respects, and be revised and tried again, before such a system could hope to succeed. Such a project--fat with expense, dislocation, and risk--would never be undertaken if the end could be achieved in another fashion. It would be academic in the worse sense of the word. As explained below, a far simpler and more elegant solution is available by linking contractualism to a dominant security interest, creating secured contractualism.

However, the central difficulty for contractualists is the problem of control of the debtor's assets. There are two control problems: pre-default and post-default. If the contractualist creditor is unsecured, the most intractable problem is the absence of asset constraint[143] prior to default. Even the debtor who has locked itself into one of the menu choices proposed by Professor Rasmussen is left free to manipulate its assets, especially through the use of multiple corporations in multiple jurisdictions and conveyances to good-faith transferees. Certain transfers that are fraudulent or without real benefit to the debtor might be set aside under bankruptcy law or other laws, but many transfers to good-faith transferees are not recoverable for the benefit of unsecured creditors.[144] As noted earlier, a lawsuit against the debtor is generally an exercise in futility.[145]

326-32; Block-Lieb, *supra* note xx, at 558. The notice problem in some respects is worse with the ever-green approach, because subsequent creditors and other parties (e.g., potential joint venturers with the debtor) must determine which contracts-of-bankruptcy are current and which are not, when a subsequent contract cancels or amends a prior one. If the scheme is provides that only certain subsequent contracts are superceding, then there must be a standard to apply to determine which contract controls. There will be confusion in the market when those standards are, inevitably, unclear of application in the concrete case. That is, sometimes (often?) the subsequent party will be unable to determine whether contract B supercedes contract A under the standard and therefore will not be able to predict which bankruptcy system would apply. *Cf.* Contracting Out, *supra* note xx.

[142] Indeed, that scheme seems flatly inconsistent with Professor Schwartz' interesting earlier proposal for absolute priority to the first lender. *See* Schwartz, Priority, *supra* note xx, at pp.

[143] CR to definition.

[144] Code §548. Indeed, a transfer of assets in breach of contract is not viewed as necessarily dishonest

Furthermore, the debtor may not be making the transfers in bad faith. Its manipulations may be motivated by tax or financial reporting considerations, as may have been true on some occasions with Enron, rather than an intent to defraud creditors, but their effect may be to leave creditors with a marvelous bankruptcy scheme vis a vis an empty shell of a debtor. An unsecured contractualist system leaves the counterparty utterly exposed to a complete restructuring of the business and conveyance of assets. While such transfers may be breaches of contract or even ultra vires, they will often be effective as property transfers, leaving the contractualist with only an unsecured claim for damages against a debtor already in general default who will pay little or nothing to unsecured creditors.[146]

The easiest example of the risk of such transfers is the debtor's grant of a dominant security interest in violation of its bargain with the contractualist creditor. The debtor signs a contract with the creditor containing elaborate bankruptcy provisions. A year later, under financial pressure, the debtor grants a dominant security interest in violation of that contract. Despite any covenants against such a grant, the grant is fully effective under Article 9.[147] Upon the debtor's general default, the contractualist creditor is left with an unsecured contract scheme while the secured party is selling all the assets of the company and distributing the proceeds to itself.[148]

That example invokes the wisdom of Professor Gilmore. In his famous treatise, he gave the back of his hand to "negative covenants," mere contractual promises made to unsecured lenders to the effect that the debtor would not grant security to anyone else. Professor Gilmore viewed them as nearly valueless for the

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or evidence of bad faith, as "efficient breach" theory demonstrates. *See generally,* Peter Linzer, *On the Amorality of Contract Remedies--Efficiency, Equity, and the Second Restatement*, 81 Colum. L. Rev. 111 (1981); Edward Yorio, *In Defense of Money Damages for Breach of Contract*, 82 Colum. L. Rev. 1365 (1982).

[145] CR.

[146] One who thought that such things cannot happen with public companies because of disclosure requirements would be mistaken. *See infra* CR note with Enron report.

[147] UCC 9-401(b). Professor Mann found that a major benefit to security is the power to enforce covenants. Ronald J. Mann, *Explaining the Pattern of Secured Credit*, 110 HARV. L. REV. 625, 669-674 (1997) [hereinafter "Mann, Pattern"].

[148] A legal reform putting the unsecured contractualist ahead of the secured party would change that result, but that seems an obviously bad idea, exchanging a perfectly workable and well-understood priority and control system for a new and untested one, for no good reason. Rather different is the proposal to make a negative-pledge clause a sort of reverse security interest, which gives the creditor priority over subsequently perfecting secured parties. Carl S. Bjerre, *Secured Transactions Inside Out: Negative Pledge Covenants, Property And Perfection*, 84 Cornell L. Rev. 305 (1999) [hereafter Bjerre, Negative Pledge]. Nonetheless, such a system would constitute fruit-basket-turnover of existing systems, no doubt with unforeseen consequences. Thus only a powerful case for its benefits could support its adoption--yet another interesting discussion we must omit here. But it should be noted that the Bjeere proposal is really a modification of the secured-credit system itself, through notice and a sort of priority, so it is conceptually consistent with the model presented here, depending upon the details.

reason just given.[149] The elaborate contracts contemplated by the contractualists are simply expanded versions of those illusionary bargains.[150]

Given that the contractualists fail to address collateral protection before default, it is not surprising they also ignore the problems of collateral control and enterprise control after a general default, although control is essential to their schemes. To enforce their covenants, they would have to procure legislative enactment of a new code with extensive provisions enforcing the rights necessary to their proposed regime. It is not possible to manage a general default without enterprise control, which is given to the trustee in bankruptcy by the automatic stay. In a contractualist regime, a bristle of court orders would be required following a general default. Even if the procedures are to be governed by contract, the new code would have to provide default rules for all the points not covered in a given contractual bargain and regulate the inevitable abuses that arise in reaction to all legal innovations. For example, one element required under a system of automated bankruptcy, although not discussed by its proponents, would be a method for determining interim control of the defaulting enterprise while the parties to the various automated debt instruments worked through the schemes' contractual option process. Who would appoint the controller pending the completion of the process? Would it be the highest tier creditors or the lowest or a neutral party? Would the controller's incentive be to protect the minimum asset value, leaving the lower tiers potentially with no remaining value or would its incentive be to maximize asset value for all tiers although some risk would be necessary? The power to appoint the controller would undoubtedly affect the likelihood that the appointee would choose one path or the other. This problem is discussed further in Part V.[151]

These three problems--notice, serial contracting, and asset control—are impossible to solve in the contractualist system, but are easily solved once a security interest is granted to a dominant secured creditor.[152] As discussed above, we have a

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[149] GILMORE SECURITY INTERESTS, *supra* note xx, at 1017. For a contemporary confirmation of that view, *see* Jonathan R.C. Arkins, *"OK-so you've promised, right?": The Negative Pledge Clause and the "Security" It Provides*, 2000 Int. Banking L.J. 198 (2000) (negative pledge clause has little value). Another recent author agrees with that conclusion, but would change it by making negative-pledge clauses registrable and therefore enforceable. Bjerre, Negative Pledge, *supra* note xx. *But see* LoPucki, Unsecured Bargain, *supra* note xx. Professor LoPucki there argues that such covenants do work in the case of large public companies. Short of a full rebuttal of that interesting idea in this article, it must suffice to say here that it applies only to large companies and assumes that security interests are always obvious as such. The kind of off-book deals revealed to the public in Enron and other cases suggests that even public companies may enter into what amount to secured transactions without calling them by that name and that lenders, one is sorry to say, may be willing to ignore the legal risks involved. CR to Enron examiner footnote.

[150] One article has claimed that mere covenants give priority in distribution and makes the "ownership rights" given by a security interest "unimportant" in a commercial context. These assertions are unsupported legally or empirically. *See* A Schwartz, Priorities, *supra* note xx, at 212-13, 243.

[151] CR.

[152] The critique of contractualism in this article applies a bit differently with regard to waiver proposals, like the one offered by Professor Schwarcz. This article focuses primarily on the automated

highly sophisticated system of secured credit, long refined, that has largely overcome these very difficulties. If the contractual powers desired by the contractualists are given to a dominant secured creditor, a simple Article 9 filing would give effective notice to the world, directly and through private credit agencies, that would solve instantly the otherwise hopeless problems of notice. By virtue of that notice (that is, perfection),[153] the secured party would have a high level of assurance of asset constraint and thus priority.[154] The debtor could not dispose of its assets, or interests in them, because good-faith transferees would be deterred by notice and transfers in the teeth of notice would be recoverable. As against a dominant secured creditor, the debtor would be well-aware that it would violate covenants at the risk of almost instant loss of control of its entire enterprise. Finally, in the case of general default, the dominant secured creditor would simply take enterprise control and manage affairs in its own best interests, within broad limits. Virtually everything the contractualists desire is available under present law to a dominant secured creditor.

