BANKRUPTCY CONTROL OF THE RECOVERY PROCESS

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An anniversary is a useful mnemonic. In the present instance, it reminds us to step back from the hurtling present and reflect about the bankruptcy process at a more fundamental level. Professor Adler's thoughtful paper does just that.[1] His paper addresses both aspects of bankruptcy law: business and consumer. This comment will be limited to the business bankruptcy analysis he presents, leaving the consumer bankruptcy point for another day.[2] One approach to gaining perspective on bankruptcy basics is to see our bankruptcy law through the lens of comparative study of commercial law around the world. That will be my primary method in this comment.

I understand Professor Adler's argument to be as follows. He agrees with Professors Baird and Rasmussen that the recovery process should be governed by

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[1] Barry E. Adler, *Bankruptcy Primitives*, 12 AM. BANKR. INST. L. REV. 219 (2004) [hereinafter *Bankruptcy Primitives*] (discussing past, present and future of bankruptcy law, broken down into its fundamental features).

[2] In both the consumer and business contexts, Professor Adler's paper makes a number of interesting observations, far more than I could address in a comment, so I limit myself to a few issues that seem to me to be basic to business bankruptcies.

contract, although he would privatize it even more thoroughly.[3] He doubts their claim that creditor control of large bankruptcies has been or will shortly be fully achieved.[4] He disputes that such control of the recovery process is desirable[5] and he fears that too many companies are still going unexecuted.[6] He appears to adhere to his long-standing proposal for a Chameleon Equity approach.[7]

Because he believes that an automatic internal sale (Chameleon Equity) would be better than the present bankruptcy system, he concludes that the recovery *process*, in or out of bankruptcy, is unimportant. It follows for him that the only interesting theoretical questions in our field relate to priority. The reason that priority questions remain important is that there are a few priority questions as to which contracting cannot produce satisfactory answers. A narrow exception to the rule of private contract should be invoked, he argues, as to tort victims and perhaps certain other involuntary or weakly adjusting creditors as well.[8] Thus the real issues

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[3] *Bankruptcy Primitives*, *supra* note 1, at 236–39 (discussing importance of freedom of contract for both individual and corporate debtors).

[4] I agree with him that the empirical claims made by Professors Baird and Rasmussen are overbroad. They suggest that most, if not all, public company bankruptcies are now lender controlled. *See* Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751, 752, 779 (2002) [hereinafter *The End of Bankruptcy*]. Like Professor Adler, I think it is likely that more such bankruptcies are lender controlled (Baird and Rasmussen might say "creditor controlled"), but many are not. I also dissent from the notion that business bankruptcies of smaller, nonpublic companies are unimportant. *See also id.* at 752 ("For the vast majority of firms in financial trouble, the traditional corporate reorganization has become increasingly irrelevant.").

[5] *Bankruptcy Primitives*, *supra* note 1, at 224–25 (arguing flaws in creditor controlled bankruptcy process).

[6] *Id.* at 222 (stating concern about new world of traditional chapter 11 in that judicial supervision may produce too little liquidation). I suspect he is correct that creditors in control will sometimes seek reorganization when it serves their interests, whether or not it is economically efficient to do so. Eastern Airlines, a reorganization failure fully supported by the leading creditors, remains the most spectacular example. Professor Adler is also concerned that under the present system liquidation might be taking place too often. *Id.*

[7] *See* Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 STAN. L. REV. 311, 319–23 (1993) [hereinafter Adler, Chameleon] (discussing market-based pre- and post-insolvency proposals as potentially improved methods of maximizing value for creditors); Barry E. Adler, *A Theory of Corporate Insolvency*, 72 N.Y.U. L. REV. 343, 365-66 (1997) (discussing the benefits of the Chameleon Equity approach and suggesting that all court-supervised or collective approaches may have excessive costs). His 1997 article and his current paper only raise questions about collective action, rather than proposing alternatives. His conclusion in 1997 was:

> In a world free from legal impediment, investors *might* design a firm's capital structure so that insolvency would be a strong signal of a firm's inviability. Consequently, corporate bankruptcy law and proposed alternative collective procedures remain without *certain* justification. This is so because creditor inability to act collectively *may* not be a problem, but a solution.

Id. at 382 (emphasis added).

Neither paper disavows Chameleon Equity as a superior alternative to the current system, and the current paper does not put forward a preferred approach. Indeed, the current paper seems to reassert Chameleon Equity as the best currently articulated approach, saying, "Thus, as compared to possible alternatives (such as firms that include Chameleon Equity in their capital structures), chapter 11—new world or old—may be suboptimal." *Id.* at 233. Thus it is Chameleon Equity that I address in this paper.

