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Absolute Priority and Its Discontents

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Chapter 11 of the US Bankruptcy Code emerged out of the distinctive challenges lawyers and judges faced in the United States in the late nineteenth century, an era in which robber barons built giant railroads with the money they acquired from bankers in London, Frankfurt, and Amsterdam.² The American experience with Chapter 11 offers useful lessons, but it would be exceedingly odd if such a statutory regime perfectly matched the needs of other economies today. This is true with respect to all of Chapter 11's features, but perhaps

most of all with respect to its basic organizing principle, which is the absolute priority rule.

The absolute priority rule in its modern form is easy to state. It entitles each class of creditors in a reorganization to insist upon being paid in full before any junior creditor receives anything. In this short essay, I first want to set out the core rationale for the rule. Second, I offer a note of caution about much of the language and rhetoric of American bankruptcy practitioners. Finally, I set out some legitimate criticisms of absolute priority and try to put them in perspective.

I.

The great challenge facing reorganization of large firms is how to solve the problem that exists when too many creditors chase too few assets. We need a sensible procedure to sort out the mess. It is no accident that it is the judiciary committee that handles bankruptcy legislation in the U.S. Congress, not the commerce committee. In the first instance, bankruptcy is just a procedure for sorting out rights. Absolute priority keeps the procedure focused on the problem at hand. We need to sort out rights, not reshape them. There is no need to reshuffle substantive entitlements in order to give a firm a sound capital structure. Designing a sensible procedure does not require changing whatever rights are already in place.³

Moreover, changing rights in bankruptcy may be self-defeating. Let us say that you think that, when firms shut down, workers should get additional rights. This *might* be a good

idea. But if it is, it should apply to all firms that are shutting down, not just those that enter bankruptcy. The number of substantial Chapter 11s in the U.S. each year – firms that enter Chapter 11 with liabilities of \$10 million or more – is fewer than 500. This is one tenth of one percent of all business failures in the U.S. in a given year. The vast, vast majority of firms that fail never enter Chapter 11.⁴

Protect workers of failing firms only if their firms enter Chapter 11 and you leave most workers unprotected. And changing rights only in bankruptcy gives creditors a reason to avoid bankruptcy even when bankruptcy makes sense. Changing substantive rights can also produce bankruptcies that should never happen in the first place.⁵ Enhancing the rights of existing stakeholders in bankruptcy gives them a reason to enter bankruptcy even when it does not serve any larger purpose.⁶ U.S. law today consistently maintains non-

¹ Harry A. Bigelow Distinguished Service Professor, University of Chicago Law School. This paper is based on a talk given on February 24, 2020, at a conference organized by The Amsterdam Center for Law and Economics (ACLE), a joint initiative of the Faculty of Economics and Business and the Faculty of Law at the University of Amsterdam. I am grateful to the Frank Greenberg Fund for research support.

² For a review of this history, see D.A. SKEEL, Jr., *Debt's Dominion: A History of Bankruptcy Law in America* (2001).

³ This conception of bankruptcy was put forward forcefully by Thomas Jackson in the early 1980s. See T.H. JACKSON, "Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain", 91 *Yale L.J.* 857 (1982).

⁴ See E.R. MORRISON, "Bankruptcy's Rarity: Small Business Workouts in the United States", 5 *Eur. Co. & Fin. L. Rev.* 172 (2008).

⁵ For an example, see *In re Integrated Telecom Express, Inc.*, 384 F.3d 108 (3d Cir. 2004), a firm with over \$100 million in cash and virtually no debt that filed simply to take advantage of special rules governing damages owed landlords.