This simple move would solve most of the problems to which so many law-review pages have been devoted by providing Article 9 notice, Article 9 collateral protection, and Article 9 enterprise control, all under well-established, routinely

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and complete-system approaches, although the fundamental difficulties of a waiver proposal are closely related. The critique of waiver proposals cannot be fully realized in this article, but five points are key. The first is notice. Permitting enforcement of waivers will effectively make many debtors reorganization ineligible, in the sense that bankruptcy relief will be ineffective to permit reorganization because of the waiver. It would be very important for creditors, both those existing at the time of waiver and future creditors, to have notice of the debtor's dramatic change in status from a reorganization-eligible to a reorganization-inelible debtor. An Article 9 filing would provide this notice, albeit inadequately; no other efficacious method is apparent. Second, if the waiver is on behalf of a dominant secured party, it is largely irrelevant because of the bankruptcy veto, explained *infra*. Third, the waiver could operate on behalf of ordinary secured creditors, who may thus be able to disable the bankruptcy process without offering an alternative system for managing a general default, unlike a dominant secured party that can offer such a management alternative. As noted above, an ordinary secured party does not have a legitimate economic claim to that power. Fourth, although it seems highly unlikely such a waiver would be obtained by an unsecured creditor, the loss of bankruptcy control would be even harder to justify if it operated in favor of an unsecured creditor who lacks even a right to a special priority, much less the right of collateral control. Finally, and most importantly, the incentive problem creates serious difficulties with this approach, except in the case of the dominant secured party and few other creditors with any substantial interest. As noted earlier, this last point may explain why most of the cases enforcing a waiver have been single-asset real estate cases. CR.

[153] Naturally, once the role and effect of a dominant secured creditor became fully appreciated, especially if such dominant credits became routine, questions would arise about the adequacy of the present Article 9 safeguards, which have been debated for the most part as if most secured creditors were ordinary secured parties. Much more elaborate disclosures might be appropriate for secured creditors claiming the power to manage a general default. Indeed, one may ask if more disclosure should be required now for those with dominant security interests.

[154] The article 9 provisions operate through a negative predicate. Secured parties trump all others with interests in the collateral, unless there is a stated exception in favor of a stated claimant with a stated sort of interest under stated circumstances. UCC §9-201(a). An exemplary exception is where a buyer of consumer goods from another consumer may defeat a secured party's interest in the goods if the security interest was perfected by a method other than filing. UCC §9-320(b).

enforced existing law. A dominant security interest is the only extant method for achieving the asset constraint and enterprise control necessary to contractualism. It is the necessary and sufficient condition for the privatization of bankruptcy law, that is, privatization of the management of a general default.

Yet there is a serpent in this contractualist fruit, to be discussed in the next section.

Part V. The Problem with Secured Contractualism

On the analysis just completed, the whole contractualist project collapses into secured credit theory, which gives rise to two sorts of serious problems for its proponents. The first difficulty—the transactional efficiency problem--is that after twenty-five years of debate the efficiency of secured credit remains problematic. Its proponents in that debate have gotten no farther than the Scottish verdict, "not proven." Furthermore, the value of control to the secured party and its cost to the debtor have received little attention in the efficiency debate, leaving the debate incomplete as well as unresolved. The second difficulty is that the secured-contractualist proposal requires a certain kind of security interest, a dominant one, to permit management of a general default as a substitute for a public bankruptcy regime. But management by a dominant secured party raises serious and unresolved questions in any system that encourages the extension of credit by anyone other than a dominant secured party. These two points, which represent severe obstacles to the contractualist project, are discussed in the next section.

A. The Efficiency of Secured Credit

For more than two decades, academics have engaged in a wide-ranging debate about the efficiency *vel non* of secured credit. No other subject has dominated commercial-law scholarship to such an extent for so long with such inconclusive results. Yet the fact that contractualism must rest upon a secured-credit foundation means that a positive finding for the efficiency of secured credit is essential to it.

The long debate began with a classic article by Professors Jackson and Kronman in the Yale Law Journal in 1979.[155] They asked if secured credit is socially beneficial.[156] This article was seminal indeed, as a vast law-review literature grew from it.[157] Traditionally, secured credit was thought to be useful because it reduced the risk to the secured party, permitting a lower interest rate as well as enabling loans

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[155] Jackson and Kronman, *supra* note xx.

[156] It is interesting that their central concern in this article was to demonstrate the efficiency of the priority choices made in Article 9. They raised the "fundamental question" of the efficiency of security interests generally only as a necessary predicate. Jackson and Kronman, *supra* note xx, at 1146.

[157] CR note 9 or so.

that might otherwise not be made at all.[158] In effect, the debtor and creditor could split a reduction in costs that followed a reduction in risk. But Jackson and Kronman identified a difficulty with that argument: any reduction in the secured party's risk was necessarily accompanied by an increase in risk for unsecured parties, who would therefore increase their charges and ration their credit, leaving the overall costs at best the same.[159]

These authors, like many who followed them, were sure that secured credit must be efficient. The task then became, in Professor LoPucki's felicitous phrase, like Cinderella's sisters, trying "to fit the glass slipper" of efficiency to a theory of secured credit.[160] All the resulting theories began with debtor misbehavior, labeled "moral hazard," which was the common enemy of all creditors. The "moral hazard" was that the debtor would borrow on the basis of business plan A and then operate under business plan B.[161] Plan B would have a greater upside, all of which would be captured by the debtor, at the cost of greater risk, most of which would be borne by the creditor. The debtor would propose to the lender, let's say, a video shop. Then, the lender's money in hand, it would purchase a race car, because all of the upside of the risky business would fall to equity owners, while the risk of failure would be borne primarily by the lender (and the driver).[162] To protect against this moral hazard, the lender takes a security interest[163] which makes it difficult for the debtor to transfer assets and therefore difficult for it to change businesses.[164]

Jackson and Kronman postulated that the cost of "monitoring" the debtor was the key. If taking the security interest reduced the secured creditor's risk and monitoring costs enough it would outbalance the increase in the unsecured creditor's added risk and monitoring costs whenever the unsecured creditor had lower monitoring costs than the creditor who wished to be secured. Professor Schwartz in

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[158] Carlson, Efficiency, *supra* note xx, at 2180.

[159] Jackson and Kronman, *supra* note xx, at 1153-54. Given that even under the Article 9 system secured credit has some cost, the result would actually be a loss of social wealth because of the net increase in costs.

[160] LoPucki, Unsecured Bargain, *supra* note xx, at 1894, n. 23.

[161] Somehow in these analyses only the debtor faced moral hazards, rarely the creditors. *See, e.g.*, Levmore, Monitors, *supra* note 9, at 51-52 (1982); Scott, Relational, *supra* note 9, at 912; Carlson, Efficiency, *supra* note 9, at 2186-88. *But see* Reiner Kraakman and Henry Hansmann, *Hands-Tying Contracts: Book Publishing, Venture Capital Financing, and Secured Debt*, 8 J.L. Eco. Org. 628, 649 (1992) (noting that lenders may be loathe to ever allow debtors to enter into new ventures, because profits will not accrue to the lender) [hereafter "Hands-Tying"]; Mann, Explaining, *supra* note xx, at 664-67.

[162] *See, e.g.*, Paul M. Shupack, *Preferred Capital Structures And The Question Of Filing*, XX Minn. L. Rev. 787, 790 (1995).

[163] These articles failed to make it clear that a security interest would broadly constrain the debtor's misconduct only if it was a "dominant security interest," a concept described *supra* note xx and accompanying text.

[164] Carlson, Efficiency, *supra* note xx, at 2188-89; Levmore, Monitors, *supra* note xx at 51-52; Scott, Relational Theory, *supra* note 47, at 926-27.

two classic articles destroyed this and other monitoring arguments and they have been largely abandoned.[165] Yet many other defenders of secured credit proffered other feet to fit the efficiency slipper, only to face withering criticism from Schwartz and others.

In general, the task was to find a benefit to other creditors that offset the increased risk to those creditors. Schwartz argued that a classic economic model would always return the overall costs to equilibrium, rising on the unsecured side as they fell on the secured side.[166] He also argued that every theory that showed the efficiency of secured credit necessarily proved too much. If secured credit were efficient on the theory presented, all debt would be issued secured, a pattern far different from the reality observed in the financial markets.[167] A number of articles written since have attempted to show that there are a series of reasons that security would be used in one circumstance or industry and not in another, so that security might be efficient despite its failure to be ubiquitous.[168] However, these articles have not succeeded in establishing a persuasive response to Schwartz' first point. That is, they have not been able to demonstrate a benefit to unsecured creditors that would reduce the increase in their costs arising from the loss of access to the collateral in case of default. Absent that reduction, no mechanism has been persuasively proposed by which the increase in unsecured credit costs would not equal or exceed the reduction of cost to the secured party, producing a net loss of wealth.