[8] *Bankruptcy Primitives*, *supra* note 1, at 242–43 (stating policy favoring nonconsensual claimants would cause company's investors to internalize both costs and benefits of corporate activity).

in business bankruptcy law are the identification of these few areas where the law must determine the proper priority to be given to certain beneficiaries because the market place cannot do so justly or efficiently.

He seems to make two fundamental theoretical claims:

a) That he and others have described systems permitting the privatization of the recovery process by replacing bankruptcy law with contract, thus obviating the collective action function of bankruptcy law.

b) That priority rather than process lies at the center of bankruptcy theory.

I agree with Professor Adler's policy conclusions, but disagree with his conceptual foundation. Like him, I think that it is appropriate to use bankruptcy law to vindicate national commercial policy and I agree emphatically that a priority for tort victims, at least as against secured parties, is a desirable bankruptcy reform.[9] I do so despite the fact that I disagree with both of his conceptual claims. It is that conceptual disagreement I address in this comment. Because contractual privatization is Professor Adler's central premise, we need a term broader than "bankruptcy." I will use the phrase "recovery process" to include any system for management of a debtor's general default, whether public (bankruptcy) or private (contractual).

In summary, I will argue that management of the recovery process requires control of the debtor's assets and affairs. Control is the essential function of bankruptcy. Private control can be efficiently obtained only by a blanket lien on the debtor's assets, a "dominant security interest." But control of the recovery process through a dominant security interest may yield serious inefficiencies and undesired redistributional effects. This question of public or private control is the central one in bankruptcy theory. Priority, while important, is ancillary, a conclusion precisely opposite to Professor Adler's, but consistent with the views of Professor Tabb.[10]

As to the first conceptual claim, that contract is to govern the recovery process, in a recent article[11] I argue that contract bankruptcy cannot replace bankruptcy law unless the contract is coupled with a dominant security interest, which is a security interest in substantially all of the assets of the debtor.[12] The essence of the argument is simple. Without a dominant security interest, a system of contract bankruptcy

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[9] Priority over other unsecured creditors creates a more complicated picture, because unsecured creditors lack the control that secured parties may have. The result is that they cannot protect themselves by demanding insurance against tort recoveries as secured parties can do. As a consequence, they might have to over-discount (that is, over-charge) against a tort priority trump, producing serious inefficiencies. But all that is beyond this paper. The case for tort priority as against secured parties is well made by Professor LoPucki. *See* Lynn M. LoPucki, *The Unsecured Creditor's Bargain*, 80 VA. L. REV. 1887, 1921–23, 1952–54 (1994) (explaining security and property theory).

[10] Charles J. Tabb, *Of Contractarians and Bankruptcy Reform: A Skeptical View*, 12 AM. BANK. INST. L. REV. 259 (2004).

[11] Jay L. Westbrook, *The Control of Wealth in Bankruptcy*, 82 TEX. L. REV. 795 (2004) [hereinafter *Control of Wealth*].

[12] The paper notes the possibility that a strategic security interest in key assets might perform the same office, but that elaboration of the argument is not further addressed in that paper or here. *Id.*

cannot provide either the notice that is necessary to bind third parties or the required control of the debtor's assets. Both notice and control are essential to its success. With a dominant security interest, Article 9 and existing bankruptcy law provide both notice and control. A dominant security interest would make contract bankruptcy theoretically feasible, although the widespread adoption of such a system is both unlikely and undesirable.[13]

Professor Adler has presented proposals for systems of contract bankruptcy,[14] and several other eminent scholars have proposed systems of their own. These proposals can be pigeon-holed, somewhat roughly, under the rubrics "automated bankruptcy," "complete system bankruptcy," and "waiver of bankruptcy."[15] The school of thought that argues for privatization of the recovery process[16] through one or another of the contract approaches just mentioned can be described as "contractualism."[17] Like Professor Adler in his current paper, I will leave the details to the cited references. Suffice to say that each of these proposals would, in one way or another and to one extent or another, enforce contracts containing recovery-process procedures different from, and trumping, existing bankruptcy law. A key link in Professor Adler's analysis is an assumption that contracts of that sort might provide creditors with control of the recovery process from the start of the credit-extension process.[18]

My paper argues that mere contract cannot provide the essential requirements of a system governing the recovery process: notice to third parties and control of assets. The contractualists generally recognize the existence of the notice problem, but reject the position of Professor Jackson.[19] He argued that bankruptcy is a collective process precisely because a debtor has many creditors (not to speak of other important constituencies).[20] He concluded it is not possible to bind all of them by contract, so the law creates a collective procedure that mimics so far as possible the contract the creditors would negotiate if they could. In contrast, the

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[13] Professor Elizabeth Warren and I are have recently completed an article that draws on the data from the Business Bankruptcy Project to demonstrate the unfeasibility and inefficiency of contractualism because of the number and types of creditors found in typical business bankruptcies, including large ones. Elizabeth Warren & Jay L. Westbrook, *Contracting Out of Bankruptcy: An Empirical Intervention*, 118 HARV. L. REV. (forthcoming) (on file with authors) [hereinafter *Intervention*].