⁶ My debate with Elizabeth Warren a number of years ago revolved around this idea that sensible bankruptcy laws should discourage forum-shopping. Compare E. WARREN, "Bankruptcy Policy", 54 *U. Chi. L. Rev.* 775 (1987), with Douglas G. BAIRD, "Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren", 54 *U. Chi. L. Rev.* 815 (1987).

bankruptcy rights in bankruptcy, and this is generally thought a good thing.⁷

Another virtue of the absolute priority rule is the way that priority rules affect incentives before the fact.⁸ This reason to respect absolute priority has nothing to do with our sympathy for creditors. In a well-functioning capital market, creditors as a group obtain the market return, no more and no less. But the stronger the priority rule, the easier it is for good entrepreneurs to thrive. Successful entrepreneurs are liquidity-constrained. They cannot find as much capital as they can usefully deploy. The less you give creditors in bad states of the world, the more they will demand in the first instance. And the harder or more expensive it is for good entrepreneurs to raise capital, the less entrepreneurial activity you will have.

Absolute priority also promotes the reorganization process itself, at least in a regime like Chapter 11 that relies so heavily on negotiation. It might be possible to have a law of corporate reorganizations in which a judge or bureaucrat

imposes a new capital structure by fiat, but the U.S. law of corporate reorganizations relies on creditors to sit down at a conference table and forge a new capital structure on their own. The absolute priority rule provides a clear benchmark that simplifies these negotiations.

If the firm is worth less than the senior class is owed and the junior classes are bringing nothing to the party, the junior classes have little to gain from being obstreperous. They can demand no more than the costs that are saved from avoiding a lengthy cramdown hearing in which the court ensures that everyone's substantive rights are meticulously respected. At the same time, absolute priority is a group-based right. No one senior creditor has the ability to throw sand in the gears. The absolute priority rule gives senior creditors as a group the right to insist on coming first, but they can waive that right if it is in their interest. If the majority of any class thinks it is a good idea to compromise and include the junior classes, they can.

II.

All too often, American bankruptcy professionals only begrudgingly accept the absolute priority rule. It makes them distinctly uncomfortable. There are several reasons for this discomfort, but none go to the merits of the rule. In the first instance, the virtues of the absolute priority rule are hard for bankruptcy professionals to observe. Bankruptcy professionals never see the healthy firms that came into being only because of the absolute priority rule. And what they do see is unattractive. The firm is a mess and those asserting the absolute priority rule are hedge funds and banks, not widows and orphans. They are not choir boys. They are not nice people.

And when negotiations proceed smoothly, bankruptcy professionals rarely credit the way a clear rule like absolute priority made it possible. Indeed, absolute priority in the U.S. sometimes seems honored in the breach.⁹ But this is easy to exaggerate. It is important not to equate the *existence* of a right with its *exercise*. The absolute priority rule gives the senior creditors as a class the ability to waive their rights if they choose.

On occasion, paying junior creditors in full makes sense. For example, firms in Chapter 11 usually pay prepetition wages

so that their workers keep coming to work. They honor warranties to maintain the good will of the general public. Airlines always preserve frequent flyer miles in Chapter 11. They do not want to alienate their customers and have them switch to another carrier. This all requires paying prepetition claims. Creditors who enjoy absolute priority willingly waive their priority rights here. It is just good business.¹⁰

Bankruptcy professionals sometimes talk in ways that betray a lack of affection for the absolute priority rule for one more reason. American law has always been solicitous of individual debtors. We began as a debtor nation. We have protected flesh-and-blood individuals from their creditors starting in the eighteenth century, especially when the creditors came from abroad.¹¹ We have long believed you should be able to pull up stakes and start all over again. In this tradition, the Bankruptcy Code protects individuals out on their luck. American bankruptcy law does a second, altogether different job, in addition to restructuring large corporations. It gives the honest, but unfortunate debtor a fresh start.¹²

Lawyers sometimes transplant the rhetoric apt for flesh-and-blood individuals to large corporations without noting the difference between the two sorts of bankruptcies. A large

⁷ The Supreme Court returns many times to a principle it set out in *Butner / United States*, 440 U.S. 48, 55 (1979): "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."

⁸ See A. SCHWARTZ, "A Contract Theory Approach to Business Bankruptcy", 107 *Yale L.J.* 1807 (1998).

⁹ See S.J. LUBBEN, "The Overstated Absolute Priority Rule", 21 *Fordham J. Corp. & Fin. L.* 581 (2016).

