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ESSAY

THE CREDITORS' BARGAIN RECONSTITUTED: COMMENTS ON BARRY ADLER'S *THE CREDITORS' BARGAIN REVISITED*

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In his book, *The Logic and Limits of Bankruptcy Law,* Thomas Jackson asserts that bankruptcy law should approximate the bargain creditors would strike at the initiation of the firm (T1) regarding the possibility that the firm might later fail and default on its debts (T2).[1] Jackson reasons that the firm's creditors would choose a collective remedy that limits the power of individual creditors to force an inefficient liquidation. They would agree to stop the race of diligence.

In his thoughtful and provocative contribution to this symposium, *The Creditors' Bargain Revisited,* Barry Adler asks whether, in the current world of finance and bankruptcy, creditors would choose the same collective remedy?[2] His answer is, "No." As he sees it, creditors would prefer the unfettered right to exercise their negotiated remedies.[3] Barry offers three pieces of evidence: (1) sophisticated creditors frequently say that they would prefer to opt out of collective bankruptcy in favor of individual collection;[4] (2) creditors frequently seek to adopt bankruptcy remote structures such as securitization through special purpose vehicles to avoid the bankruptcy process;[5] and (3) blanket (often second) lien financing is frequently used by undersecured creditors to control and implement an all asset sale.[6] Instead, he posits his preferred, noncollective,

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1 THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 3-4 (1986).

2 Barry Adler, *The Creditors' Bargain Revisited*, 166 U. PA. L. REV. 1853, 1854 (2018).

3 *Id.*

4 *Id.*

5 *Id.* at 1861.

6 *Id.* at 1864 n.25.

approach to insolvency: an express bargain based in creditor autonomy, or as he puts it, "a contractual alternative to bankruptcy."[7]

My response proceeds in three steps. First, I channel Inigo Montoya from *The Princess Bride* to suggest that the "Creditors' Bargain" does not mean what Barry thinks it means.[8] Second, I situate Barry's contractualism in relation to the alternate "collective" theories of bankruptcy value distribution: the relativism of Baird and Casey; and a more rigorous version of the creditors' bargain articulated by me and Melissa Jacoby in previous work.[9] Third, I argue for the normative superiority of the collective approach, both for its fidelity to the Creditors' Bargain heuristic and because of its consistency with a broader set of corporate governance norms that seek to encourage adequate capitalization and risk internalization.[10]

I. THE ORIGINAL POSITION: THE "CREDITORS' BARGAIN" DOES NOT MEAN WHAT BARRY THINKS IT MEANS

Barry is, without a doubt, correct that creditors would prefer a debtor–creditor regime that leaves their individual remedies intact. However, the lesson that Barry derives about collective remedies rests on a misunderstanding of the nature of Jackson's Creditors' Bargain. Barry uses creditors' expressed opinions and their behavior, as manifested in a number of emerging credit patterns, as evidence that the Jackson's hypothetical bargain theory is wrong.[11] But Jackson never claimed that the Creditors' Bargain was a majoritarian rule. He never asked what creditors actually wanted in the real world (then or now); creditors in the real world always want as much as they can get, both in terms of leverage and priority. The Creditors' Bargain heuristic, instead, asks what certain ideal creditors *would* want under a specific set of circumstances.

Jackson posits a specialized version of John Rawls's hypothesized "original position." In *A Theory of Justice,* Rawls imagines a world where stakeholders bargain over the just legal regime for their society from behind a "veil of ignorance."[12] Jackson applies Rawls's *thought* exercise to creditors, imagining the hypothetical bargain that would arise in T1 (the initial capitalization of the firm), if: (1) creditors are rational; (2) they do not know who they will be in T2 (when/if the firm becomes insolvent and defaults); and (3) they anticipate value destruction

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7 *Id.* at 1857.

8 WILLIAM GOLDMAN, THE PRINCESS BRIDE 114 (Mariner Books 2007).

9 Melissa B. Jacoby & Edward Janger, *Tracing Equity: Realizing and Allocating Value in Chapter 11*, 96 TEX. L. REV. 673 (2018); *see also* Melissa B. Jacoby & Edward Janger, *Ice Cube Bonds: Allocating the Price of Process in Chapter 11 Cases*, 123 YALE L.J. 862 (2014); Edward J. Janger, *The Logic and Limits of Liens*, 2015 U. ILL. L. REV. 589.

10 *See* Jacoby & Janger, *Tracing Equity, supra* note 9, at 713.

11 *See* Adler, *supra* note 2, at 1855-58.