[14] *See* Adler, Chameleon, *supra* note 7.

[15] *Control of Wealth*, *supra* note 11, at 828–29; *see* ELIZABETH WARREN & JAY L. WESTBROOK, THE LAW OF DEBTORS AND CREDITORS 1029–42 (Aspen Law & Business ed., 4th ed. 2001).

[16] Thus the "recovery process" means any system, public or private, for redeploying or recapitalizing assets and distributing the resulting value.

[17] WARREN & WESTBROOK, *supra* note 15, at 1029–30.

[18] Professors Baird and Rasmussen seem clearly to believe this state has been achieved, at least in large public companies. *The End of Bankruptcy*, *supra* note 4, at 778 n.125.

[19] THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW (Harvard Univ. Press ed., 1986).

[20] *See generally* Elizabeth Warren, *Bankruptcy Policymaking in an Imperfect World*, 92 MICH. L. REV. 336, 354–56 (1993-94) (discussing non-creditor stakeholders).

contractualists contend that the problem of binding third parties can be overcome in various ways, [21] including "menus" in articles of incorporation.[22]

The problem of notice is far more complex and subtle than a reading of contractualist literature would suggest.[23] How should notice be given and what elements are necessary in that notice? Must it include the details of various bankruptcy systems contained in the debtor's contracts? How is the market to know which contract is currently binding on the debtor as to its possible default, so as to predict what procedures will be used in the recovery process? How would necessary changes in the articles of incorporation be agreed and then communicated? Without elaborating on all of these difficulties here,[24] the central point is that the problem of notice has been brilliantly solved by the Article 9 secured credit system; it is widely understood and universally applied within the United States. It would make no sense to spend another century working through some new system of notice, litigating each unanticipated point and then re-codifying, when a security interest with Article 9 notice solves the problem.[25]

Of course, such a bankruptcy-contract system would necessarily rest upon a dominant security interest in substantially all the assets of the debtor, because we could hardly have a variety of secured parties and their bankruptcy contracts managing a single debtor's general default. But a single secured party with a dominant security interest could give a satisfactory notice that could plausibly bind third parties.

Even more important for contractualism is the problem of control of the debtor's assets. The full discussion takes many more pages than are available here. In summary, contractualism requires control of assets, in one sense or another, both prior to default and in the recovery process.[26] Control prior to default is necessary, lest the debtor's transfer of assets in the course of its business and prior to default leave the contractualist creditor with a wonderful bankruptcy system that applies to few assets of value. Of course, the contractualist creditor would have many covenants against transfers or encumbrances, but for a mere unsecured creditor

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[21] At least some of the proposals seem to assume that securities disclosure requirements for public companies will solve the notice problem, although post-Enron such a position seems difficult to maintain.

[22] *See* Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 TEX. L. REV. 51, 100–21 (1992) (urging congressionally enacted bankruptcy menu and considering limitations on corporate selection of menu options to prevent strategic selection).

[23] *See generally* Susan Block-Lieb, *The Logic and Limits of Contract Bankruptcy*, 2001 U. ILL. L. REV. 503 (2001) (exploring costs and benefits of contractualist approach to bankruptcy); Lynn M. LoPucki, *Contract Bankruptcy: A Reply to Alan Schwartz*, 109 YALE L.J. 317 (1999) (arguing contractualist theory fails in application to real world circumstances due to redistributional impulses and inefficiency); Lynn M. LoPucki, *The Case for Cooperative Territoriality in International Bankruptcy*, 98 MICH. L. REV. 2216, 2244–45 (2000) (discussing problems relating to notice in contractualist approach to bankruptcy); *Control of Wealth*, *supra* note 11, at 831–33.

[24] *See Intervention*, *supra* note 13.

[25] Such a solution would, of course, raise its own difficulties, but would still make far more sense than re-inventing the wheel.

[26] *Control of Wealth*, *supra* note 11, at 833–35.

those covenants would be worth very little. Professor Gilmore regarded such "negative covenants" with contempt, because they are ineffective.[27] The only effective control over asset transfer is one that permits recovery of assets from the transferee. Only a security interest under Article 9 provides consistent protection of that sort. The various fraudulent conveyance statutes and similar devices have only limited usefulness in that regard, especially since many transfers will have been made in good faith (if, perhaps, stupidly).

