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Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain

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Bankruptcy, at first glance, may be thought of as a procedure geared principally toward relieving an overburdened debtor from "oppressive" debt. Yet this discharge-centered view of bankruptcy is correct neither from an historical perspective nor from a realistic appraisal of the presence and operation of most of the provisions in the federal bankruptcy laws over the years.[1] For although discharge of the debtor (and such related issues as "exemptions" that enable an individual debtor to keep assets out of the bankruptcy pool) may well be the motivating *cause* of a majority of bankruptcy cases,[2] most of the bankruptcy *process* is in fact concerned with creditor-distribution questions. Assets are marshalled so that they can be allocated among those holding claims against the debtor or the debtor's property. Claims are determined so that participants in the allocation process may be assembled. And the rules governing priorities determine who, among the claimants, will get what and in what order.

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1. *See* W. HAWKLAND & P. LOISEAUX, CASES AND MATERIALS ON DEBTOR-CREDITOR RELATIONS 461 (1978) ("Although not clearly recognized by the end of the eighteenth century, the right to be discharged has now been firmly established . . . ."); J. MACLACHLAN, BANKRUPTCY 16-17, 20-21 (1956) (historically, discharge not an important element of bankruptcy policy); *see also* Bankruptcy Act of 1800, ch. 19, § 36, 2 Stat. 19, 31 (repealed 1803); Bankruptcy Act of 1867, ch. 176, § 33, 14 Stat. 517, 533 (repealed 1878); Levinthal, *The Early History of English Bankruptcy*, 67 U. PA. L. REV. 1, 14 (1919); Riesenfeld, *The Evolution of Modern Bankruptcy Law*, 31 MINN. L. REV. 401, 406 (1947).
2. J. MACLACHLAN, *supra* note 1, at 15-17.

Although the Bankruptcy Code[3] specifies some of these priority rules, the claimants who fare best in the bankruptcy process hold special entitlements under applicable non-bankruptcy law.[4] The priorities enunciated in the Bankruptcy Code itself deal largely with the allocation of rights among persons not entitled to preferential treatment outside of bankruptcy.[5]

Despite the importance and durability of such distributional rules, no normative theory has been developed against which these inter-creditor bankruptcy rules could be examined.[6] This Article will attempt to supply that theoretical analysis by exploring the role bankruptcy should play in shaping rules for distributions among creditors, and then testing certain existing rules against the resulting model.[7] First, the Article provides a justification for the time-honored proposition that non-bankruptcy entitlements, such as security interests, should be recognized in bankruptcy.[8] This justification is developed by using a hypothetical model that I call the "creditors' bargain" in a simple setting where all debts are assumed to be already due and owing. Second, the Article applies that model by considering the role bankruptcy should play in dealing with debts that are not yet due and owing. I call this the phenomenon of "temporal" concerns in bankruptcy.[9] The Article examines two important distinctions made by

3. The Bankruptcy Reform Act of 1978, 11 U.S.C. §§ 101-15,1326 (Supp. III 1979) [hereinafter cited by Bankruptcy Code § only].

4. *See* 2 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 45.2 (1965) (policy determination that "[t]he Bankruptcy Act itself should provide principally a procedural framework for carrying out the liquidation. The determination of which property interests . . . were to be recognized . . . was to be left to state law."); Hill, *The Erie Doctine in Bankruptcy*, 66 HARV. L. REV. 1013, 1035 (1953) ("apparent purpose" of the bankruptcy laws is to provide a system for the effectuation of state-created rights).

5. *See generally* Bankruptcy Code § 507.

6. Neither REPORT OF THE COMMISSION ON BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. NO. 137, 93rd Cong., 1st Sess. pt. 1, at 61-84 (1973) ("A Philosophical Basis for a Federal Bankruptcy Act") nor Shuchman, *An Attempt at a "Philosophy of Bankruptcy,"* 21 U.C.L.A. L. REV. 403 (1973) provides a cohesive normative approach that can be used with precision to examine the rights of creditors *inter se*.

7. This Article, because it deals integrally with reorganizations, will be limited to an examination of *business* debtors, usually in the corporate form. Many of the conclusions, however, would be applicable as well to individual debtors, who may also use Chapter 11, Bankruptcy Code § 109(d). But because of potential normative differences, this Article should not be understood as dealing, directly, with the situation of individual debtors and their creditors. For example, liquidating corporations do not need the bankruptcy process to get a discharge, since state limited-liability rules for shareholders provide the functional equivalent. *See* Bankruptcy Code § 727(a)(1). But in cases where a corporation continues to operate, state limited-liability rules do not provide an effective substitute to bankruptcy discharge. In those reorganization cases, the Bankruptcy Code provides its own discharge. *See* Bankruptcy Code § 1141(c), (d).

8. The discussion will refer only to consensually negotiated entitlements. Other forms of non-bankruptcy entitlements—such as nonconsensual liens—might raise distinct concerns. Some issues surrounding state-created priorities and statutory liens effective only in bankruptcy are discussed *infra* pp. 901-07.

9. By "temporal" concerns, I mean long-term contractual arrangements. For example, temporal concerns would arise with respect to a loan that, apart from a default (including a "bankruptcy

the Bankruptcy Code: between lenders and executory contract-holders on the one hand,[10] and between liquidation and reorganization on the other hand.[11] Justifications for these distinctions are then examined in light of the creditors' bargain model. Finally, the Article explores why the Bankruptcy Code refuses to recognize state-created priorities and statutory liens effective only in bankruptcy despite the fact that it generally recognizes other non-bankruptcy entitlements.[12]

I. Individual Rights in a Collective Proceeding: An Initial Examination of Bankruptcy as a Creditors' Bargain

A longstanding slogan is often used in discussing the non-discharge-related rules of bankruptcy law:[13] "equality is equity."[14] But this phrase explains little. It fails to deal, even roughly, with the plain fact that all bankruptcy laws to date accord substantial respect to non-bankruptcy entitlements.[15] The slogan "equality is equity" similarly fails to explain sat-

clause" default), would not be due and owing until some point in the future—say, five years from now. A loan that was substantially due and owing today, however, would not give rise to temporal concerns. The issues arising in connection with non-temporal loans are dealt with in the first part of this Article.

10. Holders of executory contracts and unexpired leases face possible "de-acceleration" in both a bankruptcy liquidation and a bankruptcy reorganization. Bankruptcy Code § 365. *See infra* pp. 880-92.

11. This inquiry is invited by the Bankruptcy Code's treatment of lenders. The Bankruptcy Code automatically accelerates the maturities of extensions of credit (whether secured or unsecured) in a Chapter 7 liquidation, yet provides the debtor with an ability to de-accelerate these maturities in a Chapter 11 reorganization. *Compare* H.R. REP. NO. 595, 95th Cong., 1st Sess. 353-54 (1977) (discussing Bankruptcy Code § 502(b) and noting that "bankruptcy operates as the acceleration of the principal amount of all claims against the debtor") *with* Bankruptcy Code § 1124(2) (in Chapter 11, a class of claims is unimpaired if, *inter alia*, the maturity of each such claim is reinstated). *See infra* pp. 881-83.

12. Related questions, such as the justification *vel non* for the various "avoiding powers" of a trustee (or *lack* of avoiding powers, such as the trustee's inability to reinstate contracts following an eve-of-bankruptcy termination, *see In re* Beck, 5 Bankr. 169 (Bankr. D. Hawaii 1980)), will not be analyzed in this Article. For an attempt to justify the preference system using what may be considered a creditors' bargain theory, see Note, *Preferential Transfers and the Value of the Insolvent Firm*, 87 YALE L.J. 1449 (1978); *cf.* 3 W. COLLIER, BANKRUPTCY ¶ 60.01, at 744 (14th ed. 1975) (if creditors and debtors could deal with impunity with debtor's assets up to the date of bankruptcy, only "tag ends" of unencumbered assets would remain). For a recent critical look at preference law as applied, see McCoid, *Bankruptcy, Preferences, and Efficiency: An Expression of Doubt*, 67 VA. L. REV. 249 (1981).

13. If the bankruptcy process was concerned *solely* with discharge and its related issues, bankruptcy law would need to define the effect of discharge and, perhaps, specify which of a debtor's existing assets would be free of the claims of creditors. Beyond that, however, the method of allocating non-exempt assets among claimants would not be relevant to these discharge-centered issues. Bankruptcy's long-standing interest in creditor-oriented distributional questions suggests, however, that the bankruptcy process is in fact motivated by additional concerns. *See* Radin, *The Nature of Bankruptcy*, 89 U. PA. L. REV. 1, 9 (1940) ("Whatever purposes bankruptcy attempts to carry out, it does by working on the creditors primarily . . . .").

14. *See* Canright v. General Finance Corp., 35 F. Supp. 841, 844 (E.D. Ill. 1940); *see also* Simonson v. Granquist, 369 U.S. 38 (1962); Kuehner v. Irving Trust Co., 299 U.S. 445 (1937); Worsley v. Demattos, 96 Eng. Rep. 1160, 1161 (K.B. 1758); McCoid, *supra* note 12, at 260-61.

15. Bankruptcy Code § 725 (prior to general distribution, trustee shall dispose of property "in

isfactorily why bankruptcy would ever be an occasion for altering the non-bankruptcy allocation of assets among creditors.[16] Bankruptcy law's beguiling slogan has been little more than a banal reminder that equals are to be treated equally in bankruptcy: the important determination of who those "equals" are is often not resolved under bankruptcy law.[17]

A more profitable line of pursuit might be to view bankruptcy as a system designed to mirror the agreement one would expect the creditors to form among themselves were they able to negotiate such an agreement from an *ex ante* position.[18] It is this approach that I characterize as the "creditors' bargain." This view provides an illuminating vantage point from which to analyze bankruptcy law's treatment of many non-bankruptcy entitlements, and a focus from which to examine the deviations made in the name of bankruptcy policy.

A. *The Creditors' Bargain and Unsecured Creditors*

First, consider a world in which a debtor could consensually create only one class of claimants, called "unsecured creditors." These unsecured creditors would enjoy typical state-law collection rights of attachment, execution, and so forth, but would not (at least prior to the time such collection rights are pursued) have the sort of property interests in or priority rights to any of their debtor's collateral that are enjoyed by secured creditors. In addition, assume for the moment that all these unsecured claim-

which an entity other than the estate has an interest, such as a lien"); Butner v. United States, 440 U.S. 48, 54 (1979) ("Congress has generally left the determination of property rights in the assets of a bankrupt's estate to state law."); *In re* Telemart Enterprises, 524 F.2d 761, 763 (9th Cir. 1975) (bankruptcy law reflects general policy of recognizing property interests); *cf.* Vanston Bondholders Protective Comm. v. Green, 329 U.S. 156, 161-63 (1946) (validity of claims of creditors generally decided under state law, unless in conflict with federal policy and equitable principles); REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, *supra* note 6, pt. 1, at 70 ("[F]or the most part, [claims arising in the open credit economy] should be recognized in the bankruptcy process.")