12 JOHN RAWLS, A THEORY OF JUSTICE 118 (rev. ed. 1971).

in T2 when individual creditors rush to dismember the debtor.[13] Unsurprisingly, Jackson concludes, that the creditors would chose a regime that solves the collective action problem and leads to a governance system that can achieve value maximization subject to Pareto superiority, thereby making all claimants better off.[14]

Barry, by contrast, claims that actual creditor preferences are an indication of the failure of the creditors' bargain heuristic.[15] But Jackson was never talking about real world creditors; he posited "hypothetical creditors" making a hypothetical governance decision.[16] Barry's real-world creditors who abjure collectivism are not, nor do they want to be, in the "original position." Instead, they are trying to break through the veil of ignorance. They seek to predetermine, in T1, who they will be in T2. This violates a condition essential to justifying the Creditors' Bargain's claim of normative superiority. Rawls's theory of justice is sometimes referred to as, "I cut, you choose" justice. It is axiomatic that the creditor, bargaining in the original position for an insolvency regime, does not get to pick who they will be in T2. After all, the chooser always wants more pie.

If Rawls's assumption of ignorance is relaxed, bargaining over social welfare devolves into special pleading. Whether creditor preferences are welfare enhancing will turn on the structure of the market. If creditors know who they will be in T2, only three types of creditors will prefer individual action: those who can ensure the benefit of their bargain because they can ensure their position at the top of the distributional hierarchy; those who can ensure that they have sufficient power in T2 to solve the collective action problem all by themselves; and, even better, those who can do both. Barry's first example, the ABS lender, falls into the first category.[17] His second example, the blanket lien lender, can sometimes satisfy both conditions.[18] As a response to this possible critique, Adler invokes Modigliani and Miller's "irrelevance hypothesis," saying the benefit offered by one stakeholder in return for a distributional preference will be offset when other stakeholders demand compensation for any additional risk.[19] But this is only true if the bargaining in T1 is not affected by: the ability to externalize—to shift the cost of the risk to other parts of the capital structure; or the need of the debtor to signal creditworthiness by offering stronger than optimal remedies.[20] Both of

13 JACKSON, *supra* note 1, at 17 n.22.

14 *Id.* at 17. He also argues for a regime that minimizes distortions to pre-bankruptcy entitlements.

15 *See* Adler, *supra* note 2, at 1855.

16 JACKSON, *supra* note 1, at 70.

17 *See* Adler, *supra* note 2, at 1855.

18 *Id.* at 1864 n.25.

19 *Id.* at 1855; *see also* Franco Modigliani & Merton Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 AM. ECON. REV. 261–97 (1958).

20 This is what Rich Levin termed the "Thaler" problem: behavioral biases such as optimism may distort the bargaining in T1. *See, e.g.*, RICHARD H. THALER & CASS SUNSTEIN, NUDGE: IMPROVING

these concerns have been raised elsewhere. Barry acknowledges the first by positing a priority for tort claimants over consensual liens, discussed later, and does not respond to the second.

In short, Barry's examples do not suggest that the collective remedy suggested by the Creditors' Bargain heuristic is undesirable or inefficient. Indeed, quite the contrary, they represent examples of the race of diligence and demonstrate the need for a mandatory collective remedy, if anything, perhaps earlier in the process.

II. CONTRACTUALISM, RELATIVISM, AND ABSOLUTE PRIORITY: "ABSOLUTE PRIORITY" DOES NOT MEAN WHAT BARRY THINKS IT MEANS

In addition to value maximization, any normative theory of bankruptcy must address the question of value distribution: who has first claim to value of the firm? Here, Adler, Jackson, and the Bankruptcy Code diverge in their use of terminology. The term at issue is "priority"—in particular, the term "absolute priority."[21] It is crucial to use those terms consistently if one is to compare contractual and collective proposals.

A. *Priority—Rawls, Jackson and the Butner Short-Cut*

With regard to priority, Jackson's Creditors' Bargain again starts with Rawls, but does not finish there. Rawls used the original position to motivate the so-called "difference principle" as a prerequisite for any inequality in resource allocation. He argued that a person in the original position would prefer equal distribution of resources, unless a proposed inequality would either benefit all, or at least makes nobody worse off.[22] In bankruptcy, Rawls's difference principle suggests that all creditors would agree to equal (proportional) distribution of assets in T2, unless inequality was both value-maximizing and Pareto superior. Under this view, the goals of value maximization and fair distribution in T2 would lead the bargainers in the original position to establish the limits of real world bargaining in T1. This would suggest imposing a condition of Pareto superiority on any deviation from a *pari passu* distribution.

Jackson does not go this far. In early work, Jackson famously posed the "puzzle of secured credit." He asked whether secured credit was efficient, and if it was, why everyone didn't use it? But neither he, nor his successors, ever answered that question.[23] Instead, Jackson, working with Baird, found a doctrinal punt—

DECISIONS ABOUT WEALTH AND HAPPINESS (2008). I think there may be an even more fundamental problem imposed by the need to signal that optimism to the creditor.