The contractualist creditor also lacks any mechanism for controlling the debtor's assets following a general default. It is true that we could develop an elaborate system of injunctions, sales procedures, and distribution mechanisms for a contractualist system, but we have one ready made in Article 9. Furthermore, Article 9 represents a century of careful balancing of protection of a secured party's interest as against the crucial need for free transferability in the market place and a minimum of inefficient over-discounting against the risk of a present or future security interest. That process was touched at least once by legal genius. The notion that we would invent such a system all over—and then litigate to polish it—seems absurd. A far better path to the same result would be to connect the contractualist system to a dominant security interest, using Article 9 notice, Article 9 asset control, and Article 9 enforcement and sale. The only plausible form of contractualism is "secured contractualism."[28]

In light of all this, it seems remarkable that the contractualists have not proposed such a link. One reason may be that such a connection creates—or perhaps merely reveals—some fundamental difficulties with the whole project. Once we see that a dominant security interest is required to make contractualism plausible, it inherits all the long-debated problems associated with secured credit. My forthcoming article addresses what I can only summarize here. There are three basic problems with contractualism linked to a dominant security interest. The first is that the case for the efficiency of secured credit is at best problematic and incomplete. It is problematic in that no effective answer has ever been given to the claim that the decreases in cost of secured credit are simply balanced by the

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[27] GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY 1017 (1965).

[28] For example, in proposing the Chameleon Equity approach, Professor Adler gives no indication how the recovery process would be managed. He seems to assume that after default management would voluntarily flee and the proposed financial transformation would take place without interregnum or litigation.

The statement in text is limited to a legally legitimate form of control. It is possible that control of a debtor could be obtained by exploitation of the agency (Berle-Means) problem to induce management to transfer its loyalty to certain corporate constituents—for example, lenders—rather than to the shareholders or the general creditor body. That may be the alleged phenomenon described by Professors Baird and Rasmussen. *See, e.g.*, *The End of Bankruptcy*, *supra* note 4, at 777–88; *see also* Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 YALE L.J. 1807, 1827, 1827 n.58 (1998) (stating one solution to creditor problem is to bribe management).

increases in the cost of unsecured credit.[29] Starting with Professor Schwartz' devastating rebuttal of the reasons offered by Jackson and Kronman and others, no response has been successful.[30] While I do not doubt that, as Professor Hill has argued,[31] secured credit is sometimes efficient for some types of transactions, no overall proof has been made, even theoretically. The case for the efficiency of secured credit is not only problematic, but incomplete because none of the efficiency theories offered have included as a benefit the control of assets gained by the secured creditor[32] nor have any of them deducted, so to speak, the cost of the loss of control by the debtor entrepreneur. The case is especially incomplete as applied to a dominant security interest, because little or no attention has been devoted to its special benefits and special costs with regard to asset control. To state the point concretely, a plausible form of contractualism would require a dramatic expansion of the use of dominant security interests, but it is far from evident that our financial markets would be improved by such a radical change in our system of commercial finance. This necessary change in the pattern of commercial finance has been obscured by the failure of contractualists to identify any method by which contractual control would be exercised.

Efficiency aside, domination of the recovery process by a secured party raises serious conflicts of interest, a problem widely recognized in the literature even by advocates of secured credit.[33] A secured party that controls the recovery process will often have interests inconsistent with those of other creditors as well as the

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[29] *See* Thomas H. Jackson & Anthony T. Kronman, *Secured Financing and Priorities Among Creditors*, 88 YALE L.J. 1143, 1153–54 (1979) (describing economic balancing between creditors and debtors in granting security interest).

[30] *See* Alan Schwartz, *Security Interests and Bankruptcy Priorities: A Review of Current Theories*, 10 J. LEGAL STUD. 1, 1–3 (1981) (discussing issuance of debt secured by personal property and relevant regulatory scheme); *see also* Alan Schwartz, *The Continuing Puzzle of Secured Debt*, 37 VAND. L. REV. 1051, 1051–52 (1984) (rejecting efforts in support of contrary views about author's 1981 paper, *A Review of Current Theories*).

[31] *See* Claire A. Hill, *Is Secured Debt Efficient?*, 80 TEX. L. REV. 1117, 1158 (2002) (suggesting "secured debt is mostly efficient, except in some instances where it may exploit the availability of regulatory and other non-market arbitrage.").

[32] The one exception or near-exception was Professor Scott. *See* Robert E. Scott, *A Relational Theory of Secured Financing*, 86 COLUM. L. REV. 901, 926–28 (1986) (examining secured creditor's relational control of debtor's assets). Professor Mann is the scholar who has demonstrated the value of control to the secured creditor, although he did not attempt to resolve the efficiency debate in the process. Ronald J. Mann, *Strategy and Force in the Liquidation of Secured Debt*, 96 MICH. L. REV. 159, 160 (1997) ("The most important effects [of secured lending] arise from the capacity of a grant of collateral to influence the actions the parties take short of forced liquidation of collateral.").