¹⁰ See D.G. BAIRD, A.J. CASEY and R.C. PICKER, "The Bankruptcy Partition", 166 *U. Pa. L. Rev.* 1675, 1705-08 (2018).

¹¹ See B.H. MANN, *Republic of Debtors: Bankruptcy in the Age of American Independence* 253 (Harvard University Press 2002).

¹² See *Local Loan Co. / Hunt*, 292 U.S. 234, 244 (1934).

insolvent corporation is not at all like an honest, but unlucky working man overwhelmed by medical bills and credit card debt. In the typical large reorganization in the U.S. today, all that is at stake is a financial restructuring at the holding company level. The workers of the operating company are paid, as are the suppliers. The only ones the reorganization affects are a private equity fund, and the various hedge funds that

own the first- and second-lien debt. Everyone in the sandbox is an adult who chose to play there. They do not need some judge to reallocate rights according to vague ideas about rehabilitation. These professionals should be able to look after themselves and live with rules that have hard-edges. If they want sympathy and love, they should play elsewhere.¹³

III.

Of course, the absolute priority rule is far from perfect. Although much of the push-back against absolute priority is poorly grounded, there are some criticisms of absolute priority that are worth taking seriously. One problem that absolute priority brings with it arises from a distinctive feature of U.S. law. In the first instance, creditors cannot simply take a senior interest in the capital structure of a corporation. Priority rights are tied to obtaining property rights in the discrete assets of the firm.¹⁴ Getting priority in land requires making a filing in county real estate records; a security interest in machinery requires a state filing; a security interest in moving vehicles requires notations on certificates of title; a security interest in aircraft requires a federal registration; a security interest in intellectual property requires a different federal registration.

If you lend to a corporation that has multiple types of assets, you have to assemble your priority position piece-by-piece. There are sometimes going to be a few gaps. You should not, however, infer that because it is sometimes hard to have iron-clad priority under U.S. law that this is a virtue to be imitated, rather than a defect to be avoided. This feature of U.S. law can be traced back to an Elizabethan statute Parliament passed in 1571.¹⁵

It is, however, very easy to overstate this problem.¹⁶ In many instances, the gaps are trivial. Financial investors lend to a holding company. Their collateral consists of the holding company's stock in the operating company. This stock is easy to foreclose upon. Indeed, the senior creditor may already have physical possession of the stock certificates. These financial restructurings are emphatically ones in which the senior creditor is unambiguously entitled to the entire firm. They also have the nice feature that the mess among the financial investors is cleanly separated from the obligations to all the workers and small suppliers.

There is another legitimate criticism one can make of the absolute priority rule. Absolute priority collapses all future possibilities to the present. It accelerates the day of reckoning. In bankruptcy, all the accounts are squared. For this reason, out-of-the-money junior creditors lose the upside – the possibility that the debtor *might* turn things around; that the fortunes of the firm might improve. With absolute priority, such dreams of resurrection disappear. The option value of out-of-the-money junior investors is vaporized.

Many people think that a day of reckoning is exactly what should happen when a firm defaults. We need to face the music and discover winners and losers. Some sensible people, however, have argued that respecting the option value of junior investors will deter senior creditors from pushing for fire sales and premature liquidations.¹⁷

Respecting the value of such options is what “relative priority” means in the U.S. “Relative priority,” as used in American law, is a term of art. It is emphatically not a vague mandate, but a rigorously defined idea about preserving option value. The question it implicates is not *whether* to respect priority, but rather *when* to do it.

The difference between relative priority and absolute priority is also easy to overstate. Modern finance theory tells us how to value options, and the option value of out-the-money interests is often quite small. In particular, in the typical large reorganization, the option value of equity is asymptotically close to zero.¹⁸ More to the point, those who push for relative priority may too easily lose sight of the problem it is supposed to solve. If you are worried about fire sales or premature liquidations, it may make more sense to focus directly on making sure that they do not happen rather than focus on priority rules.