21 Sometimes referred to as the *Boyd* rule. N. Pac. Ry. Co. v. Boyd, 228 U.S. 482 (1913).

22 RAWLS, *supra* note 12, at 65-66.

23 Thomas H. Jackson & Anthony T. Kronman, *Secured Financing and Priorities Among Creditors*, 88 YALE L.J. 1143, 1146 (1979).

federalism. They used the so-called "*Butner* principle" to bracket the inquiry.[24] In *Butner*, the Supreme Court stated that bankruptcy entitlements should presumptively track preexisting state law entitlements, unless there was a federal bankruptcy interest to the contrary.[25] Baird and Jackson chose to assume, based on this dicta, that the distributional baseline should be set at the moment of bankruptcy by reference to existing state law entitlements.[26] Deviations from the state law baseline should be allowed only if they were both efficiency enhancing and made no claimant worse off.[27] This led to the primary Jacksonian distributional prescription—respect the priority of claims, as determined under state law, including those of secured creditors.[28]

B. *Absolute Priority—Colloquialism v. The Code*

Jackson's prescription to respect state law entitlements is sometimes shorthanded as "absolute priority," but the term is a bit of a misnomer.[29] Not all priorities are created equal either in Jackson's thought experiment or in the real world. Both Barry's "contractualism" and his rejection of collectivism turn on a definition of the term "absolute priority," that, while widely used, is not reflected in the Bankruptcy Code, achievable under state law, nor (though this is not Barry's point) compelled by the Creditors' Bargain.[30]

Adler's contractualism assumes a distributional scheme that is a single value waterfall, where "senior" creditors contract for a first priority claim to all of the value of the firm. This is also a feature of the terminology used by Douglas Baird and Anthony Casey with regard to their proposals for "option preservation" and

24 The state law entitlement baseline, articulated in *Butner v. United States*, 440 U.S. 48, 55 (1979), is a consistent theme in the articles of both Baird and Jackson. Thomas H. Jackson, *Avoiding Powers in Bankruptcy*, 36 STAN. L. REV. 725, 730 n.17 (1984); *see also* Douglas G. Baird, *A World Without Bankruptcy*, LAW & CONTEMP. PROBS. 173, 187 (1987); Douglas G. Baird & Thomas H. Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. CHI. L. REV. 97, 109-16 (1984).

25 *Butner*, 440 U.S. at 55 ("Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding.").

26 JACKSON, *supra* note 1, at 21-22.

27 *Id.* at 9, 21-23, and 64; *see also* Janger, *supra* note 9, at 590-92.

28 JACKSON, *supra* note 1, at 9. It is important to note, for the purpose of future discussion, that the full Rawlsian bargain would not permit the *Butner* shortcut, and would insist on the Pareto superiority of any priority.

29 *See, e.g.*, Anthony J. Casey, *The Creditors' Bargain and Option-Preservation Priority in Chapter 11*, 78 U. CHI. L. REV. 759, 759 (2011) ("The standard law and economics understanding is that absolute priority follows inevitably from the 'creditors' bargain' model.").

30 As Melissa Jacoby and I have explained, state law incorporates a number of important limits on the scope and priority of security interests, and hence on the ability of a secured creditor to lien the going concern value of a firm. Jacoby & Janger, *Tracing Equity*, *supra* note 9, at 706. *See also* Janger, *supra* note 9, at 591.

"relative" priority.[31] Reducing entitlements to a single waterfall allows those allocating the value of a firm to focus only on one valuation question–the value of the firm as a going concern. The valuation methods discussed in this symposium, for example, have all been varieties of discounted cash flow or going concern sale approaches. They, too, all assume a single waterfall.

While this use of the term "absolute priority" to reflect a single hierarchical priority scheme is commonplace, it is not what the term means under the Bankruptcy Code and case law when applied to secured creditors' actual state law rights. The statutory "absolute priority rule" *is* embodied in 11 U.S.C. §§ 1129(b)(2)(B) and (C), which establish the priority of debt over equity and preferred equity over junior equity in cramdown. Absolute priority instantiates the rule, stated in *Boyd,* that old equity cannot participate in a bankruptcy distribution if a non-consenting class of unsecured creditors are not paid in full.[32]

There is a similar cramdown priority rule for secured creditors, but it is not identical.[33] The secured creditor's priority over unsecured debt is asset-based—limited to the value of their collateral instead of the value of the firm. While the amount of the debt may exceed the value of the encumbered assets, the priority does not. The secured creditor gets first claim to the proceeds of their collateral and retains a lien to the extent of that value, but any deficiency is not entitled to priority. In other words, on the effective date of the plan, the value of the secured creditor's collateral is realized, and their lien is stripped—limited to the "allowed amount" of the claim.