[33] *See* U.C.C. § 9-615, cmt. 6 (2000) (stating subsection (f) provides "special method for calculating a deficiency or surplus when the secured party . . . acquires the collateral at a foreclosure disposition"); *see also* Donald J. Rapson, *Consumer Protection and The Uniform Commercial Code: Efficient Treatment Of Deficiency Claims: Gilmore Would Have Repented*, 75 WASH. U. L.Q. 491, app. 2 at 543–47 (1997) (reprinting Donald J. Rapson's memo to Article 9 Drafting Committee regarding alternative valuations in foreclosure sales to secured parties). Professor Adler sees this difficulty as well, although apparently he does not see it as inconsistent with his belief about the unimportance of process. *See Bankruptcy Primitives*, *supra* note 1, at 228–32 (discussing secured creditor rollup pre-petition in debtor chapter 11 petition).

interests of the debtor and other constituencies. A dominant secured party cannot be counted upon to conduct the process neutrally, so that all other parties would be required to discount heavily their chances of recovery in that process given secured party control. The rhetoric that uses "creditor control" to mean "lender control" can obscure this point, but cannot eliminate it.[34] The British experience, discussed below, confirms it.

Finally, the widespread adoption of secured contractualism seems unlikely. Even in small business lending, some empirical researchers see a move away from dominant security interests.[35] In any case, creditors who lack the bargaining power to get a dominant security interest today will be equally unable to negotiate for a secured contractualist position, while creditors who are now getting dominant security interests hardly need any further protection.[36] Thus for most creditors secured contractualism will be either unobtainable or unnecessary.

A powerful empirical argument against secured contractualism is found in the British experience. For well over a century, the "floating charge" has been at the heart of British commercial finance. The charge has serious limitations as a priority device, but gives the chargeholder (a dominant secured party in the terms I am using) complete control over the recovery process. Such a party is entitled to appoint a receiver who takes over the company and all of its assets at a stroke and liquidates them for the benefit of the secured party.[37] The business may be sold as a going concern or piecemeal, as the receiver thinks best. The whole process is essentially private, with only the potential of court supervision in case of egregious abuse. In short, it is almost exactly the system that the contractualists propose for the United States, but for their omission to specify the necessary role of security interests. The results of the British system are the ones the contractualists applaud. It seems remarkable it has been completely ignored in the long debates over secured-creditor efficiency and contractualism.

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[34] *See Control of Wealth*, *supra* note 11, at 860.

[35] *See* Ronald J. Mann, *The Role of Secured Credit in Small-Business Lending*, 86 GEO. L.J. 1, 7 (1997) (explaining why some small-business borrowing is unsecured).

[36] For reasons discussed in my recent article, including the "bankruptcy veto," a dominant secured party does not really need much in the way of protection from bankruptcy. *See Control of Wealth*, *supra* note 11, at 817; s*ee also* Elizabeth Warren & Jay Lawrence Westbrook, *Secured Parties in Possession*, AM. BANKR. INST. J., Sept. 2003, at 12 (discussing recent cases involving "secured parties in possession" who hold liens over most of debtor's assets).

[37] There is some attention to the interests of other creditors, but not much. *See* DEP'T OF TRADE AND INDUS., PRODUCTIVITY AND ENTERPRISE: INSOLVENCY-A SECOND CHANCE 2.1–2.3, C.16 (2001) [hereinafter White Paper] (discussing administrative receivers); *Control of Wealth*, *supra* note 11, at 819 n. 79.

The British have recently abolished this system, at least in principle.[38] They have thus abandoned the crown jewel of English secured credit law, a system that many commentators have described as fundamental to English commercial finance. They have done so because they have become convinced that it is seriously harmful to other interests in the recovery process, including those of entrepreneurs and employees.[39] They conceive that a more neutral public process conducted for the benefit of all stakeholders is a better solution, based on a century's experience with a system virtually identical with those proposed by the contractualists.

Contractualism is not the main point discussed in Professor Adler's paper, but it is the lynchpin of his entire analysis. It is crucial to his central thesis that the process of bankruptcy is not of great interest, because it is to be governed by contract. For him, it is *because* contract takes over all the process questions that priority is the important issue. I have reached precisely the opposite conclusion: the characteristic role of bankruptcy is the control of the debtor's assets and the recovery process, while priority is largely governed by policies exogenous to bankruptcy.[40]

Control of the debtor's assets is a universal characteristic of bankruptcy regimes around the world. Virtually all of them use a property concept to give ownership or management of those assets to a publicly designated official or entity at the time of the opening of a bankruptcy proceeding.[41] The great majority also impose a moratorium on collection by most creditors, whether broad and automatic or by court order in each case.[42]