Given the failure to achieve that goal, there remained the question: why does secured credit flourish if it is inefficient? Professor LoPucki's conclusion was that the parties who bore the primary effects of its inefficiency were involuntary creditors, especially tort creditors, who could not raise their "prices" to offset the costs imposed by security interests.[169] Thus the benefits of security interests obtained by Citigroup are built on the backs of the maimed and killed, an incendiary proposition that has drawn heated responses.[170] Subsequently, Professors Bebchuk and Fried have further developed that point, arguing that not only tort creditors but many other unsecured creditors are "weakly adjusting" or non-adjusting.[171] To the extent they cannot adjust their costs or ration their extensions of credit, there is a surplus created from which the debtor and the secured party can split the benefits of

[165] Alan Schwartz, *Security Interests and Bankruptcy Priorities: A Review of Current Theories*, 10 J. Legal Stud. 1 (1981) [hereafter "Schwartz, Security Interests"]; Alan Schwartz, *The Continuing Puzzle of Secured Debt*, 37 Vand. L. Rev. 1051 (1984) [hereafter "Schwartz, Puzzle"].

[166] *See* Schwartz, Puzzle, *supra* note xx, at 1054. *But see* David G. Carlson, Secured *Lending As A Zero-Sum Game*, __ Cardozo L.Rev. 1635 (1998) (arguing that security is not a zero-sum game, because the secured party makes available capital that the debtor would not otherwise be able to obtain) [hereafter "Carlson, Zero Sum"].

[167] *Id.*

[168] *See* Hill, Efficient, *supra* note xx (discussing a number of such articles).

[169] LoPucki, Unsecured Bargain, *supra* note xx, at 1896-97.

[170] *See, e.g.*, Hill, Efficient, *supra* note xx, at 1117.

[171] *See* Uneasy, *supra* note xx.

security. On this theory, of course, there is no efficiency gain from secured credit, but only a redistribution of a distinctly troubling sort.

Until recently, the only writer to propose a solution related to the concept of control was Professor Scott.[172] Although he did not elaborate the idea of a dominant security interest, he clearly had in mind a dominant secured party. The social benefit that would arise from a security interest would often be part of a long-term relationship between lender and debtor. The security interest would give the lender a tether that would do more than prevent "misbehavior;" it would provide the lender a chance to educate and guide the debtor in prudent directions through a financial expertise that many debtors would lack. The leverage produced by the security interest Professor Scott called "hostage value."[173] It arose from what this article would call asset constraint and more particularly business-plan constraint.[174] Presumably, the benefit of the mentoring and restraint would flow not only to the debtor but to all the unsecured creditors as well, ensuring that the ship that carried their common financial destinies would have a better chance to remain afloat.[175] Unfortunately, this sophisticated argument has not been much developed in the nearly twenty years since it was presented.[176]

From the perspective of the defenders of security, the result of these years of debate was at best inconclusive.[177] No one was able to make the case that there is some benign general effect of secured credit that outweighs the zero-sum relationship between its reduction of the secured party's costs and its increase in the costs of unsecured creditors, adjusting or not. Given that, Professor Mann decided to ask a new question: what do secured creditors believe they get from security interests? What do they value about security interests? He undertook rigorously structured empirical research, a combination of interviews with lenders and examination of a large number of lending files.

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172 *See* Scott, Relational, *supra* note xx, at 926-28.

173 *See also* Mann, Verification, *supra* note xx, at 2244; Carlson, Zero Sum, *supra* note xx, at 1680 (". . . [P]ower is the main thing. . . . Any theory of secured lending must concentrate primarily on power.").

174 CR.

175 *See* Robert Scott and Thomas Jackson, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and The Creditors' Bargain*, 75 Va. L. Rev. 155 (1989). (using the metaphor of the "common average" in maritime salvage cases).

176 It may be that one reason for its neglect is that its central argument relates to what this article calls a dominant security interest. Many scholars have wanted to make arguments that apply to all secured credit, ignoring the crucial distinction between the ordinary and the dominant security interest. As this article demonstrates, there is much to be done to understand the functioning of secured credit law and its interaction with bankruptcy in the pure case of a dominant security interest before undertaking the much more complex application of these concepts to the enormous variety of security interests found in the market.

177 *See* Note, *Switching Priorities: Elevating The Status Of Tort Claims In Bankruptcy In Pursuit Of Optimal Deterrence*, 116 HARV. L. REV. 2541 (2003). The author suggests that the view that secured credit is efficient is "dominant" but "is most definitely not unanimous." *Id*. at 2552.

Professor Mann marshaled evidence from his researches to show that control was the central benefit to secured parties, with priority upon sale a distant second.[178] This finding went to the heart of the prior debate, because the problem of equilibrium in the allocation of priority was the central difficulty raised by Professor Schwartz and addressed by a generation of scholars. If, as Professor Mann demonstrated, control is key to the benefits of secured credit to the secured party, then control must be essential to secured credit theory, including any claims about efficiency. But except for Professor Scott, the debate had little to say about control. While Professor Mann's work was enormously valuable, it did not attempt to resolve the efficiency issue[179] and little has been done by others to build on his work.[180]

This brief summary of thousands of law-review pages demonstrates that the result of the debate concerning the efficiency of secured credit from the perspective of the debt-capital system as a whole is inconclusive and incomplete. It is inconclusive because of the failure to demonstrate that the Schwartz, LoPucki, and Bebchuk/Fried critiques are substantially unfounded. If those critiques are cogent, secured credit may inefficient in many circumstances. The debate is also is incomplete, because the benefits and costs of control in its various aspects has been almost entirely ignored. No one, even Professor Scott, has attempted to include the positive value of this material factor in all of the equations written about the efficiency of secured credit. Equally important, no one has attempt to include in those equations the costs that may be associated with the diminution of debtor control, especially in the case of a dominant security interest. Indeed, the special benefits and costs associated with dominant security interests have barely been mentioned, much less analyzed or measured.

As things stand, it is quite possible that secured credit produces net inefficiency rather than an efficiency gain when viewed across a wide range of transactions. Yet that conclusion would doom contractualism. Adoption of contractualism would require wholesale adoption of dominant security interests, a state quite foreign (literally as well as figuratively) to the United States market.[181] If

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[178] However, he does not make the distinction between "asset constraint" and post-default "collateral control" made in this article. Ronald J. Mann, *Strategy and Force in the Liquidation of Secured Debt*, 96 MICH. L. REV. 159, 160-61 (1997) [hereinafter Mann, Strategy]

[179] His work did make another very important contribution to that debate. It demonstrated that the impact of default rules ex ante (that is, transactionally) may be marginal, meaning that any efficiency gains may have only minor effects on the cost and availability of credit. Mann, Strategy, *supra* note xx, at 234-35. That point is of great and ongoing importance to theoretical debates in the field of financial distress, because of the claim that ex ante (transactional) effects, as opposed to procedural fairness and similar values, are the ones that really matter. *See* Douglas G. Baird, *Bankruptcy's Uncontested Axioms*, 108 YALE L.J. 573, (1998).

[180] It should also be noted that his work deliberately focused on problematic loans, not loans in bankruptcy or necessarily in general default. CR.

[181] Professor Hill has developed some evidence that small businesses always grant blanket (that is, dominant) security interests, but the evidence is mixed. *See* Hill, Efficient, *supra* note xx, at 1139, n. 103.

secured credit may be inefficient, always or often, then a wholesale shift in the United States debt market to one in which dominant security interest are universal or even typical would seem a very risky experiment and one unlikely to be undertaken. If that is true, contractualism is not a serious alternative to the existing system.

Efficiency aside, there is an irony in the fact that contractualists are primarily interested in large public companies.[182] These are the very companies least likely to grant dominant security interests.[183] Thus they find themselves required to assert that the large companies that disdain dominant security interests now will be eager to adopt them when they are linked to a contractualist system. That proposition is highly implausible.

B. The Incentive Problem

Beyond the general arguments about the efficiency of secured credit, contractualism assumes management of a general default by a person or persons designated by contract. As we have seen, contractualism necessarily rests on a dominant security interest, so that the assumption must be management by a secured creditor or its designee. Yet the whole question of management of the recovery process in a privatized system has been ignored, despite the fact that control of collateral—indeed, control of the enterprise following default—is essential to contractualism and available only through a dominant security interest.

Most of the vast efficiency literature assumes a dominant security interest without much serious effort to distinguish it from an ordinary security interest or to suggest that the products of a blanket lien, which are business constraint and enterprise control,[184] are different from the rights and circumstances of ordinary secured parties. As we have seen, however, a dominant secured party is in a very different position than an ordinary secured party both before and after default. One of the most important differences is that enterprise control permits a dominant secured party to manage a general default and to sell a business as a going-concern, realizing going-concern value. Realization of going-concern value is one of the most important rationales for bankruptcy reorganization, so the dominant secured party might offer an alternative to the public system in the Bankruptcy Code, which is precisely what contractualism is designed to do. However, management of a general default by a dominant secured party is problematic. One important reason is the incentive problem.

The incentive problem applies to both ordinary secured parties and dominant secured parties. It arises in ordinary debt-enforcement as well as in a general default.