What, then, is the secured creditor's collateral on the effective date? That question is answered by § 552 of the Code.[34] Under 552(a) floating liens stop floating on the petition date, but, under 552(b) the creditors' security interest continues in the "proceeds" of that original collateral, subject to the "equities" of the case.[35] The secured creditor's priority, thus, only extends to value that can be tied to assets liened on the petition date (because floating liens stop

31 Douglas G. Baird, *Priority Matters: Absolute Priority, Relative Priority, and the Costs of Bankruptcy*, 165 U. PA. L. REV. 785, 786-87 (2017); Casey, *supra* note 29, at 765.

32 N. Pac. Ry. Co. v. Boyd, 228 U.S. 482, 503-04 (1913).

33 11 U.S.C. § 1129(b)(2)(A) (2012). Indeed, the difference instantiates the *Butner* baseline, but also limits the ability of a secured creditor to participate with equity to violate the *Boyd* rule, either through a rollup, or through gifting.

34 *Id.* § 552.

35 *Id.* Melissa Jacoby and I develop this point in greater detail in our article, *Tracing Equity, supra* note 9, at 688. The key points are (1) that the term "equity" as used in both UCC Article 9 (9-315) and the Code (§ 552(b)) invokes the principle of equitable tracing; and (2) that the combined effect of §§ 552(b), 549, and 551 of the Code prevent the interest in proceeds from growing and swallowing up assets and value that were unencumbered on the petition date. *Id.* at 693-94, 700-02.

floating) and to identifiable (traceable) proceeds of those assets (subject to the equities of the case).[36]

This means that, if a firm continues in operation, rather than liquidating, there will always be two priority allocation waterfalls: one waterfall to distribute the realized or realizable value of encumbered assets (an "allowed secured claim"); and a second waterfall tied to the remaining unencumbered value of the firm (unsecured "claims" and equity "interests"). The second waterfall thus includes unencumbered assets, but also the unencumbered residual value of the firm. Even in the absence of unencumbered assets on the petition date, the second waterfall includes any going concern value of the firm, as well as any increase in value of the firm after original collateral is sold ("option value"). *The key point here is that a secured creditor's deficiency claim against the second "residual" pool of value does not have priority over unsecured creditors.*

In this regard, Barry's concept of absolute priority diverges (at least as a terminological matter) from Jackson's and from that of the Bankruptcy Code (though not from common parlance). For Barry, priority need not be tied to assets because it is contractual (though recourse against assets may be a way of enforcing that contractual priority). For Jackson, to the extent that the justification for secured creditor priority relies on the *Butner* principle, rather than an (as yet unspecified) efficiency rationale, the distributional baseline for the secured creditor would be the asset-based priority that could have been realized under state law.[37]

C. *Contractualism in Context*

In evaluating whether Adler's contractualism or Jackson's mandatory collective remedy is more desirable, it is necessary to place contractualism in context, and consider the alternatives. Barry's contractualism is one of (at least) three current normative proposals regarding value distribution in bankruptcy: two are novel; one is statutory and historical—traditional, even. The two novel proposals, contractualism and relativism, require a firm embrace of the "single waterfall" approach. The third, embodied in the existing Code and state law, respects absolute priority, but recognizes the two distinct value waterfalls, one asset-based and one that allocates the residual value of the firm.

36 *Id.* at 702. The priority of a secured creditor, entitled to adequate protection, is therefore limited in scope to the realizable value of property that can be liened and perfected under state property law (principally, but not exclusively, Article 9 of the UCC and state mortgage law).

37 Whether a secured creditor "should" be able to lien all of the value of a firm under state law, is, of course a separate question, upon which Baird and others have strong views. Baird recognizes the asset-based nature of the secured claim but continues to assume the possibility of a blanket lien on going-concern value. Douglas G. Baird, *The Rights of Secured Creditors after* ResCap, 2015 U. ILL. L. REV. 849, 860 (noting that the debate over "[w]hether one looks at a secured creditor as holding the discrete parts worth less than the going concern or whether it enjoys a right to the first cashflows of the firm . . . will undoubtedly continue . . . . Both sides cling to their views as if they were articles of religious faith.").

1. Single Waterfall Absolutist Contractualism

Adler actually suggests two versions of contractualism, though both are versions of single waterfall absolutism. He is most attached to "equity based" absolutism, or as he calls it, "Chameleon Equity."[38] A creditor's exclusive remedy would be the right to become an owner of the firm upon default.[39] Under this proposal, a firm would be constructed without debt (recourse collection rights) but instead with convertible debt.[40] On default, equity would be wiped out, debt would convert to equity and the creditors would gain ownership of the firm and would be entitled to all of the enterprise's value.[41] This structure is "absolutist" because it turns on the absolute priority of senior over junior. It is a single waterfall, because there is only one pool of value—the firm.