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[38] There are various exceptions and loopholes, so it is too soon to tell if the abolition has been successful or has been subverted by the loopholes, but it is clear that the intent was to abolish the system for most purposes. The Enterprise Act 2002, which accomplished this change, went into effect in this regard on September 15, 2003, and applies to floating charges created after that date, subject to specified exceptions. *See generally* Bob Sherwood, *Shake-up Helps Promote U.S.-style Rescue Culture: INSOLVENCY: The Enterprise Act's New Administrative Rules Take Effect Today*, FIN. TIMES (London), Sept. 15, 2003, at 11 (noting effect of Enterprise Act and abolitions of Crown preference right).

[39] *See* White Paper, *supra* note 37, at 1.1, 2.20, 4.2 (noting benefits from change).

[40] This point about priority might sound similar to the position of Professor Baird and others that all priority decisions should be left to non-bankruptcy law, but it is not. I agree with Professor Adler that policy decisions about priority may appropriately be imposed through bankruptcy law. Where we differ is that he thinks the establishment of priorities is central to bankruptcy law, while I think it is merely an ancillary function of bankruptcy. That is, I argue that the choice to make priority decisions through non-bankruptcy law or through bankruptcy law should be made on essentially pragmatic and contextual grounds, because most such decisions are not inherent to the bankruptcy function standing alone. *See Control of Wealth*, *supra* note 11, at 855, nn.264-65 and accompanying text.

[41] *See* WORLD BANK GROUP, PRINCIPLES AND GUIDELINES FOR EFFECTIVE INSOLVENCY AND CREDITOR RIGHTS SYSTEMS 32 (2001)[hereinafter WORLD BANK PRINCIPLES] (indicating at Principle 11, qualified court appointed official administers estate in interest of creditors).

[42] *See id*. at 30 (stating in Principle 10, moratorium should be imposed on disposition of debtor's assets).

By contrast, priority systems vary greatly around the world.[43] For example, as far as I know, no other country shares our national obsession with grain farmers and fishermen.[44] It is true that most countries have the Big Three priorities—for secured parties, employees, and taxes—but even these priorities vary a good deal. In Britain, the floating charge is subject to the administrative expenses of the bankruptcy[45] and in Mexico (and many other countries) a security interest is subject to wage claims.[46] Employees have strictly limited priority in some countries (for example, the United States) and nearly unlimited priority in others (for example, France). In Germany, they no longer have any priority at all.[47] Although tax claims are given priority in most countries, there is a trend away from granting that privilege to governments, Canada being a leading example.[48] The recent British reform has replaced Crown priority with a carve-out for unsecured creditors.[49] Thus even for the three most common priorities, we see enormous variation and constant change around the world.

From this perspective, it is clear that bankruptcy systems can enforce very different systems of priorities. No particular system of priorities is inherently related to the structure or nature of bankruptcy. One priority is universal (I believe) and inherent to bankruptcy: priority for administrative expenses. Without that priority, no one would be willing to clean up after the elephants.[50] All the rest are a function of policymakers' judgments about who should bear the burdens and receive the benefits of the recovery process.[51]

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[43] *See* WORLD BANK PRINCIPLES, *supra* note 41, at para. 145-48 (noting a tendency toward proliferation of various priority categories in bankruptcy laws); 1 Jan Dalhuisen, 2 DALHUISEN ON INTERNATIONAL INSOLVENCY AND BANKRUPTCY Part II, s 1.06[1] (1986); International Business Bankruptcy Subcommittee of the Business Bankruptcy Committee of the American Bar Association, INTERNATIONAL LOAN WORKOUTS AND BANKRUPTCY: PROTECTING LOANS AND INVESTMENTS IN ARGENTINA, BRAZIL, CANADA, EGYPT, ENGLAND, FRANCE, GERMANY, ISRAEL, ITALY, JAPAN, MEXICO, THE NETHERLANDS, SWITZERLAND AND VENEZUELA, 1987 A.B.A. Sec. Pub. Corp., Banking and Business Law, Division of Professional Education (*passim*).

[44] *See* 11 U.S.C. § 507(a)(5) (2002) (listing grain farmers and fisherman as fifth priority in distribution of dividends).

[45] *See* ROY M. GOODE, LEGAL PROBLEMS OF CREDIT AND SECURITY 91 (2d ed., 1988).

[46] *See* AMERICAN LAW INSTITUTE, TRANSNATIONAL INSOLVENCY PROJECT: INTERNATIONAL STATEMENT OF MEXICAN INSOLVENCY LAW § IV.F(1) (2003) [hereinafter ALI MEXICAN STATEMENT].