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[182] *See*, *e.g.*, Baird & Rasmussen, End, *supra* note xx, at 752-53.
[183] *See* Hill, Efficient, *supra* note xx, at 1139, n. 103 (conceding that large companies do not ordinarily grant sweeping security interests, but asserting they do grant security interests in particular assets).
[184] CR.

Any creditor-controlled sale--the sale aspect of what we have called "collateral control"[185]--gives rise to a serious risk of socially undesirable results.[186] Specifically, creditor control risks realization of substantially less than the full value of the asset being sold. These risks are well-recognized. Indeed, even the drafters of the Revised Article 9, despite their profound commitment to vindicating the rights of secured parties, have attempted to address some of these concerns in the debt-enforcement process.[187] A full discussion of the details of this problem is another article, but the main points are described below. It is important in a number of contexts, but it is of the highest order of importance when the issue is management of a general default by a dominant secured party.

There are two aspects to the problem. The first is a classic "free-rider" problem because the secured party lacks incentives to achieve efficient and socially desirable results. The second is the risk of self-interested behavior leading to socially suboptimal results. Exemplary of the risks created is the fact that both types of incentive difficulties may cause secured lenders to want to liquidate a debtor quickly to maximize the value of their security interests, even if delayed liquidation or reorganization might be in the best interests of other stakeholders.[188]

The free-rider problem arises from the obvious fact that the secured party managing collateral sales has no incentive to realize more than the amount of its debt. Anything above that amount must be distributed to other secured parties, the bankruptcy trustee, or the debtor, none of whom bear the costs and risks of the sales.[189] Although article 9 imposes significant procedural requirements for secured-

[185] The power of self-help, nonjudicial seizure is also very important. It may also implicate a major purpose of bankruptcy law, in my conception, although one little noted in the literature. That purpose is social control of circumstances likely to lead to social disruption and community conflicts. Westbrook, New Zealand, *supra* note xx, at 405. I do not mean to ignore its importance by putting it to one side for the purposes of this article.

[186] UCC 9-615, cmt. 6. Donald J. Rapson, *Deficient Treatment of Deficiency Claims: Gilmore Would Have Repented*, 75 Wash. U. L.Q. 491 (1997). *But see* Armour and Frisby, Rethinking, *supra* note xx. These authors justify the "imbalance" of the receivership system on grounds very similar to those offered by defenders of secured credit priority, especially Professor Schwartz in his article on priorities. CR.

[187] UCC 9-615, C 6. *See generally*, Andrea Coles-Bjerre, *Trusting the Process and Mistrusting the Results: A Structural Perspective on Article 9's Low-Price Foreclosure Rule*, 9 AM. BANKR. I. L.R. 351 (2001); Donald J. Rapson, *Default and Enforcement of Security Interests Under Revised Article 9*, 74 CHI.-KENT L. REV. 893, 917-19 (1999).

[188] *See, e.g.*, Riva D. Atlas and Jonathan D. Glater, Worldcom's Collapse: Market Place; Pact by Creditors to Work Together Falls Apart, N.Y. Times 7/23/02 (conflict among creditor groups); Ronald J. Silverman & Jeffrey T. Kirshner, *Lessons from the Derby Cycle Corp. Insolvency Proceeding*, Am. Bankr. I. Journal, April 2002, at 26 (oversecured bank group pushing for immediate liquidation of valuable assets notwithstanding risk of loss of excess value). The new German insolvency law has also run into difficulties when a few large banks with conflicting interests have control of the proceeding. *See* Christoph G. Paulus, *Germany: Lessons from the Implementation of a New Insolvency Code*, 17 Conn. J. Int'l L. 89 (2001).

[189] UCC 9-608(a)(4), 615(d).

party sales,[190] these provisions leave a broad zone of reasonableness within which quite different sale values might be obtained. As we have seen, great gaps separate liquidation value, market value, and going-concern value, but the secured party has no incentive to realize more than the value that will pay the secured debt in full.

Imagine the asset-realization department at a finance company.[191] The manager estimates that the assets of General Kompute can be quickly sold to realize sufficient proceeds to pay the company's secured debt in full. Is she likely to do the job herself or give it to the best and most creative marketer in the department? Surely not, if she is the rational maximizer we usually suppose people to be. Because satisfaction of the lender's interest will be simple, surely she will give the job to the dumbest asset-disposal person in the office, the one hired solely because he was qualified as someone's brother-in-law. She will also give the brother-in-law a list of Article 9 procedural requirements, requirements designed to be idiot-proof in most circumstances.[192] As a result, if substantially higher values could have been realized by a highly competent seller investing time and resources, they will be lost in this commonplace circumstance, to the injury of other stakeholders.[193] Within a broad zone of reasonableness,[194] the secured creditor will not be liable for that loss of value and arguably should not be, given its lack of incentives and the need to give the creditor a reasonable degree of flexibility in managing sales.[195] In the context of that branch of secured credit law devoted to enforcement of particular debts in a single default, this balance between efficiency and protection of other possible claimants may be reasonable.

The second part of the incentive problem has a somewhat darker moral hue. Indeed, it fills that near void in the literature concerning the "moral hazards" of creditors as a complement to the oft-discussed moral hazards of debtors.[196] The problem is the creditor's positive incentive to acquire the collateral at its own sale at a very low price and then re-sell the collateral at a much higher price for its own account. The hazard is created by two legal rules. The first is the flexible-sale rule already discussed, which grants a broad zone of reasonableness in the advertising and conduct of a sale. The second rule permits a secured party to "bid in" at its own

[190] These include notices to interested parties and a commercially reasonable approach to advertising and sale. UCC 9-610-14.

[191] This discussion suggests an attractive empirical project. Professor Mann has done some important work in this regard, but much remains to be done. CR.

[192] UCC 9-627.

[193] It should be noted that the Bankruptcy Code protects the selling party by permitting deduction of all reasonable costs of sale off the top. B.C. §506(c). The same rule applies outside of bankruptcy. UCC §9-615(a)(1).

[194] Jack F. Williams, *Debunking the Myth Regarding Article 9 Collateral Dispositions*, 9 Am. Bankr. L.R. 703 (2001).

[195] An example of this difficulty in the context of an attempted reorganization is discussed CR Atlas, etc. fn.

[196] CR earlier note re moral hazard.

sale. That is, the secured party is allowed to use the debt owed to it in lieu of actual cash payment for any bid it may make at its own sale.[197] Thus, if the creditor is owed $100,000, it can bid any amount up to $100,000 and defeat any lesser bid, without having to produce cash.

In both judicial and private auction sales, there are often strict requirements for a bidder other than the secured party. In particular, the bidder may have to bring sufficient cash to cover its bid or to provide cash payment very shortly after the bidding. For this and other reasons, it is often the case that few other bidders appear at foreclosure and repossession sales. This fact combines with the bidding-in rules to make it possible for secured parties to buy at their own sales at a price well below market values while avoiding sanctions for violating Article 9 notice and sale procedures.

The classic recent instance was the sale of the infamous Brentwood home of O.J. Simpson.[198] Although the sale was in the real estate context rather than the sale of personal property, the economic factors were typical. At the well-attended foreclosure sale (!), the bank holding the mortgage bought the property for the amount of the mortgage ($2.6 million) "bid in," plus $31,000. It thus defeated the only other active bidder, who began the bidding at the amount of the mortgage, plus one dollar. Less than a month later, the bank listed the property for sale for $3.95 million, the approximate price for which it sold about six months later.[199]

This sort of circumstance creates a temptation for the secured party to underbid at its own sale and then to resell for a substantial profit. Whether this result is abusive or merely self-interested, the consequence may be that far less value will be received at an Article 9 collateral sale than would be achieved by a seller anxious to maximize that value. The value that might have been obtained over and above the amount of the secured debt we may call "excess value."

In the context of debt-enforcement, absent a general default, Article 9's resolution of the competing values and risks is plausible, although still controversial.[200] It can be argued that commercial debtors are able to protect

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[197] UCC 9-610(c). "The secured creditor has peculiar advantages over other possible purchasers. Not only does he determine the time and place of the sale, but, to the extent of the secured obligation, he does not have to put up the money since he pays by offering a credit against the obligation." GILMORE, SECURITY INTERESTS §44.6 (1241-42).

[198] Carla Hall, More Hoopla At Simpson Home Auction, Los Angeles Times, July 15, 1997 [hereafter "Hoopla"]; Associated Press, Simpson House Available, For $3.9 Million, The New York Times, August 6, 1997; Todd S. Purdum, Once Again, Tinseltown Brings Down The House, The New York Times July 31, 1998 [hereafter "Tinseltown"]

[199] More formal discussions of this problem can be found in the literature. One of the common explanations are the qualifications buyers must bring to liquidation auctions. In the case of the Simpson house, a buyer was required to have cash or a cashier's check in an amount not less than the mortgage--about $2.6 million. *See* Hoopla, *supra* note xx.