Adler recognizes that this structure would not work for an operating business, but takes comfort that a similar structure has emerged through blanket lien asset-based financing.[42] Instead of viewing the firm as the pool of value, one views its assets as the pool of value, and then, slyly, declares all of the value of the firm "proceeds" of assets.[43] This move recapitulates contractualism and can mimic Chameleon Equity because, when you break it down, Chameleon Equity is just an instant foreclosure device. And, so, as Barry observes, is much of modern bankruptcy practice.[44] Single waterfall absolutism, and contractualism in particular, lead to a recreation of the race of diligence, but simply move it forward in time.

2. Single Waterfall (Relativist) Collectivism

Baird and Casey take a different approach to the single waterfall. They too assume that secured claimants have hierarchical priority over unsecured, and unsecureds have hierarchical priority over equity.[45] More importantly, they treat the firm as a single value pool, making no distinction between asset-based claims and *pari passu,* value-based claims. They find themselves troubled, however, by one implication of single waterfall absolute priority—realization. Confirmation of a Chapter 11 plan (and a going concern sale of the debtor) are realization events. The value of the firm is realized and underwater claimants (the unsecureds) are wiped out. This deprives the junior creditors of the "option" to postpone reckoning

38 Adler, *supra* note 2, at 1856; *see also* Barry E. Adler, *A World Without Debt*, 72 WASH. U. L. Q. 811 (1994).

39 Adler, *supra* note 2, at 1856.

40 *Id.*

41 *Id.*

42 *Id.* at 1863.

43 *Id.* at 1862. In a recent article Christopher Frost refers to this as "Effective Entity Priority," and highlights its tenuous legal foundation. Christopher W. Frost, *Secured Credit and Effective Entity Priority*, 49 CONN. L. REV. (forthcoming 2019).

44 Adler, *supra* note 2, at 1863.

45 Baird, *supra* note 31, at 786; Casey, *supra* note 29, at 763-64.

beyond plan confirmation. Where a firm continues in operation, as it does in Chapter 11 through a plan or going concern sale, there is always the chance that the firm will be successful enough to pay its senior creditors in full and return value to the juniors. They worry that under a regime of absolute priority for the secureds, disposition of the collateral by the secured party allocates all of the upside value of the firm to the seniors and wipes out the unsecureds.[46] In their view, the "option value" is owned by the juniors and must be cashed out if the firm is sold.[47]

3. Dual Waterfall (Collective) Absolutism

Baird and Casey are right to be concerned about this implication of "single waterfall" absolutism, but the problem is not "absolute priority," it is the single waterfall. In a recent article, *Tracing Equity: Realizing and Allocating Value in Chapter 11,* Melissa Jacoby and I argue for a third approach.[48] Our approach retains the idea of absolute priority based on state law entitlements, but recognizes that there are actually two waterfalls—one asset-based, and the other value-based. We carefully explicate the value allocation and realization rules embodied in existing law.[49] Then, we argue (again, like Inigo Montoya) that, under current law, absolute priority does not mean what most people think it means.[50] Then we explain the normative superiority of our positive version over either of the "novel" regimes described above; it does not wipe out the interest of the unsecureds in the value of the firm, nor does it deprive the secured creditor of the value of their collateral.[51] We characterize the current regime as "dual waterfall, two-point realization."

The first difference between us and the "single waterfallers" is our view that there are two distinct hierarchies applied to state law entitlements: the asset-based waterfall (defined in 11 U.S.C. §§ 506, 552, and 1129(b)(2)(A)); and the value-based waterfall (defined in §§ 502, 507, and 1129(b)(2)(B)). The Bankruptcy Code differentiates claims with asset-based priority from claims against the residual value of the firm.[52] Creditors with claims against specific assets lose their foreclosure rights but are entitled to the monetary value of their liens. Creditors

46 Baird, *supra* note 31, at 786; Casey, *supra* note 29, at 764-65.

47 Baird, *supra* note 31, at 791; Casey, *supra* note 29, at 765. Baird and Casey describe plan confirmation as "destroying" option value. *See, e.g.*, Casey, *supra* note 29, at 760. This is a misnomer. Option value is never destroyed, it is simply transferred upon disposition. If collateral is sold, the purchaser receives the benefit—and risk—of ownership. To the extent that the value of the upside is positive, that value should be realized as part of the purchase price. If the secured creditor wants to realize on the value of its collateral by selling the firm, it has to reach a deal with the juniors to purchase that option.

48 Jacoby & Janger, *Tracing Equity, supra* note 9.

49 *Id.* at 682-709.

50 *Id.* at 678-80.

51 *Id.* at 709-21.

52 This mimics the priority for a solvent firm when it is sold. Debt claims are paid before equity. And, in the race of diligence, the debt claimants have recourse to the value of the assets before equity gets anything. Bankruptcy converts the liquidation right into a claim to residual value of the firm.

with no claim to specific assets have a claim to the residual assets and going-concern value of the firm that is senior to equity.