[47] They are protected through a general unemployment fund. *See* Manfred Balz, *Market Conformity of Insolvency Proceedings: Policy Issues of the German Insolvency Law*, 23 BROOK. J. INT'L L. 167, 174 n.34 (1997) [hereinafter *Policy Issues*] ("Workers are protected for arrears up to three months by a special social security system financed by the non-insolvent firms in Germany.").

[48] *See* AMERICAN LAW INSTITUTE, TRANSNATIONAL INSOLVENCY PROJECT: INTERNATIONAL STATEMENT OF CANADIAN INSOLVENCY LAW 29 (2003) [hereinafter ALI CANADIAN STATEMENT].

[49] *See* Vanessa Finch, *Re-Invigorating Corporate Rescue*, 2003 J. BUS. L. 527, 544 (2003) (discussing effects of changes of Crown's priority).

[50] This phrase was popularized by former White House Chief of Staff John Sununu.

[51] By saying priority decisions are exogenous to bankruptcy, I do not mean to say the context of general default should not affect certain policy decisions. That context may suggest a different balance of values and of costs/benefits, requiring a different rule than that found outside of the general default context. *See also supra* note 40.

On the other hand, maximizing the value received by the chosen beneficiaries of the recovery process—that is, maximizing the value obtained from the debtor's assets and ensuring that the chosen priorities govern the distribution of that value—is the central task of bankruptcy law. That task requires control of the debtor's assets. For that reason, the core element in bankruptcy theory must be control. Only by seizing control of all of the debtor's assets can a bankruptcy system assure that their value will be maximized and distributed in accordance with the chosen priorities. With apologies, I quote from my own article:[52]

> If individual creditors were allowed to seize the debtor's assets, an orderly liquidation or reorganization would obviously be impossible. That is, employees, secured creditors, or the state, favored in most systems, might well lose value to unsecured commercial creditors in the rush for assets. The control provided by the moratorium or stay ensures that these competitors are restrained, while other doctrines[53] ensure that the bankruptcy regime will control the liquidation or recapitalization of the debtor's assets and the distribution of resulting value to the preferred beneficiaries.[54] It has long been recognized that the collective proceeding that is bankruptcy is required to maximize value,[55] but it is equally true that the control imposed by bankruptcy law is essential to enforcing the inequality of distribution—that is, priorities—mandated by each legislature. A recent study by a Spanish scholar makes a persuasive

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[52] The quote here is from *Control of Wealth*, *supra* note 11, at 824 nn.109-112. The quote includes the original footnotes from *Control of Wealth*, but renumbered for the purpose of this publication, *i.e.* footnotes 109-112 have become footnotes 53-56.

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

[54] For this reason, the very absence of control identifies some of the beneficiaries chosen by a particular regime. For example, in some countries the opening moratorium does not apply to labor (employee or union) claims. *See, e.g.*, ALI MEXICAN STATEMENT, *supra* note 46, at II. In others, secured creditors and their collateral are exempt from its reach. *See, e.g.*, ALI CANADIAN STATEMENT, *supra* note 48, at I.C.d (in liquidation cases). The practical effect of their exemption may be to maximize the value of their recoveries, while lowering the overall recovery for beneficiaries generally. It is not coincidental that the same creditors exempted from the stay in a particular system are invariably favored within a bankruptcy proceeding as well. *See* ALI MEXICAN STATEMENT, *supra* note 46, at II.F.1, IV.F.1 (labor claims); ALI CANADIAN STATEMENT, *supra* note 48, at I.C.6 (secured claims). It would be a serious conceptual error to think of these claimants as excluded from the bankruptcy process in such a system, because that process, starting with the moratorium that restrains their competitors from seizing the debtor's assets ahead of them, is designed specifically to benefit them. Their exemption from the stay is the next best thing to an advance distribution of assets. It is for that reason that their exclusion from the stay's coverage is not inconsistent with the assertion that control is essential to any bankruptcy regime.

A striking example of the effect of exclusion in our law, recently enacted, is the exemption from the stay for certain financial contracts, which amounts to a substantial priority for certain creditors, even though they are often unsecured under state law. *See* 11 U.S.C. §§ 362(b)(6-7), (17); 11 U.S.C. §§ 555-56; 559-60 (2002).

[55] *See generally* JACKSON, *supra* note 19, at 5.

> historical case for understanding the role of bankruptcy as a system for enforcing priorities and defeating a general or overall equality of distribution.[56]

One can have a bankruptcy system with any sort of priorities, as long as it has the control necessary to enforce them. One could even have a system of equality of distribution to all creditors, although no such system has been reported.[57] Bankruptcy can function correctly with any system of priorities, but it has no function without control.