16. For an illuminating discussion of this point, see Eisenberg, *Bankruptcy Law in Perspective*, 28 U.C.L.A. L. REV. 953 (1981). For justification of federal bankruptcy rules as a form of risk-spreading compulsory insurance, see P. COLEMAN, DEBTORS AND CREDITORS IN AMERICA: INSOLVENCY, IMPRISONMENT FOR DEBT, AND BANKRUPTCY 13 (1974) (legislators wanted insolvent's property distributed equitably because spreading losses among all creditors might prevent collapse of any one of them).

17. *See* 2 G. GILMORE, *supra* note 4, § 45.2, at 1286-88.

18. Recent work, although incomplete and tentative, hints at such an approach. *See, e.g.*, Ang & Chua, *Coalitions, the Me-First Rule, and the Liquidation Decision*, 11 BELL. J. ECON. 355 (1980); Weistart, *The Costs of Bankruptcy*, 41 LAW & CONTEMP. PROBS. 107 (Autumn 1977); *cf.* Clark, *The Interdisciplinary Study of Legal Evolution*, 90 YALE L.J. 1238, 1250-54 (1981) (discussing development of corporate reorganization laws in terms of developing efficient procedures to aid creditors). *But cf.* Bulow & Shoven, *The Bankruptcy Decision*, 9 BELL J. ECON. 437, 454 (1978) (treating bankruptcy as decision made when "coalition of claimants with negotiating power can gain from immediate liquidation"). The focus on bankruptcy as a law of collection from failing debtors may be viewed as consistent with the general historical development of bankruptcy. *See* J. MACLACHLAN, *supra* note 1, at 15; 2 J. STORY, COMMENTARIES ON THE CONSTITUTION OF THE UNITED STATES § 1113, at 50 n.2 (4th ed. 1873).

ants extend credit on a short-term basis.[19] Are there any reasons to believe that this unitary group of creditors would favor the existence of a government-imposed system providing for the collective treatment of claims against a common debtor?

To examine this, it is worth considering a simple hypothetical. *D* has a small printing business. Potential creditors estimate that there is a twenty percent chance that *D* will become insolvent.[20] At the point of insolvency, the business is expected to be worth $80,000 as an operating entity and $60,000 if sold piecemeal. *D* borrows $50,000 from each of two creditors, *C1* and *C2*. *C1* and *C2* expect to spend $2,000 each in pursuit of individual creditor remedies should *D* become insolvent and fail to repay them. Are there any reasons to believe that under these circumstances *D*, *C1*, and *C2* would jointly agree to contract for a collective liquidation system to deal with the twenty percent chance that *D* will not be able to pay *C1* and *C2* in full? From the creditors' point of view (and ultimately from *D*'s, since inefficiencies in a non-collective system will be charged back to *D*—either wholly or in part—in the form of higher credit costs),[21] three reasons suggest themselves: reduction of strategic costs; increased aggregate pool of assets; and administrative efficiencies.[22]

1. *Reduction of Strategic Costs*

A collective system that treats all claimants standing in the same relationship to the debtor alike has the virtue of substituting a sum "certain"[23] for the uncertain amount that might be realized under an individualistic creditors' remedy system. This has two advantages, even in a case where

19. The complications introduced by consideration of longer term extensions of credit will be discussed in detail after the simple model is established. *See infra* pp. 878-901.

20. For present purposes the model is static. I assume that *D*'s investment decisions will not change, and that *D* will not otherwise misbehave or make the business more risky. *See infra* notes 44 & 52.

21. At a number of points in this Article, I will talk about "advantages" to the creditors. In almost every such case, however, the analysis is not complete without noting how these cost savings may get passed on to the debtor. The extent to which these savings are passed on depends on the elasticities of supply of and demand for credit. *See* Meckling, *Financial Markets, Default, and Bankruptcy: The Role of the State*, 41 LAW & CONTEMP. PROBS. 13 (Autumn 1977); Weston, *Some Economic Fundamentals for an Analysis of Bankruptcy*, 41 LAW & CONTEMP. PROBS. 47 (Autumn 1977).

22. A collective process does not seem to be necessary to protect a debtor's right to a discharge. A system could be designed in which a debtor could do such things as announce that henceforth future assets would be free of prior claims. Then the creditors could fight among themselves over the debtor's "old" assets (however defined) for satisfaction of their claims. The debtor, however, may view a collective process as preferable to numerous lawsuits. To the extent that the creditors enjoy advantages from a collective system, a debtor also benefits through lower credit costs, and favors a collective system for that reason, *see supra* note 21.

23. As the discussion indicates, the advantage of a collective system is not that it provides, *ex ante*, a fully determinable sum, but only that one form of uncertainty (relative entitlements *vis-a-vis* other creditors) is eliminated.

the assets will inevitably be sold on a piecemeal basis. First, it eliminates strategic costs that would otherwise be associated with a race to the courthouse. Second, even if no such race would occur, the collective proceeding reduces variance in recoveries—which is itself a virtue to risk-averse creditors.

Consider, first, the incentives for a race and the associated strategic costs. *C1* and *C2*, in our hypothetical, have each loaned D $50,000. Each of *C1* and *C2* knows, however, that if the other creditor gets to the courthouse first (or to *D* first, to persuade *D* to pay voluntarily), that other creditor will collect $50,000, leaving only $10,000 for the "slower" creditor.[24] Absent a prior agreement, this situation presents a classic example of the game theorists' "prisoner's dilemma."[25] The central feature of a prisoner's dilemma is rational individual behavior that, in the absence of cooperation with other individuals, leads to a sub-optimal decision when viewed collectively.[26] This occurs whenever certain rules are in the interest of an entire class of persons but, because of an inability to reach a collective solution, each class member acts out of immediate self interest in such a way that a less efficient solution results. This is precisely what occurs in our hypothetical. Each creditor, unless assured of the other's cooperation, has an incentive to take advantage of individual collection remedies, and to do so before the other creditor acts. Unless each creditor individually attempts to "beat out" the other, that creditor will fare worse than the other. Yet this race not only creates costs for the individual creditors (such as frequent checking of the courthouse records for evidence of actions against the debtor by other creditors), it is also likely to lead to a premature termination of a debtor's business, because each creditor will consider only that creditor's own advantage from racing, instead of the disadvantages imposed on creditors collectively.[27] Thus, each creditor must participate in collectively non-optimal "advantage-taking" simply to avoid being taken advantage of. This creates a race to use individualistic remedies, even though it is not in the creditors' collective interest to use them at

24. Use of these numbers assumes that the individualistic remedies system would inexorably lead to piecemeal dismemberment of *D* in the absence of some sort of an agreement between *C1* and *C2*. This assumption will be relaxed later. *See infra* pp. 864-65.

25. *See* R. LUCE & H. RAIFFA, GAMES & DECISIONS (1957); A. RAPOPORT & A. CHAMMAH, PRISONER'S DILEMMA (1965). For a reasonably non-technical introduction to game theory, see generally J. WILLIAMS, THE COMPLEAT STRATEGIST (1966).

26. *See, e.g.*, P. SAMUELSON, ECONOMICS 482-83 (8th ed. 1970); Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 859-62 (1981).

27. For these reasons, there are costs to a race system that make it less desirable for the creditors as a group. If the game results are zero sum, then there is no prisoner's dilemma. *See* Gilson, *supra* note 26, at 860-61. Even risk-neutral creditors, however, are likely to find themselves in a form of prisoner's dilemma. *See infra* note 28 & pp. 864-65.

all.[28]

An assumption of creditor risk-aversion facilitates the exposition of the logic of collective action. If both *C1* and *C2* have a fifty percent chance of winning through the use of individualistic remedies, then each faces a fifty percent chance of being paid in full ($50,000) and a fifty percent chance of being paid only $10,000. But if *C1* and *C2* agree to share equally in the event of *D*'s misfortune, each could be assured of $30,000. If *C1* and *C2* are risk-averse, one would expect them, prior to extending credit to *D*, to agree on a distributional system in the event of *D*'s insolvency in which each would receive this partial, but certain, payment of $30,000. The reduction of uncertainty would itself be viewed as a virtue by *C1* and *C2* and, therefore, by *D* as well, who would get lower aggregate credit costs.

. . .

28. A collective agreement would avoid the costs associated with this race only if individual creditors could not avoid the collective proceeding by precipitous conduct. A damage or a specific performance-type rule could be fashioned to protect the collective proceeding. Bankruptcy law, by enabling the trustee (as representative of the creditors) to undo pre-bankruptcy collections through his "preference" power, effectively creates a specific performance rule that not only makes the collective system mandatory but also acts as a deterrent against the sort of "race" that would otherwise occur. *See* Clark, *supra* note 18, at 1251; Note, *supra* note 12; *see also infra* note 148.

29. *See* J. VAN HORNE, FINANCIAL MANAGEMENT AND POLICY 60-65 (4th ed. 1977).

30. This incentive will be particularly troublesome if we assume that this advantage-taking behavior will result in a smaller pool of assets than would exist if the creditors acted collectively. *See infra* pp. 864-65.

31. Moreover, the diversification challenge is overstated. All that it implies in any event is that *C1* and *C2*, if able to diversify fully, would be indifferent between an individualistic system and a collective system. Some creditors, however, may be unable to achieve, in a cost-effective fashion, the degree of diversification necessary to remove the cost of uncertainty. The amount of diversification required to minimize the uncertainty cost may be quite large. *See* Langbein & Posner, *Market Funds and Trust Investment Law*, 1976 AM. B. FOUND. RESEARCH J. 1. We may expect that *some* creditors (those not sufficiently diversified) would favor a collective system, while diversified (or easily diversifiable) creditors would be indifferent between the two systems.

2. *Increased Aggregate Pool of Assets*

The use of individualistic remedies may lead to a piecemeal dismantling of a debtor's business by the untimely removal of necessary operating assets. To the extent that a non-piecemeal bankruptcy process (whether in the form of liquidation or reorganization) is likely to increase the aggregate pool of assets, its substitution for individualistic remedies may be advantageous to the creditors as a group. In the above hypothetical, for example, keeping *D*'s printing business in one piece increases the pool of assets available to *D*'s creditors by $20,000. Whether or not *D*'s printing business should be sold to a third party as a going concern (*i.e.*, "liquidated" at its highest value use), or "reorganized,"[33] it is obviously to the joint advantage of *C1* and *C2* to keep the entity alive. Again, however, *C1* and *C2* face a classic prisoner's dilemma: they are jointly better off if they act collectively, but if they are unable to act collectively, rational individual behavior will require collectively non-optimal advantage-taking on the part of each.[34] It is true that an agreement to act collectively could theoret-

32. For example, judicial liens may not be available until a debt has matured, and certain types of judicial assistance are sometimes limited to particular claims. These rules may frustrate or delay *C1*'s ability to take advantage of special talents.