The second difference is that we take a different view of realization than Adler or Baird and Casey. In a world of blanket lien financing and underwater seconds, Barry's contractual approach would treat bankruptcy as a realization moment for unsecureds—often taking nothing. While the secureds would have the power to choose between realization (sale) or ownership (plan or credit bid). Baird and Casey are concerned about this aspect of absolutism.[53] Absolute priority turns bankruptcy, or at least plan confirmation into a realization event. The senior creditors gain ownership of the firm, while out of the money juniors are deprived of any option value—the upside is foreclosed. They remedy this by allocating to the unsecureds the value of an option on the value of the firm in excess of the secured creditors debt.[54] In other words, the unsecured creditors retain some value, but they are subordinated to the undersecured blanket lien claimant's deficiency claim.

We, by contrast, recognize and accept that plan confirmation and/or disposition of the collateral operate as realization events for both secured creditors and unsecured creditors. Collateral disposition operates as a realization event for the secureds and they are entitled only to the value of their assets (including appreciation prior to disposition and any identifiable proceeds), while the unsecureds can choose, through the plan process, between realization (sale) or ownership (plan). The key difference between us and the single waterfallers is that, subject to adequate protection, any value that cannot be traced to encumbered assets is allocated to the estate. This includes going concern value that could not be realized without bankruptcy. Where there is significant going concern or synergistic value preserved through bankruptcy, that value is allocated to the unsecured creditors (including the secured creditor's deficiency, if any). This, in our view, is the approach that the Bankruptcy Code envisions. Indeed, it was enacted at a time when asset-based lending was relatively more piecemeal than today. It is also more faithful to the state law baseline, and, therefore closer to the "Rawlsian/Jacksonian" bargain than either of the competing proposals.

III. THE NORMATIVE SUPERIORITY OF DUAL WATERFALL ABSOLUTISM: THE LEGAL LIMITS OF CONTRACTUALISM

This, of course, leads to the ultimate question: which approach is normatively superior? Is "dual waterfall" collectivism normatively preferable to single waterfall collectivism or contractualism? Again, Melissa Jacoby and I discuss this question in greater detail elsewhere, but I will summarize our argument here, and tie it with a new collectivist bow, based on the Creditors' Bargain.

53 *See supra* note 47.

54 *See supra* note 47.

A. *The Creditors Bargain Reconstituted*

Basic corporate finance explains that governance rights should go to the juniormost variable claimant who is in the money—the fulcrum. That is the investor who bears the downside risk and benefits from the upside. When a firm becomes insolvent, creditors who once thought they were fixed become variable. Thus, the creditors who bargain in the original position about insolvency will anticipate two flavors of debt claim against an insolvent debtor: "still fixed" and "now variable." And, where the original position contains multiple priority levels, they would add a twist: "still fixed"; "now partially fixed"; and "now variable."

Under the law of most jurisdictions (other than the United States), insolvency is a realization moment for the old variable claimants (equity), but also for the fixed and formerly fixed claimants.[55] Fiduciary duties shift, and often mandate commencing a bankruptcy (usually liquidation proceeding).[56] In liquidation, the single waterfall is descriptively accurate, as all of the value is asset derived. The firm winds up, wiping out equity, and distributing the value of the assets first to those with a priority claim to the assets, and then any remainder to the residual, unsecured creditors.

If, however, this immediate realization through liquidation is likely to be inefficient, either because it will yield fire sale prices or sacrifice going concern value, the creditors in the original position should want to try to come up with a way out of the box. They will prefer, if possible, to delay realization to maximize value. This is what Chapter 11 does; realization is delayed (in order to preserve going concern value). The question is, what treatment would be chosen for the senior (still fixed) and junior (now variable) by the creditors in the original position assuming they don't know who they will be?

In our view, juniors (and in an operating business there will always be dispersed juniors) will not agree to full subordination, because it basically turns them into variable claimants at the outset, but without the benefit of any upside. They get wiped out along with equity. Nobody would lend into such a junior position. In the original position, the juniors would not agree to Adler's single waterfall absolutism. Instead, the argument is that they would choose a version of reset that will maximize the value of their now variable claim while respecting the rights of the seniors.

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55 *See, e.g.*, Insolvency Act of 1986, c.45, § 214 (Eng.).

56 *See* UNITED NATIONS, UNCITRAL LEGISLATIVE GUIDE ON INSOLVENCY LAW, PART FOUR: DIRECTORS' OBLIGATIONS IN THE PERIOD APPROACHING INSOLVENCY (2013), http://www.uncitral.org/pdf/english/texts/insolven/Leg-Guide-Insol-Part4-ebook-E.pdf [https://perma.cc/SK54-NH6Y].