[200] Because it is controversial, aspects of the problem as it affects consumer debtors have been left

themselves against the loss of excess value. Furthermore, other claimants against a debtor are not generally identified outside of a general default. When the discounted risks of creditor-controlled sales are balanced against the real gains from the flexible Article 9 sale provisions,[201] it can be argued that the drafters have struck the right balance in the context of debt enforcement.[202]

Once a general default has occurred, however, the proper balance may be very different. In the recovery process following a general default, we find a debtor in general financial distress and a number of other claimants to any excess value. These considerations are central to the explanation for the trumping of the collateral-control right in bankruptcy even as to a dominant secured party that could potentially obtain going-concern value.[203] Protection of the other claimants requires that a neutral bankruptcy controller conduct the management of the assets and their redeployment or recapitalization. Where excess value can be obtained, the secured party would still receive its full priority payment, but there would be something left for the other claimants. By seizing control, the bankruptcy regime protects the secured party's priority right, while also achieving the bankruptcy purpose of the maximum distribution for all the chosen beneficiaries.[204] Among other things, this point clearly distinguishes the branch of financial-distress law concerned with the secured party's enforcement of a particular debt[205] from its enforcement in the context of general default. It is when a general default has occurred and the recovery process has begun that other claimants can be identified, implicating the collective purposes of bankruptcy.[206]

The incentive problem just described is just one aspect of the larger problem of management of the recovery process in a way that protects the various interests chosen by Congress as beneficiaries of the Bankruptcy Code. Suppose, for example, that Congress adopted the automated bankruptcy scheme proposed by Professor Bebchuk.[207] Although his proposal does not address the necessary interlude between general default and exercise of his various options up the ladder of priority, it is obvious that process would take some time, especially in a large public company and especially in the typical case where there is a desperate shortage of necessary

open for continued common law control. *See, e.g.*, UCC §9-615 and comments.

[201] CR.

[202] We need not decide in this discussion if the balance struck is correct, only that it is arguable.

[203] CR.

[204] This discussion ignores any argument that maintenance of the secured party's collateral control rights would produce transactional savings in excess of the combined transactional and situational loses resulting from the incentive problem. Given that the efficiency debate over secured credit has ignored the valuation of the control right, we have no estimate of savings against which to balance costs.

[205] CR.

[206] CR to earlier statement of same.

[207] CR.

information about the financial condition of the company, information crucial to the investment decisions about to be made at each tier.[208]

During this interim period, someone has to manage the company and its business. That management may profoundly effect the situation of the interested parties. A manager appointed by the first, or lowest, tier of investors may be likely to take some significant risks with the company's assets[209] seeking an increase in asset value sufficient to cover the position of that lowest tier.[210] Any manager who failed to do so would be very unlikely to receive another appointment from a bottom-tier creditor class. If the top tier appoints the manager, however, we may fairly predict that the business will be managed into a coma of risk avoidance if that is necessary to protect that minimum remaining value that will satisfy the top tier of investors. Indeed, managers seeking top tier appointments may actually aim for short-term value reduction, which after bankruptcy might leave the top tier investors with an appreciating asset as the business cycle continues. Thus the incentive problem exists in any system in which there are competing claimants with different priorities or otherwise differing interests.[211]

The consequence of the incentive problem for secured creditors is that bankruptcy must trump collateral control rights, whether or not going-concern value is obtainable, because of the risk that a creditor-controlled sale will sacrifice excess value. Bankruptcy serves as a mechanism by which private parties can determine whether that trump will be invoked. That is, in the circumstance of general default, the debtor and other claimants hold an option to file bankruptcy and thereby to invoke its protection for all beneficiaries. It is plausible that the debtor and unsecured

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[208] The central importance of information and the difficulty of obtaining it even from a public company is captured in the phrase "due diligence" in the merger and acquisition practice. *See, e.g.*, , Bryan Burrough & John Helyar, BARBARIANS AT THE GATE: THE FALL OF RJR NABISCO, 301-302, 368-369, (1990).

[209] For example, assume a value in the enterprise of 100 units, with five tiers of debt each owed 20 units. One form of management of the general default pending the option process would yield a certain value of 20 units, but make it unlikely that more than 40 units of value would be preserved, while a second approach to management would give a reasonable chance of preserving 80 units of value, but require a 10% chance of a complete loss. The top tier creditors would prefer the first, safe, low-value approach, while the bottom two tiers of creditors would prefer the second choice. Can such matters be efficiently resolved by contract, given problems of notice and the lessons of behavioral economics? These questions need serious discussion, which the model in this article may provoke.

[210] This point was assumed at first to be the position with the DIP concept, where management would be protecting shareholders, the bottom tier of claimants in a corporation. However, the hoary, intractable agency problem so familiar in the corporate literature rose again here, soon after the Code was adopted. Shareholder have been disappointed ever since. *See, e.g.*, Baird & Rasmussen, End, *supra* note xx; Lynn LoPucki and William Whitford, *Patterns in the Reorganizations of Large, Publicly Held Companies*, 78 Cornell 597, 610-11 and Table 2 (1993).

[211] The differing interests may be economic rather than resting on legal priorities. A bondholder and a supplier owed equal amounts may differ sharply, in that the bondholder may simply want the best tradable instrument available, looking to get as far away from this company as possible, while the supplier wants cash, but also is looking for future business from the reorganized debtor.

parties have the right set of incentives to act as bankruptcy gatekeepers. If they do not believe there is a general default or if they do not believe there is a reasonable chance to obtain excess value, over and above the secured party's debt, they are unlikely to accept the costs and risks necessary to generate the collective trump represented by a bankruptcy petition.[212] In those situations, they may conclude the secured party might as well have the collateral control and conduct the sale.

On the other hand, where there is a general default and other claimants believe that the business may realize excess value, whether by sale or restructuring, they can invoke bankruptcy and ensure negation of the secured party's collateral control. By giving the bankruptcy option to those most likely to suffer from the effects of the secured-creditor incentive problem, the law provides private parties with a choice between private secured-creditor control and public bankruptcy control.

Subject to the possible effects of a de facto bankruptcy veto,[213] current United States bankruptcy law clearly follows the model proposed here, providing the option of the bankruptcy trump for the protection of beneficiaries other than a secured party. It provides that secured creditors should not be allowed to sell collateral after a general default if the realizable value of the collateral is likely to exceed the secured debt, either in liquidation or reorganization. If there is such value, then, as the analysis would predict, the automatic stay cannot be lifted at all under section 362(d)(2)[214] and will rarely be lifted for lack of adequate protection under section 362(d)(1).[215] Unless the stay is lifted, the secured creditor's collateral control remains negated. The point is driven home by the fact that all of the burdens in adequate protection litigation are on the trustee (DIP) except the burden to prove there is equity in the property. The presence of value in excess of the secured debt requires bankruptcy control to maximize returns for all beneficiaries. If the bankruptcy controller is prepared to exercise that control, the secured party is required to show there is no excess value or to yield to the bankruptcy trump. In the case of the dominant secured party, existence of the "bankruptcy veto" may defeat this statutory scheme as a practical matter, because of the secured party's control of

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[212] It is at this point in the analysis that the argument arises that debtors have too few disincentives to file bankruptcy and therefore the choices are unbalanced, an argument that will have to be addressed in another article.

[213] CR.

[214] That section, discussed below, requires that the collateral be surrendered to the secured party if there is no value above the secured debt (equity) and the collateral is not necessary to a reorganization. CR.

[215] The presence of equity works in a different way under section 362(d)(1). There the excess value, over the secured debt, serves to provide the adequate protection necessary under that provision to block the lifting of the stay sought by the secured party. By its very existence, it protects against a decline in value below the level of the secured debt (*see, e.g., In re Rogers Development Corp.*, 2 B.R. 679 (Bankr. E.D. Va. 1980). CR. There might be an exception if the equity is so small as to make loss of adequate protection likely over the relevant period.

all of the resources of the estate,[216] but the statutory scheme demonstrates the intent and purpose of existing law.

While the incentive problem is logical and intuitive, it has not been demonstrated empirically. Some of the empirical work done by Professor Mann may cast doubt on its importance as a factual matter. In a sample of 72 commercial loan files identified by the lender as "problem loans," he found no evidence of secured creditors sacrificing excess value in the sale of collateral. Specifically, he found that most often debtors paid the loans from refinancing, sales of collateral, or continued business operations thanks to the lender's forbearance from enforcement. In only three cases did the lender sell the collateral and it lost money in each of those cases, suggesting there was no excess value to forfeit in those instances. Mann's interviews suggested that the reason for so few enforcement actions was the loan officers' conviction that seizing collateral meant a nearly certain loss.