33. A reorganization involves more than simply keeping a business alive; it also involves a process whereby the original claim holders and interest holders become "owners" of the business. *See infra* pp. 893-95.

34. This illustrates a species of the "common pool" problem. The problem arises with common pool resources, such as oil. Individual owners of drilling rights tapping into this pool have incentives to remove as much oil as each such owner possibly can even though the value of the pool would be

ically be negotiated after a precipitating event (*i.e.*, after *C1* has taken the steps necessary to acquire a judicial lien). By acquiring a judicial lien, *C1* has assured herself of $50,000 prior to the advent of these negotiations. *C2*, however, is faced with losing the difference between $30,000 and $10,000 if he cannot convince *C1* to keep the entity together. This provides a $20,000 bargaining chip for *C1* and *C2* to allocate among themselves through negotiations carried out after *C1*'s attachment but before the ultimate foreclosure.

The bargaining, however, will be costly.[35] This bargaining with *C1* could be avoided if the remaining creditors were able to act collectively and repurchase the asset at the foreclosure rate of $50,000, or replace it for $50,000. In any case in which there is a large number of such creditors, not only would free-rider problems make any collective agreement after one creditor has attached almost impossible,[36] but subsequent creditors would still have incentives to "beat out" the remaining creditors by using their individual remedies and collecting first on the remaining assets.[37] For these reasons, *ex post* deals capable of preserving the debtor's "going concern" value, while possible, would not be very likely in a large number of cases. Such an agreement would be much more likely *ex ante*. Neither *C1* nor *C2* would know at that time which one will be the first to attach.[38] They do know, however, that the total pool of assets available to satisfy their claims may be increased through collective action. For those reasons, one would expect them to agree to a collective system that deterred the sub-optimal behavior of the prisoner's dilemma, and allowed *C1* and *C2* to capture and share the "going concern" value of *D*'s business—the difference between the worth of *D*'s assets in a piecemeal sale and the worth of those assets as a continuing business.[39]

maximized by a slower withdrawal. The solution to a number of "common pool" problems has been statutory "compulsory unitization"—a result that parallels the compulsory collective proceeding solution to the present problem. *See generally* Sweeney, Tollison, & Willett, *Market Failure, The Common Pool Problem, and Ocean Resource Exploitation*, 17 J.L. & ECON. 179 (1974). As before, the *ex post* incentives to achieve the advantages that come from being first may lead to a more-rapid-than-optimal resort to individual creditor remedies, and a more rapid destruction of the debtor's going concern value than would otherwise be the case. *See supra* pp. 861-63.

35. This is an example of bilateral monopoly. *See* R. POSNER, ECONOMIC ANALYSIS OF LAW 45 (2d ed. 1977); Arrow, *The Organization of Economic Activity: Issues Pertinent to the Choice of Market Versus Nonmarket Allocation*, in 1 THE ANALYSIS AND EVALUATION OF PUBLIC EXPENDITURES: THE PPB SYSTEM, 91st Cong., 1st Sess. 47 (1969).

36. J. HIRSCHLEIFER, PRICE THEORY AND APPLICATIONS 537-38, 561-64 (2d ed. 1980); R. POSNER, *supra* note 35, at 45-46; *see also* Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1170-72 (1981); Grossman & Hart, *Takeover Bids, the Free-Rider Problem, and the Theory of the Corporation*, 11 BELL J. ECON. 42 (1980).

37. *See supra* pp. 861-64.

38. *See supra* p. 864.

39. This agreement would need to provide not only for a collective proceeding, but also for a deterrent or policing device to keep creditors from attempting to avoid the collective proceeding by

3. *Administrative Efficiencies*

Issues such as the precise amount of the debtor's assets and the nature and extent of secured claims must be resolved in virtually every collection proceeding. We have posited that *C1* and *C2* would each spend $2,000 in an individual collection proceeding. In a number of cases, it is likely that *C1* and *C2* will attempt to collect their claims at roughly the same time. This would happen if, for example, *D* were insolvent and had announced that he was implementing his discharge right. A single inquiry into recurring collection questions is likely to be less expensive than the multiple inquiries necessary in an individualistic remedies system.[40] If a collective proceeding costs *C1* and *C2* a total of $3,000, for example, its use would save *C1* and *C2* $500 each. At the time of negotiating the creditors' bargain, this reduced cost would be viewed as a clear advantage of a collective process.[41] Consequently, in the event of *D*'s insolvency, we would expect to see *D*, *C1*, and *C2* prefer a collective system, and therefore agree to the inclusion of a procedure for implementing such a system in their *ex ante* bargain.

The three considerations I have described above make it likely that a general unsecured creditor will agree to a collective system in lieu of a scheme of individualistic remedies. No single creditor, however, would agree to be bound to this collective system unless it were a compulsory system binding all other creditors: to allow the debtor to contract with other creditors on an opt-out basis would destroy the advantages of a collective proceeding.[42]

Although we would expect to see a mandatory collective proceeding as a standard feature of the creditors' bargain, no *ex ante* meeting of the creditors will, realistically, take place. A debtor's pool of creditors changes over time and even the debtor is unlikely to know who the creditors of the business will be at any point in the future.[43] As a result, the creditors themselves cannot be expected to negotiate this agreement,[44] even though

"gun jumping." *See supra* note 28.

40. *See* Weistart, *supra* note 18, at 109.

41. The single inquiry may also be less expensive for *D*, since it would reduce expenditures associated with creditor collection of claims and increase *pro tanto* the pool of assets available for the creditors.

42. *See supra* notes 28 & 39.

43. This is likely to be true with respect to consensual creditors; it is almost certainly true with respect to non-consensual creditors, such as tort claimants.

44. Nor could we expect the debtor to do it for them, by including a procedure for implementing a collective proceeding as a standard contract feature. First of all, a debtor's incentive to take advantage of creditors would make consistent inclusion of this clause implausible. *See generally* O. WILLIAMSON, MARKETS AND HIERARCHIES 26-28 (1975); Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976); Smith & Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. FIN. ECON. 117, 125-31 (1979); White, *Public Policy Toward Bankruptcy: Me-First and Other Priority Rules*, 11 BELL J. ECON. 550, 556-

it would be in their joint interest to do so. A federal bankruptcy rule solves this problem by making available a mandatory collective system after insolvency has occurred.

It is important, however, not to overstate the role of the collective system imposed by the government. The *presence* of a bankruptcy system does not mandate its *use*. The realization that a creditor could always initiate the bankruptcy process[45] would deter attempts in any non-bankruptcy collective proceeding to provide any creditor with less than the minimum obtainable in a bankruptcy proceeding. The availability of a mandatory collective system in which distributions are governed by a set of statutory rules is, therefore, important because it stipulates a minimum set of entitlements for claimants that, in turn, provides a framework for implementing a consensual collective proceeding outside of the bankruptcy process.[46] One would normally expect to see consensual deals among creditors outside of the bankruptcy process attempted first,[47] at least to the extent that there are potential cost savings in remaining outside of the formal bankruptcy process,[48] since those savings could be consensually allocated. The formal bankruptcy process would presumably be used only when individualistic "advantage-taking" in the setting of multi-party negotiations[49] makes a consensual deal too costly to strike[50]—which may occur frequently as the number of creditors increases.

But because the bankruptcy rules set the stage against which consensual collective proceedings will be negotiated outside of bankruptcy, it is important that those rules be drawn in a fashion that is likely to minimize incentives for inefficient recourse to a collective proceeding.[51] These rules

62 (1980). In some respects, the situation is analogous to the public corporation context, where government-imposed general corporation rules regulating the relationship between owners and managers are necessary in view of the inability to achieve optimal results through consensual bargaining, due to the large number of stockholders. *See* Brudney & Clark, *A New Look at Corporate Opportunities*, 94 HARV. L. REV. 997 (1981). Secondly, the debtor does not bargain consensually with a number of his claimants, such as non-consensual tort creditors.

45. This would be subject to rules governing creditor initiation of the bankruptcy process. *See infra* p. 892.

46. *See* Moore, *Foreword*, 41 LAW & CONTEMP. PROBS. 1, 9 (Autumn 1977).

47. Such workouts are, in fact, commonly observed. *See, e.g.*, Coogan, Broude, & Glatt, *Comments on Some Reorganization Provisions of the Pending Bankruptcy Bills*, 30 BUS. LAW. 1149, 1154-60 (1975); Krause, *Insolvent Debtor Adjustments Under Relevant State Court Statutes as Against Proceedings Under the Bankruptcy Act*, 12 BUS. LAW. 184, 185 (1957).

48. The extent of these cost savings would depend not only on the relative costs, in the abstract, of the two proceedings, but also on the extent to which the costs of a formal bankruptcy proceeding could be externalized, because a portion of court costs are picked up by the taxpayers as a group. Most of the costs of the bankruptcy process, however, are borne by the participants themselves. *See* Bankruptcy Code §§ 326-331, 503(b)(1) & (2), 507(a)(1), 726(a)(1).

49. *See supra* p. 865.

50. *See Discussion of the Economics of Bankruptcy Reform*, 41 LAW & CONTEMP. PROBS. 123, 171 (Autumn 1977) (comment of Mr. Coogan).

51. *See* Ang & Chua, *supra* note 18.

should be clear and determinable, so as to be ascertainable at low cost in any negotiated non-bankruptcy collective process. The remaining sections of this Article will consider the form some of these rules should take.