B. *The Global Legal Norm of Adequate Capitalization*

This is where the two collective approaches diverge along the single versus dual waterfall axis. One must determine the extent of the seniors' priority. We argue that the proper version is to reset the secured creditor's fixed claim to the value of the assets and then require the juniors and the undersecured portion of the senior's debt to share *pari passu*. This is also what the Bankruptcy Code does through §§ 1129(b) and 506. Baird and Casey assume that a blanket lien can encumber the entire value of a firm, including its going concern value, and therefore limit the post-default reset to the value of the firm in excess of the lienholder's debt.[57]

Our approach has three features to recommend it: (1) antijudgment proofing; (2) antirollup (*Boyd*); and (3) proper governance incentives.

Both of the single waterfall approaches encourage judgment proofing. If a debtor can borrow at a low interest rate by granting priority to one creditor without compensating nonconsensual or nonadjusting creditors, then doing so will increase equity's return on investment by artificially reducing the cost of capital. This point is not new. The drafters of prerevision Article 9 noted this tendency wistfully when they validated floating liens.[58] LoPucki made the argument forcefully when he advocated a priority for tort claims in his articles, *The Unsecured Creditors' Bargain* and *The Death of Liability*.[59] Elizabeth Warren, Bebchuck, and Fried similarly proposed a carveout from the secured creditors' lien to reinstate the lamented equity cushion.[60]

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57 Baird, *supra* note 31, at 802; Casey, *supra* note 29, at 790.

58 Comment 2 to 9-204 provides:

> This Article accepts the principle of a "continuing general lien". It rejects the doctrine-of which the judicial attitude toward after-acquired property interests was one expression-that there is reason to invalidate as a matter of law what has been variously called the floating charge, the free-handed mortgage, and the lien on a shifting stock. This Article validates a security interest in the debtor's existing and future assets, even though . . . the debtor has liberty to use or dispose of collateral without being required to account for proceeds or substitute new collateral . . . .
>
> The widespread nineteenth century prejudice against the floating charge was based on a feeling, often inarticulate in the opinions, that a commercial borrower should not be allowed to encumber all his assets present and future, and that for the protection not only of the borrower but of his other creditors a cushion of free assets should be preserved. That inarticulate premise has much to recommend it. *This Article decisively rejects it not on the ground that it was wrong in policy but on the ground that it was not effective*.

U.C.C. § 9-204 cmt. 2 (AM. LAW INST. & UNIF. LAW COMM'N 1972) (emphasis added).

59 Lynn M. LoPucki, *The Death of Liability*, 106 YALE L.J. 1, 4-5 (1996) (showing that modern technology and lending practices, including secured credit, facilitate judgment proofing and undercut the effectiveness of traditional liability rules); Lynn M. LoPucki, *The Unsecured Creditor's Bargain*, 80 VA. L. REV. 1887, 1939-40 (1994).

60 *See also* Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857, 859 (1996); Elizabeth Warren, *Making Policy with Imperfect Information: The Article 9 Full Priority Debates*, 82 CORNELL L. REV. 1373, 1390-91 (1997).

Indeed, while Article 9 validates floating liens, this is only part of the picture with regard to adequate capitalization. One would expect that the junior creditors in the original position would insist that a firm that conducts business should maintain adequate capital to internalize the risks of its operations, both to non-consensual creditors and those it owes a contractual obligation. The state law baseline is not insensitive to this. There are a wide variety of legal doctrines that enforce a norm of adequate capitalization through both liability and property rules. These include fiduciary duties, fraudulent conveyance law, and veil piercing, among others. Where the debtor has not retained a reasonable level of free assets to pay its creditors, the secured creditors' lien may be invaded.[61]

As a matter of tort theory this makes sense. If one takes a Calabresian perspective, the law of torts should allocate losses where the costs of bargaining are high and put the burden of the loss on the least cost avoider.[62] The problem is that a liability rule offers no help, as the assets are already gone. Fraudulent conveyance law, fiduciary duties, and veil piercing therefore enforce this norm by looking to the lienholders, managers, and the owners.

Bankruptcy law is not the only legal doctrine that limits the ability of creditors to contract around the separation between asset-based and value-based claims—the dual waterfall. There are a number of anti-subordination or anti-rollup doctrines outside of bankruptcy. Marshalling rules for example require a creditor to look to assets that are not subject to a junior interest.

The most important example of an antirollup rule is the property doctrine of equitable merger. When a mortgage holder comes into ownership of the fee, the mortgage merges into the fee and cannot be foreclosed. All of the single waterfall approaches violate this principle and allow the debtor to do business without worrying about their nonfinancial creditors.[63] Where the single waterfall extends to all of the value of the firm, the secured creditor and the debtor have contracted around the doctrine of merger. They violate the spirit of *Boyd* in the name of "absolute priority."

Thus, the dual waterfall serves the goal of preventing rollups by preventing the senior creditor and the debtor from contracting around the distinction between financial creditors and operational creditors. It insures that the risks of operating a business will always remain with the juniormost claimants, and that equity will not be able to contract with a senior claimant to squeeze out an intermediate class.