Mann's work is very helpful, but it is well short of showing that the incentive problem does not exist. As he concedes, the size and nature of his sample makes the data suggestive at most. He was deliberately sampling the "middle" case of loans, problematic but not in bankruptcy or foreclosure.[217] Although many of the debtors refinanced their loans with "his" lenders, his methodology did not provide for following those debtors following the refinance, so we do not know their ultimate fate or the fate of their assets. His work strongly supports the conclusions that most problem loans work out and that formal legal actions, whether under part 6 of Article 9 or in bankruptcy, are relatively rare. It does not tell us to what extent the incentive problem should be a serious concern in the cases that do go to legal action. His conclusion rests strongly on the belief of loan officers that liquidations mean loss. That conclusion is consistent with the literature as to the effect of forced sales,[218] but does not tell us what happens in the universe of cases that go into bankruptcy, especially Chapter 11 reorganization, because not a single one of the 72 cases in his primary sample ended in bankruptcy of any kind.[219] As Professor Mann so ably demonstrates, bankruptcy or repossession represents the unusual case.

What results obtain in a bankruptcy, especially a reorganization bankruptcy, remains for future empirical report. It may be, for example, that Mann's refinancing debtors were the ones that had excess value, over and above their existing secured loans, and that is why they were able to refinance. On the other hand, it would generally be conceded that bankruptcies are fairly often filed where the lenders are oversecured—that is, where there is value in the collateral in excess of the secured

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[216] CR.

[217] Indeed, many of the files were identified by the lenders as "problem loans," but they were not necessarily in default at all. Mann, Strategy, *supra* note xx, at 172, 199-201.

[218] CR.

[219] There are a number of other variables. For example, to what extent is there a going-concern market for a particular kind of business? Absent such a market, the likelihood of a loss upon liquidation will be quite high.

debt, so the incentive problem could be presented if there were secured-creditor control of the general default. Until further data appear, logic and intuition are joined by substantial anecdotal evidence[220] to suggest that the incentive problem is a serious one in a significant number of cases that require legal intervention. The fact that the incentive problem was perceived as operative and harmful in Britain offers some empirical proof as well.

As explained earlier,[221] neutrality is a necessary concept in a system for managing a general default in any system in which the policymaker provides for multiple beneficiaries and charges the manager with maximizing value for all of them. A dominant secured party cannot be a neutral manager and its management creates a serious potential of loss for other beneficiaries. It is just that result that provided the impetus for a major restructuring of the system in Britain.[222]

Part VI. Future Empirical Evidence

A. Abandonment of Administrative Receivership in Britain

A further blow for contractualists is the fact that a long-established, functioning system very near to secured contractualism has been abolished in one of the most successful commercial societies in the world.[223] The British system

[220] CR Atlas, Silverman note.

[221] CR.

[222] For this sort of criticism of the floating-charge regime in the United Kingdom, *see* Mokal, Elegy, *supra* note xx, text at nn. 70, 80-82. Mokal also criticizes the system for excessive costs. *Id*. at n. 75. On the other hand, he believes the great power given to the secured creditor to oust management, even on a merely technical default, is a benign feature retained by the new British system, a viewpoint that many would not share. *See, e.g*., Finch, Invigorating, *supra* note xx, at n. 31.

[223] Enterprise Act 2002 §250 & Sched. 18, §§72A-72H. Andrew McKnight, The Reform of Corporate Insolvency Law in Great Britain, [2002] J.I.B.L. 324, 332 [hereafter "McKinight, Reform"]. The statement in text must be qualified to the extent that there are exclusions from the new regime that permit administrative receivership to continue for certain types of transactions and that grandfather existing loans. *Id*. Enterprise Act §§72B-72G. There is also a remaining power in floating chargeholders to appoint the administrators acting under court supervision even in new cases. *Id*. at 325; Vernon S. Dennis, *The Enterprise Bill—"Administration: the key to corporate rescue,"* [2002] 152 The New L. J. 1688, 1689. The effects of those provisions are not yet clear, although their effect may be to defeat the government's hopes. *See* Finch, Invigorating, *supra* note xx. On the other hand, the concept of administrator responsibility to all creditors represents a fundamental change in attitude. *Id*. Furthermore, British abolition of administrative receivership (private receivers) is consistent with a Commonwealth trend.

Our friends in Canada relegated their English-style receivership system to a backwater twenty years ago, even though their commercial law remains very protective of secured creditors. American Law Institute, Transnational Insolvency Project, INTERNATIONAL STATEMENT OF CANADIAN INSOLVENCY LAW sec. IB(3)-(5) (forthcoming 2003) [hereafter ALI Canadian Statement]. Australian law seems to be moving away from secured-creditor control, although it has not yet gone as far as the new Enterprise Act in Britain. G. Dal Pont & L. Griggs, *The Resuscitation of the Corporate Cadaver: An Autopsy of Business Rescue Laws*, 4 Austl. J. Corp. L. 1 (1994); Colin described earlier is very similar to a contractualist system. In effect, it permits liquidation or going-concern sale through an entirely private system of managing the recovery process. It is in almost every respect what the contractualists theorists propose, with the addition of the dominant security interest this article has shown is necessary for the success of their project. Yet Britain has adopted legislation designed to abolish or radically change this system in the direction of the sort of reorganization procedures found in Chapter 11 and the other modern reorganization regimes emerging around the world, a change called "a seismic shift for the country that invented . . . privately appointed receivers.[224] From the perspective of English lenders, proposals to abolish motherhood and the flag would pale in comparison.[225] The reforms may have the effect of altering the commercial lending market in Britain profoundly. They overturn over a century of well-established British law. Obviously, the perceived need for reform was very great.

The reforms, which come into effect during 2003, prohibit the appointment of an "administrative receiver" out of court under a debenture, the power that was central to the position of a floating charge holder throughout the twentieth century.[226] Instead, an "administrator" will be appointed. The appointment may be by the court, by the company, or by the debentureholder, but the administrator's responsibility will be to the court. The administrator is explicitly charged with attending to the interests of all creditors and with seeking a restructuring of the company, rather than a liquidation. These provisions work a conceptual revolution in British financial law.

The reasons for this radical change included a conviction that secured creditors acting in their own interests were failing to permit or encourage reorganization (in Britain, "rescue") of viable businesses, an important aspect of the

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Anderson, *The Australian Corporate Rescue Regime:Bold Experiment or Sensible Policy?*, 10 Intl. Insov. Rev. 81 (2001).

[224] E. Bruce Leonard, *The Coming Revolution in U.K. Insolvency Law: Part II*, 22 Am. Bankr. I. Journal 26 (2003).

[225] The abolition came less than twenty years after a very prestigious and influential report had flatly stated ''we are satisfied that the floating charge has become so fundamental a part of the financial structure of the United Kingdom that its abolition cannot be contemplated." Cork Committee, "Insolvency Law and Practice", Report of the Review Committee Cmmd 8558 (June 1982), para. 110. The centrality of the floating charge in English lending practice was also acknowledged recently by the Privy Council in *Agnew v Commissioner of Inland Revenue*. There, Lord Millett said: "The floating charge is capable of affording the creditor, by a single instrument, an effective and comprehensive security upon the entire undertaking of the debtor company and its assets from time to time, while at the same time leaving the company free to deal with its assets and pay its trade creditors in the ordinary course of business without reference to the holder. Such a form of security is particularly attractive to banks, and it rapidly acquired an importance in English commercial life which ... should not be underestimated." [2001] 2 A.C. 710. Yet the central provision of the new legislation generally prohibits debentureholders (holders of floating charges) from appointing a receiver (an "administrative receiver"), subject to certain exceptions. *See, e.g.*, Finch, Invigorating, *supra* note xx, at n. 22. As noted earlier, the power of appointment of a private administrative receiver has long been seen as the essence of the floating charge. CR.

[226] *See* McKinight, Reform, *supra* note xx.

incentive problem.[227] Specifically, a conviction arose that the balance in financial law in Britain was skewed too far in favor of the lender and against the entrepreneur, discouraging the development of an entrepreneurial culture like that in the United States.[228]

Abandonment of an essentially contractualist regime by an advanced and sophisticated commercial society, especially on the stated grounds, is a devastating commentary on the social value of the contractualist project, especially when the system seems to be moving toward abandonment or serious decline in other developed countries in the Commonwealth. Secured credit may have its uses, but in Britain it has come to be perceived as materially suboptimal when used to support a system that in the midst of the economic crisis following a general financial default hands over complete control of the recovery process to a secured creditor.

B. Empirical Work

Establishment of the fact that privatization of the management of general defaults must rest upon a dominant security interest generates a considerable empirical agenda. The top item must be a further exploration of the British experience, which has been a "natural experiment" for the ideas of the contractualists, who must start with the hypothesis that the British were wrong to think that the receivership system had serious flaws. In the United States, an important object of inquiry would be actual experience with management of general defaults by secured creditors. That would require an opportunity to examine creditors' files systematically, with all its attendant difficulties, but would follow a path already blazed by Professor Mann. It might also be revealing to study bankruptcy files to compare recoveries by general creditors in cases with or without secured parties, both dominant and ordinary. Yet another significant question would be the frequency and extent of the exercise of the bankruptcy veto and the results of dominant secured party management.