B. *Property Claimants and the Creditors' Bargain*

To this point, we have assumed that all creditors were similarly situated in that they all held unsecured claims. Our scope will now be expanded to include creditors whose contracts afford them superior rights *vis-a-vis* other creditors.[52]

Consider, for purposes of this discussion, the utility of the creditors' bargain model in dealing with consensually secured claimants. In this discussion, it is a key assumption that consensually negotiated security interests have aggregate efficiencies: that a secured party is at least as well off with a security interest (and a concomitantly lower return on the investment) as without; that unsecured creditors are also at least as well off (having a riskier investment but a concomitantly greater return); and that the debtor's total cost of credit has been reduced because of efficiencies in allowing secured credit. Consequently, from an *ex ante* position, the debtor and the creditors would view it as in their joint interest to behave in a fashion that will keep the efficiencies of such consensually negotiated security interests.[53]

Assuming that other creditors would consent to the existence of secured creditors, we can now turn to the question of whether those secured creditors would consent to be bound by a collective proceeding. Fully secured creditors[54] are not direct beneficiaries of either the "reduction of strategic costs" or the "increased aggregate pool of assets" advantages of a collective proceeding previously explored.[55] Moreover, fully secured creditors are less likely to view "administrative efficiencies"[56] as a reason to support a

52. These superior rights may result from a consensual agreement between the creditor and the debtor or may be conferred by state law. The conferral of superior rights by state law is discussed *infra* pp. 901-07. The model being developed will, for the most part, treat a firm as having only secured and unsecured creditors. The possibility of distinct treatment between other classes (for example, creditors and equity-interests) will not be discussed in detail, although an analysis of the issues in these situations would be similar. As holders of the residual, however, equity-holders may have additional incentives to engage in risk-preferring activitites that lead to non-optimal bankruptcy decisions. *Cf.* White, *supra* note 44 (incentive effects on firm's investment decisions whenever creditors are paid ahead of equity-holders).

53. *See* Jackson & Kronman, *Secured Financing and Priorities Among Creditors*, 88 YALE L.J. 1143 (1979); Schwartz, *Security Interests and Bankruptcy Priorities: A Review of Current Theories*, 10 J. LEGAL STUD. 1 (1981). *But see* Schwartz, *supra*, at 30-33 (possible advantage-taking of uninformed unsecured creditors by secured creditors).

54. The discussion assumes that the creditors were assured of being fully secured at all times. This assumption makes the following discussion simpler, as it allows us to deal with polar cases.

55. *See supra* pp. 861-63.

56. *See supra* p. 866. Fully secured creditors would also be able to pass the costs of collection back to the debtor and hence, at least in part, to the unsecured creditors. *See infra* note 58.

collective proceeding because at least some of these administratively difficult issues, such as the availability of assets and the priorities of competing claimants, have previously been negotiated away.

These observations ignore, however, the aggregate advantages that will accrue to the debtor and all the creditors[57] from minimizing the debtor's total credit costs. Unsecured creditors have several reasons for desiring a collective proceeding. Consider first the "increased aggregate pool of assets." If a secured creditor could remove collateral from the debtor's estate and remain outside of any collective proceeding this advantage would be diminished or lost. One would expect, therefore, that the unsecured creditors would be willing to pay a secured creditor at least something to agree to join in the collective proceeding. Moreover, while a secured creditor might otherwise be indifferent to the administrative efficiencies associated with a collective proceeding (because a secured creditor's costs of collection are often contractually allocated to the debtor),[58] the debtor and the creditors as a group will benefit as a result of *ex ante* adjustments for the elimination of such costs. Since costs passed on to the debtor by a secured creditor would increase the secured creditor's claim, they would, *pro tanto*, reduce the pool of assets available for the unsecured creditors and thereby increase their costs of credit. As a result, the unsecured creditors would in fact be sensitive to these costs. The introduction of secured creditors into the model, accordingly, should not make a difference: we would still expect the debtor and the creditors (including secured creditors) to select a system in which the aggregate collection costs would be minimized.[59]

The system in which collection costs are best minimized remains the collective proceeding. Since the advantages of secured credit would be weakened to the point of being lost if a secured creditor could be forced to participate on a *pro rata* basis with unsecured creditors in any bankruptcy proceeding,[60] maintaining these advantages requires respecting a secured creditor's ability to be paid first from the assets constituting the secured creditor's collateral. But this is not inconsistent with a mandatory collec-

57. Who gains the advantages will depend, in part, on the elasticities of the supply of and demand for credit. *See supra* note 21. The secured creditor, however, is not precluded from being such a beneficiary.

58. U.C.C. § 9-504(1)(a) (1972) expressly permits contract provisions that pass on to the debtor a secured party's expenses of collection.

59. There are at least two ways of fashioning the argument. The first is to assume that creditors already know their non-bankruptcy entitlements, and, possessing those entitlements, attempt to agree, consensually, to a collective proceeding. This is the descriptive approach of the text, although it is subject to some limitations. *See infra* note 62. It would be equally possible to invoke the Rawlsian "veil of ignorance" by assuming that the debtor and his creditors are trying to fashion a system that would maximize the group's collective welfare before their entitlements are known. *See* J. RAWLS, A THEORY OF JUSTICE 136-42 (1971) (imposition of "veil of ignorance" on those bargaining). The ultimate resolution, however, seems the same using either approach.

60. *See* Schwartz, *supra* note 53, at 34.

tive system: the unsecured creditors, for the reasons we have just explored, would view a secured creditor's ability to ignore the collective proceeding as a cost of credit. It is, therefore, in the joint interest of the unsecured creditors (and hence in the debtor's interest as well) to have a secured creditor included in the collective proceeding. A secured creditor, on the other hand, would have no reason to object to such an inclusion *if* left as well off as before.[61] Thus, the mandatory inclusion of a secured creditor in the collective asset-disbursement process, even if that creditor's preferential entitlements were respected, would produce a net benefit: the secured creditor would be no worse off than before and the unsecured creditors could be made better off.[62]

Consider the hypothetical examined earlier,[63] except allow *C1* to be a creditor with a security interest in *D*'s printing press, the principal piece of *D*'s business equipment. This press could be sold for $50,000 on the open market. By virtue of this security interest, *C1* is "assured" of receiving $50,000, the amount of *C1*'s loan. If *C1* is able to proceed independently of *C2*, however, thereby forcing a piecemeal liquidation, *C2* will

61. The premise of Kaldor-Hicks efficiency—that a move is desirable if the "winners" *could* compensate the "losers," even if no such compensation occurs—suggests, in the abstract, that the advantages of a collective proceeding might warrant its implementation even if the entitlements of secured creditors were not recognized. *See* Hicks, *Foundations of Welfare Economics*, 49 ECON. J. 696 (1939); Kaldor, *Welfare Propositions of Economics and Interpersonal Comparisons of Utility*, 49 ECON. J. 549 (1939); *see also* Coleman, *Efficiency, Utility and Wealth Maximization*, 8 HOFSTRA L. REV. 509 (1980) (a reasonably accessible discussion of Kaldor-Hicks efficiency in legal context). The effects of a collective system in which the value of secured creditors' non-bankruptcy entitlements was not respected suggests, however, that such a system, in addition to potentially involving inter-personal utility comparisons, would be *less* desirable than a system that respected the value of those entitlements. Reducing the entitlements of secured creditors in bankruptcy will presumably reduce some of the advantages of secured credit in the first place. *See supra* note 60. Thus, a collective system that recognized those entitlements would be superior to one that did not. Secondly, the ability to *threaten* secured creditors with a diminution in their non-bankruptcy entitlements by threatening bankruptcy might lead to strategic behavior and non-optimal bankruptcy decisions. *See, e.g.*, Muris, *Opportunistic Behavior and the Law of Contracts*, 65 MINN. L. REV. 521, 532-52 (1981); Posner, *Gratuitous Promises in Economics and Law*, 6 J. LEGAL STUD. 411, 421-24 (1977).

62. *Cf.* Ang & Chua, *supra* note 18 (inefficient liquidation decisions made when non-bankruptcy rights not respected). A collective proceeding that allocates all of the gains to the unsecured creditors is not, of course, the only system possible. One alternative would be for gains to be allocated equally among all creditors. Indeed, in an actual consensual bargain, it is unlikely that secured creditors would agree to the bargain unless they received *some* of the gains resulting from that bargain. The model used here goes no further than to show that the secured crditor would be *indifferent* between the two systems and hence is, in that respect, a bit at odds with a true creditors' bargain model. But a model where the gains are allocated entirely to the unsecured creditors has certain advantages. First, such a system (as represented by Chapter 7 of the Bankruptcy Code) is easy to operate. Moreover, since many (if not most) secured creditors face at least *some* possibility of being an unsecured creditor, the interests of secured parties are not unidimensional. Finally, state law effectively prohibits secured creditors from ever being paid more than in full. Debtors have non-waivable redemption rights and forced-sale rights, and surplus proceeds on disposition of the collateral must be returned to them. *See, e.g.*, U.C.C. §§ 9-501(3), 9-502(2), 9-505, 9-506 (1972). There is unlikely to be a bankruptcy-related reason to upset that state law determination, which sets a maximum on a secured creditor's entitlement.

63. *See supra* p. 861.

receive only $10,000. If *C1* and *C2* proceed collectively (and sell *D*'s business as a going concern), *C2* would recieve $30,000. Thus, at the time *C1* attempted to collect by foreclosing on *D*'s printing press, we would expect *C1* and *C2* to negotiate an agreement to proceed collectively, with *C2* paying *C1* between $0 and $20,000 to agree to this.[64] Exactly as before, however (when *C1* and *C2* were both unsecured, but *C1* had just attached), the uncertainties of these negotiations, plus the inevitable "free rider" problems that would arise if there were multiple unsecured creditors, make an *ex ante* agreement preferable.[65] Under such an agreement, *C2* would assure *C1* of her ability to get her full $50,000, while *C1* would agree to protect *C2*'s ability to get the $30,000, by agreeing to keep *D*'s assets "together" so that they could be sold for $80,000 (again, through a going concern liquidation or a reorganization).[66]

This suggests that there is nothing "unfair" about recognizing a secured creditor's prior entitlements in bankruptcy.[67] Instead, it is exactly the sort of agreement we would expect to see negotiated voluntarily once the issue of the *existence* of secured credit were decided. To the extent there are advantages to secured financing, respecting the non-bankruptcy priority of secured creditors is a necessary corollary of protecting those advantages. Moreover, a secured creditor has already "paid" for this prior entitlement—really a higher probability of being repaid—through receipt of a lower return. Conversely, the unsecured creditors have already been "paid" for allowing this prior entitlement and they receive a higher rate of return because of their lower priority position.[68] The creditors' bargain model, then, provides a satisfying theoretical explanation of why bankruptcy law should make a fundamental decision to honor negotiated non-bankruptcy entitlements.

II. Non-Temporal Applications: Applying the Model to the Bankruptcy Code

Historically the bankruptcy process has recognized non-bankruptcy en-

64. This bargaining process could be circumvented if the creditors were able to act collectively. *See supra* p. 865. The problems of actually obtaining such consensual agreement remain, however.

65. *See supra* pp. 864-65.

66. *C1*'s "payment" for this agreement may be in the form of a higher interest rate. Conversely, C2 would be expected to "pay" for this collective advantage, perhaps by receving a lower interest rate. This, of course, is not the only possible agreement. *See supra* note 62.