61 Jacoby & Janger, *Tracing Equity*, *supra* note 9, at 709-10.

62 GUIDO CALABRESI, THE COSTS OF ACCIDENTS: A LEGAL AND ECONOMIC ANALYSIS 58 (1970).

63 4 POWELL ON REAL PROPERTY § 37.32[1] (Michael Allan Wolf ed., 2016). The question of whether a merger occurs depends on the intent of the parties. *In re* Apex Carpet Finishers, Inc., 585 F.2d 1323, 1325 (5th Cir. 1978); Downstate Nat'l Bank v. Elmore, 587 N.E.2d 90, 94 (Ill. Ct. App. 1992).

C. *The Single Waterfall in a Torts First World*

Judgment proofing is a significant fly in the contractualist ointment. Barry acknowledges in *The Creditors' Bargain Revisited*,[64] as well as in his earlier work,[65] that there is no justification for subordinating non-consensual creditors to a contractual waterfall. They did not assent, and they did not have notice. As such, the ability to shift risk to these creditors creates moral hazard. Debtors and consensual creditors will have an incentive to judgment proof. Accordingly, Barry would give involuntary claimants priority over the blanket lien creditor.[66] Here, he is undoubtedly right. However, this means that Barry's absolutism is not so absolute.

Indeed, the exception may swallow the rule. The great fear of the dual waterfall, as articulated by Adler, Baird, and Casey, is that it requires a costly valuation process. The threat of costly valuation hearings, they fear, will allow the juniors to extort value from the seniors. As Barry puts it, they lead to a "feast for lawyers"—an imbroglio.[67] But Barry's torts-first contractualism does not avoid valuation hearings. Once torts are at the head of the distribution queue, ahead of the blanket lien lender, you need to value the tort claim. This can be just as time consuming and messy as valuing the assets.

How big a hole are we talking about? Perhaps large—tax claimants, utilities, product liability claimants, and even certain business torts. Even in the absence of a tort of wrongful trading or deepening insolvency, fraud, constructive fraudulent conveyance, and veil piercing for undercapitalization may all become part of the mix. In short, while this may not be a bad thing, it eliminates most of the benefit of contractualism or, for that matter, relativism. Once torts are put first, Barry's contractualism will still require complicated ex post valuations. Indeed, they will likely be more complicated valuation exercises than simply setting the value for ascertainable assts.

D. *The Practical Limits of Absolute Priority*

There is a possible response to our view. Douglas Baird, in his article *Priority Matters*, points out that the restructurings of most modern large companies are purely financial, leaving the trade, the employees (at least those still employed) and many other junior creditors unimpaired.[68] To the extent that contractualism simply applies to financial creditors and not to operating creditors, then the creditors are

64 Adler, *supra* note 2, at 1856 n.10.

65 Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy,* 45 STAN. L. REV. 311 (1993).

66 Adler, *supra* note 2, at 1856 n.10.

67 *Id.* at 1854; *see also* SOL STEIN, BANKRUPTCY: A FEAST FOR LAWYERS 303 (1989).

68 Baird, *supra* note 31, at 796-97.

free to choose between Barry's absolutism and Baird and Casey's relativism. If operational creditors are not being asked to take a haircut, it is hard to object.

But the empirical claim appears overdrawn. Modern practice is full of devices that are designed to allow the debtor to choose which unsecured creditors to impair and which to subject to a haircut. Critical vendor motions, employee retention plans, and even assumption of executory contracts do allow the debtor to pay those creditors whose services or cooperation are essential. The problem is that not all modern bankruptcies are "financial," and not all operational creditors remain relational at the time of bankruptcy.

This point cuts in both directions. First, it may make restructuring too expensive: airline, industrial, and municipal bankruptcies are, by and large, aimed at addressing legacy labor issues. In those cases, where relational creditors are being asked to take a haircut, collectivism and the dual waterfall are crucial. Second, there are equality of distribution concerns. Not all relational creditors remain relational at the time of bankruptcy. No-longer-critical vendors get wiped out, while currently-critical vendors get paid in full. When operational and non-consensual creditors are being asked to share the burden of continuing the business, it is important that principles of equal treatment and best interests (Rawls's "difference principle" resurfaces here) be respected, and that a pool of capital remains available to pay those formerly operational creditors.

CONCLUSION

To summarize, Barry's report of the death of collectivism may be somewhat exaggerated and respect for "absolute priority" is essential. However, in neither case do the terms mean what Barry thinks they mean. Indeed, once they are properly understood, the approach followed in the Bankruptcy Code, and the Creditors' Bargain, as Jacoby and I have reconstituted it, is normatively superior to either Barry's contractualism or the relativists' collectivism.

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