Because of the difficulties with these types of inquiries, however, these issues are among those that might be illuminated by "gaming." Both game theory and actual game experiments, using players given an appropriate set of rules and rewards, might suggest the existence and strength of various incentives, both positive and perverse, that are difficult to study in the wild.

Part VII. Summary and Implications of the Control Model

[227] Department of Trade and Industry, The Insolvency Service, Productivity and Enterprise: Insolvency - A Second Chance 2.1-2.3, C:16 (2001) [hereafter "DTI White Paper"]. *See* Mokal, Elegy, *supra* note xx, at n. 80 and accompanying text; Finch, Invigorating, *supra* note xx, text following n. 32.
[228] DTI White Paper at 1.

By establishing the fundamental elements of a model that links secured credit and bankruptcy and identifies control as the central issue in the law governing the recovery process for distressed businesses, this article has explained why control is the governing issue and has begun the process of identifying the key implications of that finding. It has also introduced the concept of neutrality and its relationship to the case for public management of general defaults.

A bankruptcy regime exists to enforce a set of priorities chosen by legislators. A study of bankruptcy laws around the world reveals that no particular set of priority choices, including a choice of general equality, is essential to bankruptcy, but that the control necessary to enforce the chosen priorities is essential. Another way to state that conclusion is that most priority decisions are exogenous to bankruptcy law,[229] arising from efficiency and distributional goals and ideas of fairness that are external to bankruptcy policy as such.[230] Control decisions, by contrast, are central to bankruptcy policy.[231]

The struggle for control of the recovery process is ultimately between a public and a private ordering. The primary approach to privatization is contractualism. This discussion has shown that the only plausible form of contractualism is secured contractualism. The reason is that contractualism requires control of a debtor's assets, not merely priority in the proceeds of their sale, and only secured credit law provides both outside of bankruptcy. We have looked more deeply to see that contractualism requires both pre-default constraint and post-default control. Further, it requires complete constraint and control, which can be provided only by a dominant security interest. Thus the constraints and controls provided by a dominant security interest are essential to a privatized, contractual bankruptcy regime.

[229] The major exceptions to the statement in text are administration, marginality and entrepreneurship. Administration is the necessary priority for the operation of the bankruptcy process itself. B.C. §§503(b), 507(a)(1). Marginality is the idea that the bankruptcy-regime benefits of a policy decision may be so marginal compared to its bankruptcy-regime costs that the policy would be better vindicated in a larger context. Thus a demonstration of marginality might be persuasive in defeating a proposed vindication of some social or economic policy through the bankruptcy process. The recent German decision to abolish employee priorities in bankruptcy was driven by this sort of argument. The workers are protected by an unemployment fund instead. Manfred Balz, *Market Conformity Of Insolvency Proceedings: Policy Issues Of The German Insolvency Law*, 23 BROOK. J. INT'L L. 167, 174 at n. 34 (1997). Encouragement of entrepreneurship is an independent economic policy, but is so closely related to risk allocation and other factors affected by bankruptcy law that it represents a combination of exogenous and endogenous factors.

[230] This point, along with marginality (CR), has contributed to the conventional, but mistaken, idea that non-bankruptcy law should determine all of the policy content of bankruptcy law. *See, e.g.*, Thomas H. Jackson, *Bankruptcy, Non- Bankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L.J. 857 (1982);); Tene, *supra* note xx, at 362, n. 385.

[231] The decision about the role of management and equity in a reorganizing company lies at the crossroads between control and priority, which is no doubt one reason it has been so difficult and controversial. That decision is related to the function and importance assigned to venture capital and entrepreneurs. *See* White Paper, *supra* note xx, at §1.1.

Control is the intersection and linkage between the major components of the recovery process, secured-credit law and bankruptcy law. Although the elaboration of that proposition must await another day, the centrality of control to the question of contractualism, the most discussed reform program in the field in recent years, is the key step. Because control is central to realization of maximum value for the beneficiaries chosen by Congress, and because there will be conflicts of interest among beneficiaries as to the best management for maximization of each beneficiary's interest, management by any one creditor or creditor interest will often be inconsistent with the Congressional scheme. If the law establishes multiple beneficiaries, only a neutral manager will maximize value appropriately. Necessarily, any attempt to modify priorities or control by contract must therefore be inconsistent with those policy choices. On the other hand, where policy choices and specific circumstances result in only one class of beneficiaries—as with an undersecured dominant secured party—then control by that class may be appropriate.[232]

Although secured contractualism has not been discussed by the contractualists, it is clear that the central issues that must be addressed by them are a) the transactional efficiency of secured credit; and b) the efficiency and fairness of management of the recovery process by a secured creditor in any system that encourages credit extensions by other sorts of creditors.[233] The first issue requires a new look at transactional efficiency that includes valuation of control, which has never been addressed directly in the vast American legal literature on the subject. The second issue, post-default control, is similarly unexamined in that literature, but requires serious and intense scrutiny if we are to understand the ramifications of the proposed privatization of the management of general defaults. We have made a start on that question in this paper by exploring the incentive problem.

The control model carries a number of implications for the theory of the law governing financial defaults. Their development will have to await other articles, but it may be useful to discuss the relationship of one concept to the control model, albeit in a preliminary way. The concept is "lender control."

In two recent articles,[234] Professors Baird and Rasmussen have advanced our understanding by putting forward control as a central issue in bankruptcy law. Although they have not named the phenomenon they have identified, to call it

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[232] Another important issue that arises from the analysis discussed here is the propriety of the use of a collective, publicly supported proceeding, bankruptcy, for the benefit of a single secured creditor, who arguably should support the burdens of the recovery process by itself when no other person or social interest will benefit from a bankruptcy proceeding. Elizabeth Warren and Jay L. Westbrook, *Secured Parties In Possession*, 22 Am. Bankr. I. J. 12 (2003).

[233] It also raises important questions about bankruptcy policy as to entrepreneurial activity and venture capital investments in an economic system that depends upon them, but we put those points to one side for now.

[234] Baird & Rasmussen, End, *supra* note xx; Control, *supra* note xx.

"lender control" will be close to the mark.[235] They assert that lenders have recently come to dominate the Chapter 11 cases of large public companies and that this development should be applauded.[236] Although their approach is stimulating and helpful, their description of the phenomenon presents some serious difficulties. Its empirical deficiencies have been well-addressed by Professor LoPucki,[237] and it presents some important conceptual problems as well. The discussion here will assume without conceding that their factual assertion is correct.[238] It will be limited to two points: comparing and contrasting the type of lender control they discuss with control by a dominant secured party; and identifying some of the problematic aspects of that sort of lender control.

In one important respect, the Baird and Rasmussen analysis is supportive of the model presented here. They see security interests as an important aspect of lender control in many cases.[239] They do not distinguish, however, between ordinary and dominant security interests nor between pre-default and post-default control. As to the first, one key issue implied by the analysis presented in this article is whether control by an ordinary secured party is legitimate. For example, is it appropriate, economically or legally, for a secured party with a security interest only in accounts receivable or only in equipment to attempt to hold reorganization hostage to its demands, even though it is not a dominant secured party and therefore incapable of realizing going-concern value itself? This power might be called "hostage value," but seems very different from the concept put forward under that name by Professor Scott.[240] "Threat value" might be closer. This article stops short of addressing this interesting question, which is answered firmly in the negative by Chapter 11 of the

[235] They are quite vague about just who will be in control and how that determination will be made. Aside from an interesting discussion of management control when the manager is uniquely essential to the business, they generally refer to "creditors" in control, but without much specificity. Nonetheless, they suggest that an "institutional lender" or investor may somehow take charge. Control Rights at 957. The End of Bankruptcy article is almost entirely about lenders taking control, so it seems correct to take that as their paradigm. *See* Baird & Rasmussen, End, *supra* note xx.

[236] They also suggest that bankruptcy reorganization is no longer very useful for smaller, non-public companies and that such the only non-public companies using Chapter 11 are largely marginal, odd-ball outfits with some specific, perhaps shady use for bankruptcy, like dodging the IRS. *See* Baird & Rasmussen, End, *supra* note xx, at 752-53. Their only published support for this claim is that the number of Chapter 11 filings in 2000, at the end of the Nineties bubble, was only half as great as the number in 1991, in the midst of a recession. They fail to note that the total number of business filings in 2000 was also about half as large as in 1991, not just Chapter 11. http://www.abiworld.org-/stats/1980annual.html (last visited 7-31-03). Yet they do not suggest bankruptcy in general has become obsolete. This article is not the place to respond to their larger claims about fundamental changes in the nature and structure of American business that make Chapter 11 bankruptcy irrelevant.

[237] Lynn LoPucki, *The Nature of the Bankrupt Firm: A Reply to Baird and Rasmussen's The End of Bankruptcy,* Stan. L. Rev. XX (forthcoming).

[238] The present author is inclined to think they are correct in this particular regard as to a portion of the major bankruptcy cases, although perhaps a smaller percentage than they assert.

[239] Baird & Rasmussen, End, *supra* note xx, at 784-85.

[240] CR.