67. Jackson & Kronman, *supra* note 53, at 1148 ("Since creditors remain free to select their own debtors and to set the terms on which they will lend, there is no compelling argument based on considerations of fairness for adopting one legal rule . . . rather than another . . . ."); *see also* Ang & Chua, *supra* note 18; Meckling, *supra* note 21, at 15-16; *cf.* Eisenberg, *supra* note 16, at 956-59 (justifying adherence to non-bankruptcy rules absent clear evidence that they encroach on some bankruptcy-related policy).

68. *See* Jackson & Kronman, *supra* note 53, at 1147-48, 1153-55; *cf.* Eisenberg, *supra* note 16, at 965 ("both groups know the rules of the game when they extend credit").

titlements, and, to that extent, the law seems generally consistent with the normative theory just developed. It is not necessarily true, however, that bankruptcy law faithfully mirrors the normative theory in all respects. For it remains true that the *nature* of a secured creditor's non-bankruptcy entitlements are changed in bankruptcy.[69] A secured creditor is not necessarily paid upon the institution of a bankruptcy proceeding, nor is a secured creditor necessarily allowed to resort to his back-up right to realize on his collateral.[70] To measure whether, and to what extent, the existing bankruptcy process deviates without adequate justification from a recognition of non-bankruptcy entitlements, even in the case of non-temporal loans, it is necessary to examine in greater detail the actual operation of the provisions of the Bankruptcy Code.[71] Although those provisions protect, in theory, the value of a creditor's non-bankruptcy entitlements, in actual application it appears that this value-equivalence is consistently undermined.

A. *"Indubitable Equivalence" and the Invitation to Fudge*

Consider the following set of facts: *D*'s printing press (in which *C1* has a security interest) can be sold for $50,000.[72] *D*'s other business assets can be sold for $10,000. But the value of keeping all of the assets together is $80,000, $20,000 in excess of their individual values. (Assume also that *D*'s printing press cannot readily be replaced on the open market—that is, *D* cannot buy a new press for $50,000 without substantial delay and, therefore, cannot protect the $80,000 value in that fashion.) In this instance, the creditors' bargain model would suggest that the efficient solution would be to pay *C1* $50,000 in cash, and to have *D* keep the printing press. *D* should keep the collateral because the benefits to *D*'s business, and to *D*'s unsecured creditors, exceed the benefits that *C1* would enjoy exerting her individual default right to receive $50,000 in cash. But the

69. This is also true of unsecured creditors who are precluded from resorting to their individual rights to obtain property upon the institution of the collective bankruptcy system. *See supra* pp. 861-66.

70. *See* Bankruptcy Code § 362(a). In a liquidation proceeding, the "automatic stay" affects a creditor's substantive rights only until the assets are actually disbursed. *See* Bankruptcy Code § 725. In a reorganization proceeding, however, the deferral of substantive rights may last longer. *See* Bankruptcy Code § 1129(b)(2)(A), discussed *infra* pp. 882-86.

71. The creditors' bargain theory suggests only that it may be necessary to keep the collateral, so that the debtor's "going concern" value may be captured (or the other advantages of a collective proceeding may be realized). It does not, itself, explain why a secured creditor is not entitled to be paid, in cash, immediately after the initiation of a bankruptcy proceeding. To explain, as the theory does (and as the Bankruptcy Code itself implies, *see* § 362(d)(2)) that the aggregate maximizing solution is to leave property with the estate when it is "necessary to an effective reorganization," does not answer the question of how a secured creditor's pre-bankruptcy rights are protected.

72. Market value is the proper measure of an asset's value from the point of view of the secured creditor, because a debtor can require the secured creditor to *sell* the asset or the debtor may *redeem* the asset. *See supra* note 62.

collective process may then be viewed as a redemption of *C1*'s property rights in the printing press. This may be done in one of two ways. *D* may do it directly, by putting out bids (including among the unsecured creditors) for someone to lend *D* $50,000 to pay off *C1* in return for a security interest in the printing press, which, freed of *C1*'s interest, would become available for such a secured loan.[73] Alternatively, *C1* could be required to make the loan herself by being given the marketplace rate for such a loan. If *C1* is no longer the more efficient lender, this would induce *C1* to assign the claim and its associated security to the efficient marketplace lender,[74] allowing *C1* to gain her $50,000 that way.

While the Bankruptcy Code does not preclude application of either of the two alternatives, neither is used, except perhaps on rare occasions. In the situation represented by the above hypothetical, the Bankruptcy Code, consistent with the creditors' bargain model, would allow *D* to keep the printing press: it would be "necessary to an effective reorganization"[75] in the sense that *D*'s estate would be worth $20,000 more by virtue of keeping the printing press. *C1*, however, is not *necessarily* paid $50,000 in cash (although in theory *C1* could be); instead, *C1* is entitled only to the "indubitable equivalent"[76] of her right to take the printing press and thereupon realize $50,000.

We still have not strayed very far from the learnings of the creditors' bargain model; indeed, the "indubitable equivalence" standard at least purports to preserve the value of the non-bankruptcy entitlement. The conceptual underpinnings of the principle of indubitable equivalence seem to require that *C1* receive something in the bankruptcy proceeding so as to leave *C1* indifferent as between receiving $50,000 in cash, today, and leaving $50,000 "on loan" to *D*, secured by *D*'s printing press.[77] This

73. *C1* might, of course, be one of those bidders.

74. It would be difficult to choose between these two alternatives. If there is no particular reason to believe that *C1* will again be the efficient lender, it would normally seem better to have *D* negotiate directly with potential new lenders. This is so because, depending on the needs or desires of a particular lender, loan terms may be optimized from *D*'s perspective when *D* does the negotiating himself (there is no reason to assume that *D*'s contract with *C1* necessarily contains an optimum set of terms for a secured loan made by another lender). *Cf.* Jackson & Kronman, *supra* note 53, at 1150-61 (discussing factors leading particular lender to make a secured loan). The phenomenon of repeat lending, however, suggests that it is in fact likely that *C1* and *D* would again be the optimal parties to a loan agreement. *C1* and *D*, for example, may well have informational advantages concerning each other that would lead them to continue to deal on much the same terms as before. In that event, it may be more efficient simply to give *C1* the marketplace rate for such a loan.

75. Bankruptcy Code § 362(d)(2). This should be the case even where the debtor's property is being sold as a "going concern."

76. Bankruptcy Code § 361(3). This rather odd statutory language comes from Judge Learned Hand's opinion in *In re* Murel Holding Corp., 75 F.2d 941, 942 (2d Cir. 1935). *See* S. REP. NO. 989, 95th Cong., 2d Sess 127-28; *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5787, 5913.

77. *See* H.R. REP. NO. 595, *supra* note 11, at 339 (purpose of Bankruptcy Code § 361 is to ensure that secured creditor receives essentially what was bargained for); *id.* at 342 (automatic stay does not affect rights of creditors but instead simply stays enforcement of those rights pending orderly

would have to be an amount equal, in *C1*'s eyes, to *C1*'s other investment opportunities for $50,000.[78] To achieve that equivalence, the amount would also have to be sufficient compensation for the risks of having outstanding a loan securing a debt owing from a person in *D*'s position. Included in any calculation of the "correct" level of this compensation should be the recognition that if *C1* is no longer the most efficient lender, *C1* may assign the loan contract and security to the lender who is. In that case, the level of compensation should be calculated on the basis of *C1* receiving $50,000 by such assignment (which *C1* could then invest in some venture in which she was the efficient lender). For that reason, indubitable equivalence ultimately requires only that *C1* be compensated on the basis of the market rate for secured loans to such a debtor.[79]

Despite this theoretical harmony, the indubitable equivalence standard ultimately is the device through which adherence to the creditors' bargain model is systematically ignored. The hypothetical satisfaction of an entitlement through a court-determined indubitable equivalent seldom achieves the results dictated by application of the creditors' bargain model,

examination of debtor's and creditor's rights); *In re* Anchorage Boat Sales, 4 Bankr. 635 (Bankr. E.D.N.Y. 1980) (secured creditor must receive compensation equivalent to having today amount equal to value of the collateral that could be reinvested); *see also In re* Alyucan Interstate Corp., 12 Bankr. 803, 807-09 (Bankr. D. Utah 1981) (adequate protection protects value of bargain); *In re* Graydon, 8 Bankr. 475 (Bankr. S.D. Fla. 1981) (general discussion of adequate protection); *cf. In re* Landmark at Plaza Park, Ltd., 7 Bankr. 653 (Bankr. D.N.J. 1980) (Bankruptcy Code § 1129(b) case discussing providing present value equivalence). *Contra In re* American Mariner Indus., 10 Bankr. 711 (Bankr. C.D. Cal. 1981) (undersecured creditor not entitled to compensation for loss of use of money during stay). The concept of indubitable equivalance described in the text of this Article appears to be consistent with Judge Hand's original use of the phrases "adequate protection" and "indubitable equivalence." He wrote:

> It is plain that "adequate protection" must be completely compensatory; and that payment ten years hence is not generally the equivalent of payment now. Interest is indeed the common measure of the difference, but a creditor who fears the safety of his principal will scarcely be content with that; he wishes to get his money or at least the property. We see no reason to suppose that the statute was intended to deprive him of that in the interest of junior holders, unless by a substitute of the most indubitable equivalence.

In re Murel Holding Corp., 75 F.2d 941, 942 (2d Cir. 1935). *See also In re* New York, New Haven & Hartford R.R., 147 F.2d 40, 48 (2d Cir. 1945) (fair and equitable treatment requires banks to be classified as secured creditors to extent that they would have realized on their collateral had they not been restrained from selling).

78. Payment of interest on the loan up to the value of the collateral, therefore, seems called for as a matter of "indubitable equivalence," even if it were not directly recoverable under Bankruptcy Code § 506(b). *In re* Anchorage Boat Sales, 4 Bankr. 635 (Bankr. E.D.N.Y. 1980). The unsecured creditors are, in effect, "redeeming" from *C1* her right to receive $50,000 today because to do so is *pareto superior*. *See supra* p. 870 & note 61. This reasoning is not limited to the case of secured creditors. If any bankruptcy case involved sufficient assets to pay the unsecured creditors in full and still return something to the equity interests, the unsecured creditors should likewise be paid for the "redemption" of *their* individual rights (of execution and so forth) on the ground that to do so is *pareto superior*. In this situation, interest is expressly allowed, *see* Bankruptcy Code § 726(a)(5), although the "legal rate of interest" is probably inadequate. Absent a case in which there would otherwise be assets available to the equity interests, paying interest on the unsecured creditors' claims would be a gesture without meaning, as it would have no inter-class consequences.