There is at least one other danger that has been identified with absolute priority. Denying the entrepreneur a stake in

13. See D.G. BAIRD and R.K. RASMUSSEN, “Antibankruptcy”, 119 *Yale L.J.* 648, 687-88 (2010); M.S. HUEBNER and B.A. TISDELL, “As the Wheel Turns: New Dynamics in the Coming Restructuring Cycle” in *The Americas Restructuring and Insolvency Guide 2008/2009*, at 77, 80 (2008) (detailing how Chapter 11 is evolving “into a forum by which sophisticated players in an increasingly liquid claims market resolve financial distress”).

14. See E. JANGER, “The Logic and Limits of Liens”, 2015 *U. Ill. L. Rev.* 589.

15. See 13 Eliz., ch. 5 (1571), repealed by The Law of Property Act, 15 Geo. 5, ch. 20, § 172 (1925).

16. See D.G. BAIRD, “The Rights of Secured Creditors After *Rescap*”, 2015 *Il. L. Rev.* 849.

17. See, e.g., A.J. CASEY, “The Creditors’ Bargain and Option-Preservation Priority in Chapter 11”, 78 *U. Chi. L. Rev.* 759, 765 (2011).

18. See American Bankruptcy Institute Commission to Study the Reform of Chapter 11, 2012-2014: Final Report and Recommendations, 222 (2014).

the reorganized firm *might* lead to a loss of value. The firm *may* be worth more with the original entrepreneur in place, and it may be possible to keep her around only if she has a piece of the action. A great restaurant is great only because of the chef. Everyone is better off if she remains in place.

There are some important caveats, however. First, to say that the entrepreneur *may* give value to the business as a going concern is quite different from saying that this entrepreneur does add value. Indeed, the entrepreneur running the business may be the *problem*, not the *solution*. Here we need to return to a point made earlier. The absolute priority rule does not prevent the entrepreneur from staying with the firm. It merely determines *who* makes the decision. Absolute priority puts that decision in the hands of the senior investors. To be sure, there is no guarantee senior creditors will keep *good* firms open, but there is also no guarantee that junior investors will shut down *bad* firms if the decision is left to them.

In addition, it is essential to focus on the business that is in bankruptcy. The case for absolute priority is relatively weaker for very small business. For the smallest businesses, creditors should not expect to share in the value of the firm

as a going concern. Many businesses have no separate identity apart from the person who runs it. Until a firm achieves a certain size, creditors can expect to receive no more than the piecemeal liquidation value of the assets. It has no value as a going concern without its owner. A small retail shop that leases its space and employs a handful of workers may have few unencumbered assets. A special regime for such small entrepreneurs was put in place in the U.S. this year that confronts this reality.

A new part of the Bankruptcy Code allows the self-employed to hold on to their small businesses as long as secured creditors are paid in full and general creditors receive the income that the business generates for at least three years. A bipartisan Congress enacted this law with broad support from judges, academics, and practitioners. It was not controversial even among the strongest believers in absolute priority. It gives a fresh start to those who are essentially self-employed, and it comes at little cost to creditors. It is important to note, however, that this new law affects, in the main, only those very small businesses that do not have an identity apart from the person who runs it.¹⁹

CONCLUSION

Several decades of experience in the U.S. with Chapter 11 may offer some direction to those in other jurisdictions interested in bankruptcy reform. Firms in financial distress are invariably firms about which tough decisions need to be made. Some firms need to be shut down. There are going to be winners and losers. The first question to ask about any

reorganization regime is whether it forces everyone to make the *right* decisions at the *right* time. The biggest danger from departures from absolute priority may be that they often introduce uncertainty and equivocation rather than confront hard questions. In the long run, this may be in no one's interest.

¹⁹ In particular, the total amount of debt must be less than \$3 million. See 11 U.S.C. § 101 (51D). (This figure has been temporarily raised under the CARES Act.) In the US, the businesses that fall under this threshold rarely have an identity apart from the owner. Even if it is healthy, such businesses typically close their doors when the owner retires. Even businesses such as a substantial restaurant in a major city are too large to qualify as "small businesses" as the Bankruptcy Code defines them.