Bankruptcy Code.[241] Given that Baird and Rasmussen do not make the ordinary-dominant distinction, it is not surprising that they do not address it either.

Indeed, these two authors seem unsure whether the lenders whose control they celebrate are secured or not. They have difficulty identifying the "creditors" that will take charge. They flirt with the idea of a secured creditor playing that role,[242] but never settle on it, although many of their exemplary cases involve security interests.[243] In short, their argument for a system in which "investors" contract for "control rights" comes to the edge of presenting a model based on a dominant security interest, but stops short of making any connection between bankruptcy and secured credit.

Baird and Rasmussen do not ignore the pre-default period, but they offer evidence as to control only during the recovery process. As to the period beginning with the initiation of the lending relationship, they merely assert that "investors" have established methods of pre-default control, without offering any evidence other than a citation to two articles that are purely theoretical.[244] It does not seem that any real company has yet adopted the financial structures suggested by either of the cited articles. Of course, a dominant security interest would provide the desired control, but they do not propose it as their model. Indeed, they do not propose any method for solving the problems of contractualist lack of control discussed in Part IV of this article because they do not recognize those problems. Without that discussion, there can be no plausible model for control of the debtor's assets by contract or for control of the general-default process, as we saw in Part IV.

The only pre-bankruptcy control that is discussed in the End article seems to refer to post-distress control—that is, control that lenders obtain prior to bankruptcy but after the debtor has fallen into serious financial trouble.[245] The authors may well have in mind that the lenders obtain dominant security interests in that context, although they do not say so. To the extent they are not relying on a dominant security interest, the problem presented shades into that presented by post-bankruptcy control, to which we now turn.

According to the End article, one important way lenders have seized post-default control is through the post-bankruptcy lending process.[246] This suggestion

[241] A secured party may be "crammed down" by a Chapter 11 debtor's plan as long as it receives the value of its collateral plus interest over time. B.C. §1129(b)(2)(A). (There is a twist in the "1111(b) election" but it is not relevant to this point.) Thus an ordinary secured party cannot hold a reorganization hostage by refusing to agree to a plan. A dominant secured party might be able to do so, where it can exercise a bankruptcy veto. CR.

[242] Control Rights at 957.

[243] Baird & Rasmussen, End, *supra* note xx, at 784-85.

[244] Baird & Rasmussen, End, *supra* note xx, at n. 125 (citing Adler and A. Schwartz).

[245] Baird & Rasmussen, End, *supra*, at 784-85.

[246] *Id.*

raises both empirical and normative issues. Why and how has this happened? Is it a desirable development? Baird and Rasmussen devote little attention to either issue.

Absent a dominant security interest, it is not clear why post-bankruptcy lenders (usually called "DIP lenders") should have great leverage in a Chapter 11, at least at the outset of the case. Odd as it seems to many non-Americans, DIP lending is highly sought after and competitive in the United States. There is no need, ordinarily, to go hat in hand to existing lenders to beg for more money. So why would the Debtor In Possession (DIP) give control to the DIP lenders, as Baird and Rasmussen say they do? If the authors are correct in their factual claims, it is clear that serious empirical inquiry—by questionnaire, by data compilation, or otherwise—should be undertaken to answer this question. Could it be that management, which controls the DIP, sometimes abandons the equity owners and other company constituencies in favor of lenders who tacitly agree to maintain management in control? That result would be somewhat consistent with the positions of those who claim that management should have an exclusive duty to creditors once the business is "in the vicinity" of insolvency,[247] but would seem highly problematic to those who disagree.[248] One can imagine a number of motives and pathways by which lender control through management might be reached, but hard evidence would be much better than speculation. In any event, Baird and Rasmussen do not explain.

The normative issue raised by the End article is whether it is appropriate for the DIP, through management, to be controlled by the "lenders." The authors exhibit the tendency found in much of the commercial-law literature to confuse "lenders" with creditors, when the creditor body in fact consists of many classes of creditors, often including classes of lenders conflicted inter se.[249] By assuming some lender or lenders represents all creditors, they can assume that control by lenders is the same as control by creditors, which they applaud. In fact, control by a group of lenders is highly unlikely to be neutral as among creditors—much less as among a broader range of company constituencies[250]—and therefore it is unlikely to serve the Congressional purposes, for the reasons explained in Part V. On the analysis

[247] See, *e.g.*, *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, No. 12150, 1991 Del. Ch. LEXIS 215, at *108–*09 (Del. Ch. Dec. 30, 1991). *See also* Andrew Keay, *The Duty of Directors to Take Account of Creditors' Interests: Has It Any Role to Play?* J. Bus. L. 379, 385 (July 2002). It would be only somewhat consistent because the process would not necessarily be limited to companies "in the vicinity" of insolvency, putting to one side the very difficult problem of defining and identifying that condition. Lipson, *supra* note xx.

[248] *See, e.g.*, Lipson, *supra* note xx; Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law,* 85 Va. L. Rev. 247, 287 (1999); Daniel R. Fischel, *The Corporate Governance Movement,* 35 Vand. L. Rev. 1259, 1263–65 (1982).

[249] *See generally*, Stephen J. Lubben, *The Direct Costs Of Corporate Reorganization: An Empirical Examination Of Professional Fees In Large Chapter 11 Cases*, 74 Am. Bankr. L.J. 509 (2000) [hereafter "Lubben, Costs"]

[250] *See* Elizabeth Warren, *Bankruptcy Policymaking in an Imperfect World*, 92 MICH. L. REV. 336 (1992).

presented here, a takeover of the Chapter 11 process by one group of creditors would seem to be the occasion for concern, not celebration.[251]

Part VIII. Conclusion.

Although the literature in the field of commercial finance and financial default has long been preoccupied with questions of priority, control is the central concept in any persuasive model of the field. A lack of understanding of the role of control explains the failure to recognize and analyze the crucial distinction between an ordinary secured party and a dominant secured party and to see that the latter offers a possible alternative to the bankruptcy trustee. The blurring of the types of control generated by these two different types of security interest and confusion between pre-default and post-default control has prevented development of the important insights provided by Professors Scott and Mann with regard to control as a central value-generating element in pricing secured transactions and measuring their economic efficiency. A focus on control as the fundamental concept in the law of default, linking secured credit law and bankruptcy law at their roots, will, among other things, force recognition of priority issues as largely exogenous to bankruptcy law, while neutrality issues rise to the top. Most immediately, as shown above, an analysis based on control shows that a dominant security interest is the *sine qua non* of contractualism. That structural relationship has been ignored by both contractualists and their critics, but its exposure has serious consequences for the contractualist enterprise.

With regard to bankruptcy reform, the analysis presented here suggests that contractualism or some other entirely private ordering of the recovery process may be a dead end, while the alleged trend to lender control of that process may require new legislation to ensure neutrality. Those conclusions are supported by the fact that there is considerable movement around the world in the general direction of United States secured-credit law and bankruptcy law. As the Canadian and British experiences demonstrate, however, other developed nations are experimenting with significantly different versions that may well offer guidance to American policymakers—but that is another article for another day.

Two forward-looking thoughts conclude the discussion. First, one motive for the work leading to this article has been an attempt to understand the strange

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[251] There is a blunt suggestion in Professor Schwartz' work that management should be bribed to be faithless to shareholders. Schwartz, Contract Theory, *supra* note xx, at 1827& n.58. Yet there seems no reason to think its faithlessness would not extent to the other creditors as well. That point can be ignored by assuming that all creditors are lenders, that there are no conflicts among creditors, or that the interests of other creditors do not matter. The first two assumptions are demonstrably false. *See* Lubben, Costs, *supra* note xx. The last assumption is not only inconsistent with the Congressional scheme, but is unsupported by any coherent argument that our economy would function better if it were adopted. Therefore, there is every reason to believe that faithless management would betray creditors whose interests conflicted with those of its paymasters.

separation between secured credit law and theory and bankruptcy law and theory. The decade-long debate over contractualism without a serious discussion of any connection between it and secured credit is the defining example of that separation. A second myopia, the absence of serious reference to the English system of secured credit and receivership in the great debates over secured credit and over contractualism, is another remarkable example of the effect of falsely dichotomous thinking about secured credit and bankruptcy. As one result, important insights into the issues of control before and after default have been left unconnected, like random pages from the blueprints for an intricate machine.

The disregard of the obviously relevant English system of secured credit is also a striking instance of the lack of comparative law study in this and many other legal fields.[252] If there are any useful thoughts in this article, they arise for the most part from the perspectives provided by some years of comparative study of secured credit and bankruptcy law. During the last decade many scholars from the United States have traveled abroad and talked with foreign lawyers and scholars, yet the influence of comparative study on American legal scholarship remains relatively slight. It is wonderful that we can go elsewhere to teach, but it is even more wonderful to learn. And we have much to learn.

[252] The void is not merely an absence of comparative articles and books, valuable as they are, but a lack of study of other laws in relation to our own, a study that would greatly effect scholars' understanding of our legal institutions.