79. Plus the costs associated with assignment. These costs may, of course, be quite high.

principally because the current standard requires no reference to available market-pricing mechanisms.[80] Even cases discussed with approval in congressional reports illustrate the inadequacy, in creditors' bargain terms, of the indubitable equivalence standard as applied.[81]

It is likely, therefore, that the compensation that is deemed to be "adequate protection" will rarely provide the secured creditor with the indubitable equivalent of realizing, at the point of bankruptcy, the market value of the item in which that creditor has a security interest.[82] This has two consequences. First, a secured creditor with knowledge of the increased risk of undercompensation at the time of making a loan will be expected to charge the debtor for this risk. This will lead to an increase in the cost of secured credit.[83] Second, it may lead to a distorted evaluation of the relative merits of reorganization versus piecemeal liquidation. For example, if the "going concern" value of the printing press, when used in conjunction with *D's* business, is $49,000 (and, hence, the going concern

80. It is possible, of course, to overcompensate the secured creditor as well. But it seems safe to say that secured creditors rarely do better in the bankruptcy process than they do in the marketplace. *See* Blum, *The Law and Language of Corporate Reorganization*, 17 U. CHI. L. REV. 565 (1950); Scott, *Bankruptcy, Secured Debt, and Optimal Capital Structure*, 32 J. FIN. 1, 14 (1977); *see also infra* note 81 (discussing *In re Bermec Corp.* and *In re Yale Express System*); *cf.* Kronman, *Specific Performance*, 45 U. CHI. L. REV. 351 (1978) (in case of "unique" goods, uncertainty may impose "an unacceptably high risk of undercompensation on the injured promisee").

81. The court in *In re* Yale Express System, 384 F.2d 990 (2d Cir. 1967), refused to allow Fruehauf Corporation, a secured creditor, either to take possession of its collateral (trailers and truck bodies) or to collect rental payments during the reorganization of Yale Express System despite the fact that the collateral was depreciating. Instead, Fruehauf was deemed protected since "the trustee has offered to fix the value of the security interest claimed by Fruehauf so that its position in any reorganiztion will be unaffected by possible depreciation." 384 F.2d at 992. This case was cited approvingly by H.R. REP. NO. 595, *supra* note 11, at 338-40. Commentators, however, have pointed out the inadequacy of this solution, because Fruehauf was not compensated for the risk that no viable reorganization would emerge. Murphy, *Restraint and Reimbursement: The Secured Creditor in Reorganization and Arrangement Proceedings*, 30 BUS. LAW. 15, 33-46 (1974); Rosenberg, *Beyond Yale Express: Corporate Reorganization and the Secured Creditor's Rights of Reclamation*, 123 U. PA. L. REV. 509, 528-29 (1975). Nor was Fruehauf to be compensated for the interest that was accruing because of the delay itself. The court in *In re* Bermec Corp., 445 F.2d 367 (2d Cir. 1971), cited approvingly by S. REP. NO. 989, *supra* note 76, at 53-54, granted Pacar Financial Corporation, a secured creditor, payments equal "to the actual current depreciation of the value of the rolling stock" in lieu of a right to repossess or a right to collect rentals during Bermec's reorganization. *In re* Bermec Corp., No. 71-B-291 (Bankr. S.D.N.Y.), *aff'd*, 445 F.2d 367 (2d Cir. 1971). Yet this surely fails to provide the "indubitable equivalent" of an immediate right to foreclose: it gives, for example, no compensation for the lost time value of money. Indeed, at least as a first approximation, the rental amounts were a good surrogate for depreciation plus interest on the loan.

82. *See In re* El Patio, Ltd., 6 Bankr. 518 (Bankr. C.D. Cal. 1980) (applying the adequate protection test of the Bankruptcy Code). The largest problem in *El Patio* is a clear under-estimation of the value of the collateral because of a refusal to consider the possibility (apparently substantial at the time of the decision) that a regulatory approval would markedly increase the value of the collateral. *Id.* at 520-21. The court did, however, properly allow the secured party to collect rentals on the property. *Id.* at 522. *Cf.* Butner v. United States, 440 U.S. 48 (1979) (entitlements to rentals decided under state law).

83. While there will also be a decrease in the cost of unsecured credit, as those creditors also adjust for their decreased risk, presumably some of the advantages of secured credit would be lost in the process. *See* Schwartz, *supra* note 53, at 34.

value of *D*'s business is $59,000), it would be sensible to sell the printing press for $50,000. This move would increase the value of *D*'s estate by $1,000. But if the unsecured creditors[84] are able, by keeping the printing press and giving *C1* "inadequate protection," to reduce the expected value of *C1*'s claim to $48,500, they have an incentive to keep the printing press and try to reorganize *D*'s business, even though the creditors as a whole would be better off by selling the printing press and going ahead with a piecemeal liquidation.[85] The threat of giving *C1* such inadequate protection, in reality, becomes a "bargaining chip" in the unsecured creditors' hands—they can attempt to use it to extract from *C1* some of the $1,500 in benefits that she would get from a piecemeal liquidation by having *C1* "bribe" them to agree to such a liquidation. This scenario involves complex, costly, and potentially intractable negotiations in order to decide which form of collective proceeding to use.[86] A secured creditor, moreover, to avoid being forced to bribe the unsecured creditors, may also engage in strategic behavior by, for example, realizing on the collateral earlier than would be collectively optimal, so as to "beat out" the unsecured creditors and foil their ability to do this.[87]

Avoidance of these "eve-of-bankruptcy" negotiations resulting from attempted advantage-taking and concomitant threats of inefficient uses of the bankruptcy process, or strategic behavior to avoid such advantage-taking would, therefore, appear preferable. This could be accomplished by the creditors agreeing, *ex ante*, among themselves, to respect the value of *C1*'s non-bankruptcy entitlements by means of true "adequate protection" (probably by resort to a market-pricing mechanism). But, for practical reasons,[88] it will be virtually impossible to have all of a debtor's creditors who are in existence at the time of these "eve-of-bankruptcy" negotiations actually reach this result by prior consensual agreement. Consequently, the failure of bankruptcy law itself to provide, as an "off the rack" rule,[89] the sort of agreement that one would predict would be reached if such an

84. The unsecured creditors in a Chapter 7 proceeding may be represented by a trustee elected by unsecured creditors (excluding creditors with interests "materially adverse" to other unsecured creditors). Bankruptcy Code § 702.

85. *See* Posner, *supra* note 61, at 421-24; *see also* Ang & Chua, *supra* note 18; White, *supra* note 44, at 563-64 (management, equity holders, and large lenders may keep failing firm operating because of possibilities for redistribution away from long-term creditors and towards themselves, rather than because continued operation is best use of firm's assets).

86. *See supra* p. 865. Some of these difficulties may be alleviated if the trustee is the sole negotiator for the unsecured creditors.

87. *See supra* pp. 862-65 (discussing the problems inherent in a "race").

88. *See supra* p. 866.

89. The term "off the rack" rule comes from Goetz & Scott, *Liquidated Damages, Penalties, and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach*, 77 COLUM. L. REV. 554, 588 n.87 (1977); *see also* Easterbrook & Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698 (1982).

ex ante agreement were possible, leads to an inefficient system. The point is not so much that secured creditors are unable to adjust for the bankruptcy result but that this adjustment process may lead to a sub-optimal amount of secured credit, with correspondingly greater credit costs for the debtor.[90]

It is particularly puzzling that bankruptcy law not only does not postulate a reason for straying from the creditors' bargain model with respect to this *ex post* reallocation, but does not even appear to sanction the reallocation at all, except in an under-the-table fashion. In retrospect, the related concepts of "adequate protection" and "indubitable equivalence" suffer not so much from theoretical disharmony with the creditors' bargain model, as from inadequate statutory firmness that permits—perhaps nurtures—the belief among bankruptcy judges that adequate protection can be granted without reliance on market-pricing mechanisms. In this respect, it tracks the theoretical consistency but practical disharmony of the absolute priority rule.[91] In both instances the gulf between theory and practice seems to stem principally from the under-utilization of available market devices for providing realistic adequate protection.

B. *Concluding Comments on Non-Temporal Bankruptcy Entitlements*

The indubitable equivalence standard provides protection for holders of secured claims that in theory is entirely consistent with the creditors' bargain model. And insofar as non-temporal questions are concerned, the Bankruptcy Code remains faithful to this theoretical protection for a secured creditor.[92] The Bankruptcy Code starts with a mandate that a secured creditor be granted "adequate protection" from the effects of the automatic stay during the time that the property is held by the bankruptcy estate.[93] At any sale of property pursuant to Bankruptcy Code section 363, a secured creditor's lien will follow the collateral that secures the loan unless "the price at which such property is to be sold is greater than the aggregate value" of the lien, or unless the secured creditor can "bid in"

90. *See supra* note 85; *see also supra* p. 876 (discussing inefficient bankruptcy decisions that may result from "eve of bankruptcy" negotiations).

91. For a discussion of the gap between the absolute priority rule as articulated and as applied, see Blum, *supra* note 80; Brudney, *The Investment Value Doctrine and Corporate Readjustments*, 72 HARV. L. REV. 645, 679 (1959); Friendly & Tondel, *The Relative Treatment of Securities in Railroad Reorganizations Under Section 77*, 7 LAW & CONTEMP. PROBS. 420 (1940); Note, *Absolute Priority Under Chapter X—A Rule of Law or a Familiar Quotation?*, 52 COLUM. L. REV. 900 (1952).

92. The protection provided by the indubitable equivalence standard may be inconsistent with the Bankruptcy Code's treatment of other state-created entitlements, as well as of temporal extensions of credit. *See infra* Parts III and IV.

93. Bankruptcy Code §§ 361, 362(c)-(d); *see supra* note 77.

the lien at the sale.[94] If there has not been such a sale during the course of the proceeding, Bankruptcy Code section 725 requires the trustee to dispose of secured property (and hence of secured claimants) before any distribution to priority claimants and other unsecured creditors.[95] Finally, in reorganizations, Chapter 11 bases payments, in present value terms, on a minimum of Chapter 7 liquidation entitlements.[96] Nothing in these rules is theoretically inconsistent with the basic creditors' bargain model previously sketched.

III.

. . .

94. *See* Bankruptcy Code § 363(f)(3), (k).

95. Bankruptcy Code § 725. If the loan is currently due and owing, these provisions will supply (in value-equivalent terms) the level of protection for such creditors in Chapter 11 as well. Bankruptcy Code § 1129(a)(7)(A)(ii). We will shortly have to deal with divergent treatment of creditors in Chapter 7 and Chapter 11, but this divergence only occurs when temporal (*i.e.*, non-currently due) extensions of credit are involved.

96. Bankruptcy Code § 1129(a)(7)(A)(ii).

. . .

IV. The De-acceleration Principle, State-Created Priorities, and Bankruptcy Statutory Liens

We have explored the uncertain justifications underlying the application of bankruptcy's de-acceleration principle[202] to consensually-created arrangements. The de-acceleration principle, however, has another, quite separate, role to play in the bankruptcy process. Beginning in the late 1930's, changes made to the Bankruptcy Act of 1898[203] have consistently moved in the direction of refusing to recognize attempts by a state to elevate the claims of any one type of claimant in bankruptcy through the device of either a state-created priority[204] or a statutory lien effective only in bankruptcy (or a similar non-bankruptcy occurrence).[205] These at-

200. *See supra* notes 179 & 196.

201. The Bankruptcy Code is quite insistent on overriding this property rule. *See* Bankruptcy Code §§ 365(k), 727(b), 1141(c), (d). While Bankruptcy Code § 365(f)(2)(B) does require that adequate assurance of future performance by the assignee be provided prior to any assignment, this is not a substitute for the property rule. Rather, it reflects a general rule of contract law regarding delegation. Under this general rule, such assurances must be provided even where the original obligor remains ultimately liable. *See* U.C.C. § 2-210(1), (5) (1972); Funk v. Baird, 70 N.D. 396, 295 N.W. 87 (1940).

202. *See supra* pp. 879-881.

203. Chandler Act, ch. 575, 52 Stat. 840-940 (1938). *See* S. REP. NO. 1159, 89th Cong., 2d Sess. (1966); *In re* Federal's, 553 F.2d 509 (6th Cir. 1977); *In re* Telemart Enterprises, 524 F.2d 761 (9th Cir. 1975).

204. "Priorities are to be distinguished from property rights. . . . The priority creditor . . . has no property right, merely a statutory advantage to be given effect on distribution." J. MACLACHLAN, *supra* note 1, at 145. A brief history of the demise of state-created priorities is contained in *Analysis of H.R. 12889,* 74th Cong., 2d Sess. 201 (1936); 3A W. COLLIER, *supra* note 12, at 2053-54.

205. The 1938 legislation, which dropped the bankruptcy priority for state-created priorities, also expressly validated state-created statutory liens, but declared that they would be paid after administration and wage priorities. Chandler Act, ch. 575, § 67c, 52 Stat. 877 (1938). In 1952, an amendment struck down all statutory liens that attached to personal property and were not accompanied by "possession, levy, sequestration or distraint." Act of July 7, 1952, ch. 579, 66 Stat. 420. When this test proved unsatisfactory, Congress amended § 67c of the Bankruptcy Act of 1898 to strike down statutory liens that became "effective upon the insolvency of the debtor, or upon distribution or liquidation of his property, or upon execution against his property levied at the instance of one other than the lienor" or were not "perfected or enforceable at the date of bankruptcy against one acquiring the rights of a bona fide purchaser from the debtor on that date . . . ." 11 U.S.C. § 107c(1)(B) (1975) (repealed prospectively, effective October 1, 1979); *see* Kennedy, *Statutory Liens in Bankruptcy,* 39 MINN. L. REV. 697, 703-22 (1955). *See generally* Marsh, *Triumph or Tragedy? The Bankruptcy Act Amendments of 1966,* 42 WASH. L. REV. 681, 713-27 (1967).

tempts by a state were felt to contradict, in a fundamental way, the notion that "equality is equity." Initiation of a bankruptcy proceeding is not, under this view, a reason for calling forth a different set of allocative entitlements by any creditor or class of creditors than existed outside of bankruptcy. The refusal to recognize a state's attempt to influence directly bankruptcy's allocation rules has raised few, if any, eyebrows. Indeed, the opposite has occurred: the purported application of the de-acceleration principle has sometimes struck down state-created entitlements that, instead of suffering from the "bankruptcy only" problems of state-created priorities or bankruptcy statutory liens,[206] appeared to be all but indistinguishable from ordinary non-bankruptcy entitlements.[207]

What, if anything, is wrong with state-created priorities and bankruptcy statutory liens?[208] Surprisingly little critical attention has been directed to this inquiry.[209] Two questions, however, seem to be raised. First, is there any justification at all for a state's attempt to prefer a given type of creditor in bankruptcy? Second, if there is a justification for such an attempt, is there any reason to believe that the use of state-created priorities and bankruptcy statutory liens is not a proper way to implement those desired preferences?

Several reasons, other than simply political expedience or special interest group pressure, may explain a state's desire to provide a level of protection to certain types of claimants, instead of leaving the issue to the area of consensual security interests. First, non-consensual claimants, such

206. Hereinafter, statutory liens effective only in bankruptcy will be referred to as "bankruptcy statutory liens," to distinguish them from statutory liens of a normal sort, which have a recognized existence and validity in and out of bankruptcy.

207. *See infra* note 228; *see also* MacLachlan, *Improving the Law of Federal Liens and Priorities*, 1 B.C. IND. & COM. L. REV. 73 (1959). Since the date of these enactments, few statutes involving true state-created priorities or bankruptcy statutory liens have been tested. A possible example of such a statute was MASS. GEN. LAWS ANN. ch. 254, § 31 (West 1961). The statute "causes a lien to arise in favor of materialmen upon the adjudication in bankruptcy of certain contractors." N.W. Day Supply Co. v. Valenti, 343 F.2d 756 (1st Cir. 1965) (declaring the statute invalid in bankruptcy); *see also* Strom v. Peikes, 123 F.2d 1003 (2d Cir. 1941).

There has also been a lengthy debate over the validity of U.C.C. § 9-306(4) (1972) under these provisions. *See* Countryman, *Code Security Interests in Bankruptcy*, 4 U.C.C. L.J. 35, 45-49 (1971); Henson, *"Proceeds" Under the Uniform Commercial Code*, 65 COLUM. L. REV. 232 (1965).

208. With respect to ipso facto clauses, which are also directed specifically at the bankruptcy process, we were able to rely on a contractual model to tentatively justify their existence. *See supra* pp. 887-892. Such an explanation is obviously not available with respect to state-created liens and priorities.

209. Most commentators note, approvingly, that the refusal to recognize state-created priorities or bankruptcy statutory liens promotes national uniformity and furthers the goal of creditor equality by striking down state interference directed at the bankruptcy process. *See, e.g., Analysis of H.R. 12889*, *supra* note 204, at 201; 3A W. COLLIER, *supra* note 12, at 2053-54; Kennedy, *supra* note 205, at 699-70; Comment, *Statutory Liens Under Section 67c of the Bankruptcy Act: Some Problems of Definition*, 43 TUL. L. REV. 305 (1969); Note, *Statutory Liens Under Section 67c of the Bankruptcy Act*, 62 YALE L.J. 1131 (1953). These reasons are unsatisfying in light of the numerous instances of deference to non-bankruptcy entitlements. *See In re* Telemart Enterprises, 524 F.2d 761 (9th Cir. 1975).

as tort creditors, pose special problems to which application of a consensual model seems largely inapplicable. Should a state believe that a certain level of deterrence is desirable to protect against certain behavior, a system of priority entitlements to "victims" of that behavior may help the state achieve that goal, at least with respect to some types of torts.[210] By giving non-consensual tort claimants priority over general unsecured creditors, those general creditors (whose chance of repayment has been made more risky than under a proportional payment scheme) will have an increased incentive to monitor the debtor to reduce the likelihood of such torts occurring in the first place.[211] Second, a state may have reason to believe that, with respect to a particular class of claimants, there is systematic advantage-taking of them by other creditors, because of an informational disparity or other reasons.[212] Intervention by a state, in giving this class of claimants priority entitlements, may be a way of addressing a form of market inefficiency.[213] Finally, the state is itself likely to be a claimant (oftentimes, as in its taxing capacity, a non-consensual one), in which case the level of priority it provides is a part of the cost calculus it has decided on in setting its rates (whether tax rates or otherwise).

There may be inefficient interferences by a state as well, due to politically-motivated causes.[214] But the relevant point is that state interventions may sometimes be efficient or otherwise justified and, in any event, are generally recognized in bankruptcy. The bankruptcy law upholds state-created entitlements unless the entitlement is directed specifically at the bankruptcy process.[215] Unless there is some reason to believe that inefficiently motivated instances of state interference are more common with

210. *Cf.* Posner, *The Rights of Creditors of Affiliated Corporations*, 43 U. CHI. L. REV. 499, 506 (1976) (discussing involuntary extensions of credit in negotiation-based model). To be sure, insurance may also serve some of these goals. But it is unlikely that insurance will be able to curb that behavior as well as a priority rule. Therefore, even if one were to have an insurance scheme, one might nonetheless want to have a priority scheme as well.

211. The issue of priority among creditors that is raised by a state-created priority or bankruptcy statutory lien does not deal directly with incentives to have the debtor behave in a socially desirable fashion. Equity-holders come after creditors, whether or not a state-created priority is created or recognized. (Indirectly, of course, there are incentives arising from monitoring and the cost of credit.) Direct incentives are created by such things as removing the discharge right with respect to certain debts. *See* Bankruptcy Code § 523(a)(6) (non-discharge of debts resulting from intentional torts); *In re* Shawsheen Dairy, 47 F. Supp. 494, 498 (D. Mass. 1942); Note, *Tort Claims and the Bankrupt Corporation*, 78 YALE L.J. 475, 479-80 (1969).

212. *See* Schwartz, *supra* note 53, at 30-33.

213. The case for this form of intervention may be difficult to make. But once a state has made such a determination, the justifications for second-guessing by a federal bankruptcy rule may likewise be slender. *See* Eisenberg, *supra* note 16, at 957-58; Schwartz, *supra* note 53, at 36.

214. *See, e.g.*, R. POSNER, *supra* note 35, at 404-07; Peltzman, *Towards a More General Theory of Regulation*, 19 J.L. & ECON. 211 (1976); Posner, *Theories of Economic Regulation*, 5 BELL J. ECON. 335 (1974).

215. *See* Bankruptcy Code § 545 (distinguishing between valid and invalid statutory liens); 124 CONG. REC. H11,114 (Sept. 28, 1978).

respect to state-created priorities or bankruptcy statutory liens than with respect to other forms of state-created entitlements, inquiry into the validity of an entitlement should first be directed at the *form* of the intervention. The relevant inquiry is whether there is anything particularly undesirable about state-created priorities or bankruptcy statutory liens that justifies the blanket prohibition against them in the bankruptcy process and that distinguishes them from other forms of non-bankruptcy entitlements.

State-created priorities and bankruptcy statutory liens attempt to direct allocative entitlements in bankruptcy, but in this respect they are indistinguishable from other types of non-bankruptcy entitlements routinely recognized in bankruptcy.[216] The difficulty with state-created priorities and bankruptcy statutory liens is that they suffer from the same "bankruptcy incentive" problems previously discussed in connection with ipso facto clauses.[217] Since the rules of the bankruptcy process set the minimum level of entitlements against which non-bankruptcy "workouts" must be evaluated,[218] a creditor enjoying a state-created priority effective only in bankruptcy will demand to be treated similarly outside of bankruptcy as well.[219] A creditor with such a priority might push for initiation of the bankruptcy process when it is not in the aggregate interests of the creditors to do so.[220] But because a creditor with a state-created priority does not necessarily have that priority right outside of the bankruptcy process, he must negotiate with the other creditors in order to receive that preferential treatment. These negotiations, because they are likely to involve a number of unsecured creditors, may involve free-rider problems that will not only make negotiations costly but also may lead ultimately to an inefficient use of the bankruptcy process.[221] Moreover, unlike the case of consensually negotiated agreements, there is no persuasive reason to believe that this state of affairs involves policing or other sorts of efficiencies that may justify retention of the system.[222] Therefore, at our creditors' bargain

216. Occasionally, a state-created priority will be distinguished from a lien on the ground that its holder is paid only after all "true" lienholders have been paid, and therefore is somewhat suspicious. *See* Comment, *supra* note 209. From the perspective of general creditors, however, the effect is the same: the person with the entitlement must be paid in full first. *See* Strom v. Peikes, 123 F.2d 1003, 1006 (2d Cir. 1941).

217. *See supra* pp. 890-892.

218. *See supra* p. 867.

219. Pre-bankruptcy payments to the holder of a state-created priority would have added protection against attack by the trustee. Bankruptcy Code § 547(b)(5) provides that a trustee may not avoid such a transfer unless it "enables such creditor to receive more than such creditor would recieve if (A) the case were a case under chapter 7 of this title; (B) the transfer had not been made; and (C) such creditor received payment of such debt to the extent provided by the provisions of this title." *Id.*

220. *See supra* p. 876.

221. An inefficient use of the bankruptcy process will occur if the negotiations break down. *See supra* pp. 890-891.

222. *See supra* pp. 887-892. Since the priority rights of these people are not fixed until bank-

meeting, if it were clear that a particular creditor was going to receive a state-created priority or bankruptcy statutory lien, we would expect the creditors as a group to view it as in their interest to give that creditor a lien that is valid both in and out of bankruptcy. Refusing to recognize state-created priorities and bankruptcy statutory liens simply requires a state that wishes to give someone a "priority" to do so by means of an entitlement that is good in and out of bankruptcy.

The puzzle with respect to state-created priorities and bankruptcy statutory liens is why a state would ever enact an entitlement that is good only in bankruptcy.[223] Part of the answer is that, at least based on reported cases from the last twenty-five years or so, few such statutes have been passed.[224] Ironically, bankruptcy law's failure to recognize entitlements only good in bankruptcy may be viewed as justified, not on the ground that it is protective of something fundamental to the bankruptcy process itself, or even of general unsecured creditors, but rather on the ground that it protects claimants in the aggregate (and ultimately the debtor) against presumptively illogical actions by state governments, which accrue to no one's advantage.[225]

From another perspective, however, the greater irony may be that bankruptcy law's obsession with formulating a rule on the subject may have done more harm than good. For while the prohibition on state-created entitlements good only in bankruptcy may occasionally strike down an aberrant state statute designed to create an irrational form of entitlement, the presence of the federal rule has, meanwhile, led to substantial confusion in its application.[226] For if an entitlement is enforceable both in

ruptcy (or similar event) they do not enjoy the protections of a first-in-time rule such as exists in Article 9 of the U.C.C. and which is a necessary part of the efficiencies (if any) of that system. *See* Jackson & Kronman, *supra* note 53, at 1161-64.

223. Even assuming that the legislative process results in inefficient decisions some of the time, it is not clear what group would lobby for a state-created priority instead of, say, a full status lien or what group would oppose full status lien treatment (if the choice were solely between that and a state-created priority). Prior to 1938, when the bankruptcy laws contained an open invitation to create state-created priorities, it is conceivable that this was viewed as a safe way to proceed.

224. *See supra* note 207. While there have been several cases striking down state-created priorities and bankruptcy statutory liens, these cases have normally not involved "bankruptcy incentive"-type statutes, *see infra* note 228. Even a statute such as U.C.C. § 9-306(4) (1972) would not create a "bankruptcy incentive" on the part of a secured creditor, as that section usually gives such a secured creditor less than he would get outside of bankruptcy. 2 G. GILMORE, *supra* note 4, at 1337-38 ("§ 9-306(4) is the reverse of . . . [a state-created priority or bankruptcy statutory lien], since it sharply cuts back the secured party's rights when insolvency proceedings are instituted"). Ironically, U.C.C. § 9-306(4) may be a statute that gives a "bankruptcy incentive" to unsecured creditors in the event of insolvency. This result might seem to be equally undesirable.

225. The creditors as a whole are not benefited because the costs of such a system are greater than the costs associated with a full-status lien system, nor does any discernable group appear to be benefitted. *See supra* note 223.

226. Indeed, the pre-1938 explicit recognition of state-created priorities by the Bankruptcy Act of 1898 may itself be the root of the evil. *See supra* note 223.

and out of bankruptcy, there is no reason, stemming from the justifications underlying condemnation of state-created priorities or bankruptcy statutory liens, to refuse recognition of the entitlement.[227] The failure to recognize this simple point has led to a variety of confusing and ill-considered decisions by appellate courts.[228] The rule against state-created priorities and bankruptcy statutory liens, if correctly understood, may be harmless and even occasionally beneficial. But since the reasons for the rule are misperceived, the resulting misapplications may engender more uncertainty than continuation of the rule is worth.[229]

227. There would be an independent reason to refuse recognition of the entitlement if it was decided that the state intervention was otherwise inefficient. *See* Schwartz, *supra* note 53, at 33-37. Few, if any, judicial decisions even reach this question, much less have adequate data on which to base a reasoned decision to strike down the state entitlement.

228. The Ninth Circuit, for example, has had an extremely difficult time distinguishing between legitimate state preferences and invalid state-created priorities and bankruptcy statutory liens. This difficulty is likely to increase credit costs because it creates uncertainty. A California statute provided that all the assets of an agent selling checks and money orders would be impressed with a trust in favor of the principal and the trust would remain until the amount due to the principal was paid. The Ninth Circuit, after noting that this would "relieve check and money order principals from the burden of tracing commingled funds," concluded that:

> Giving effect to the provisions of [the California statute] . . . would open the door to state creation of priorities in favor of various classes of creditors by labeling such priorities as "trusts." This would tend to thwart or obstruct the scheme of federal bankruptcy.

Elliott v. Bumb, 356 F.2d 749, 759-55 (9th Cir.), *cert. denied*, 385 U.S. 829 (1966). The holding misperceives the nature of the inquiry. All state-created entitlements act in favor of some group of creditors, but bankruptcy law generally recongizes them nonetheless. The inquiry, which *Elliott v. Bumb* ignored, is whether the statute applied only in bankruptcy. Without further inquiry into the efficiencies of a *particular* application of statutory trust doctrine there is nothing to suggest that these impressed trusts should be considered contrary to bankruptcy policy. The legislative history of the Bankruptcy Code recognizes, in discussing "tax trusts," that there is little difference between a "trust" and a "lien." 124 CONG. REC. H11,114 (Sept. 28, 1978). Similarly, in *In re* Leslie, 520 F.2d 761 (9th Cir. 1975), the Ninth Circuit stopped at an examination of a label, although the state statute in question is of doubtful utility given that it used a priority scheme that seems flawed. *See supra* pp. 904-05. The efficient solution—although not one open to the Ninth Circuit—would have been to strike the statute down *in toto. See* Eisenberg, *supra* note 16. In *Leslie*, California law had established a system of priorities for payment of creditors of a liquor dealer upon transfer of a liquor license. Citing Grover Escrow Corp. v. Gole, 71 Cal. 2d 61, 65, 453 P.2d 461, 463, 77 Cal. Rptr. 21, 23 (1969), the Ninth Circuit stated that the statute established "statutory priorities, not statutory liens," and struck the scheme down as inconsistent with the Bankruptcy Act of 1898. It is true that *Grover Escrow Corp.* invoked the word "priority," but it is also clear that it meant "lien":

> The precise issue is whether that section precludes a creditor from establishing priority over the escrowed proceeds of such a transaction by attachment or garnishment. We conclude that section 24074 represents a mandatory and exclusive scheme for payment of creditors of liquor license transferors, giving creditors who comply with that section priority over those who employ any form of levy on the proceeds.

71 Cal. 2d at 62, 453 P.2d at 461, 77 Cal. Rptr. at 21. Again, why is *this* state-created entitlement bad, when others are upheld? Since this statute was applicable both in and out of bankruptcy, nothing in the Bankruptcy Act of 1898 condemned its use.

229. *See* 2 G. GILMORE, *supra* note 4, at 1287 ("As appellate judicial review becomes more sporadic, it also becomes more unpredictable. . . . If [a federal judge] exercises his own judgment in a bankruptcy case, the result may well be aberrational.") (footnote omitted).

Conclusion

The bankruptcy rules governing state-created priorities and bankruptcy statutory liens reflect a normative view of the world that is consistent with the creditors' bargain model presented in this Article. But the application of those rules to particular facts seems haphazard, as the application is usually uninformed by any consistent normative model. At other places the Bankruptcy Code itself seems to deviate, without explanation, from a model that seems to illuminate and justify much of the bankruptcy process.

Bankruptcy law has, for too long, been molded and interpreted without any systematic questioning or understanding of its normative role in a larger legal, economic, and social world. This Article asserts that not only is there a coherent normative theory justifying a bankruptcy system that deals with inter-creditor questions, but also that we would be better able to formulate and apply principled bankruptcy rules if we would give systematic and critical attention to the impact of those rules on non-bankruptcy entitlements. That the answers to creditor-allocation questions posed by the bankruptcy process will often be difficult does not excuse the failure of the statutory drafters, bankruptcy judges, and the bankruptcy bar from even identifying the questions they purport to be answering.[230] Greater attention to the relevance of the creditors' bargain model in formulating the non-discharge related rules of the bankruptcy process appears to be a promising, and necessary, beginning to a principled development of our bankruptcy laws.

230. *See* Eisenberg, *supra* note 16, at 998:

> Although a Congress fully cognizant of the issues addressed here might nevertheless adhere to its existing reform decisions, it ought to do so knowing the costs of poor coordination with nonbankruptcy law. Unfortunately, the new act not only reflects these costs, but to some degree reinforces bankruptcy law's isolation, a development that can be expected to generate future discontinuities between bankruptcy and nonbankruptcy law.

Id.