For the reasons stated earlier, no unsecured contractualist creditor could obtain the necessary control over the recovery process, but a dominant secured party could do so, precisely because a dominant security interest provides control of the debtor's assets. Thus a dominant security interest offers the only private alternative to bankruptcy as a system for management of the recovery process. It is the undesirability of secured-creditor control that reveals the most serious weaknesses of secured contractualism.

For these reasons, whether Congress adopts a tort-victim priority is an important question for me, but not a fundamental one. Whether Congress—or the courts—abandon control of the recovery process to lenders as dominant secured parties is absolutely fundamental. For that reason, I am persuaded to disagree with Professor Adler and to claim that control of the recovery process is everything, while priority decisions are important but ancillary.

The analysis of bankruptcy (and secured credit) from the perspective of control promises to open a number of issues to fresh examination. For example, looking at securitization through the lens of control reveals that the "true sale" issue is really a question of permitting a debtor to enter into a secured transaction while selling the creditor an exemption from bankruptcy control.[58] Any exemption from bankruptcy

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

[57] *See* Rizwaan Jameel Mokal, *Priority as Pathology: The Pari Passu Myth*, 60 CAMBRIDGE L.J. 581, 581–82 (2001) (relying on empirical evidence to show *pari passu* principle fails to describe how assets of insolvent companies are in fact distributed); Jay Lawrence Westbrook, *Choice of Avoidance Law in Global Insolvencies*, 17 BROOK. J. INT'L L. 499, 508–09 (1991) (stating equality only applies within class, so it is of limited importance); *see also* Look Chan Ho, *On Parri Passu, Equality and Hotchpot in Cross-Border Insolvency*, LLOYD'S MAR. & COMM. L. Q. (forthcoming 2004).

[58] *See In re* LTV Steel Co., 274 B.R. 278, 281 (Bankr. N.D. Ohio 2001) (characterizing supposed "true sale" as secured transaction, thereby, permitting LTV to use cash proceeds of transferred assets as cash collateral). *See generally* Edward J. Janger, *Muddy Rules for Securitizations*, 7 FORDHAM J. CORP. & FIN. L. 301 (2002) (describing securitizations); Steven L. Schwarcz, *The Impact of Bankruptcy Reform on "True Sale" Determination in Securitization Transactions*, 7 FORDHAM J. CORP. & FIN. L. 353 (2002) (discussing recent reform efforts in this area).

control is the equivalent of a sort of superpriority, because all other creditors remain subject to that control.[59] Thus the state statutes making a true sale out of a secured transaction whenever the parties would have it so[60] changes nothing about the transaction outside of bankruptcy, but enables a party with the economic equivalent of a security interest to buy an exemption from the control that United States bankruptcy law imposes on secured parties. Such transactions are thus within the intendment, but not the letter, of section 545 of the Bankruptcy Code, which voids state-created priorities.[61] Securitization is only one of a number of issues where the control perspective generates new questions for old debates.

One of the most striking things about our bankruptcy system, in comparison with those from other countries, is the way in which it maximizes the choices available to the actors in the market by providing a core of process and control. The design of the government-imposed, unwaivable bankruptcy system thus permits almost endless experimentation in the market, while ensuring both notice and predictability as to the basics. The control of secured parties by our bankruptcy regime is the classic and most important example.[62] Other bankruptcy regimes around the world are moving toward our chapter 11 system in that and other respects precisely because it is perceived to marry predictability and flexibility to such a high degree.

Professor Tabb and I agree that Professor Adler's analysis would leave bankruptcy law and theory only a shrunken appendix containing a handful of priority questions that might be as well-addressed by non-bankruptcy law.[63] Yet I see around the world the most massive effort to rewrite domestic bankruptcy laws in more than a century.[64] Country after country is rewriting its bankruptcy laws, generally with a view to expanding their scope and strength. In some respects, the British example is the most dramatic, as noted above, moving from a system close to Professor Adler's central vision to a point decidedly closer to United States

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[59] *See supra* note 54.

[60] *See, e.g.*, Asset-Backed Securities Facilitation Act, 73 DEL. LAWS, c. 214, § 1 (2002). If the transaction is a "true" "true sale," of course, it needs no such statute.

[61] *See generally* Ronald J. Mann, *The Rise of State Bankruptcy-Directed Legislation*, 25 CARDOZO L. REV. (forthcoming 2004) (arguing certain provisions of revised Article 9 are "bankruptcy directed legislation" having no real effect outside of bankruptcy).

[62] In a number of countries, secured creditors are not restrained by the bankruptcy stay or moratorium. *See* WORLD BANK PRINCIPLES, *supra* note 41. However, the trend around the world is toward bankruptcy control of secured parties, influenced by the American experience. *Id*.

[63] *See* Tabb, *supra* note 10, at 269–70. Professor Tabb points out one example. If tort victims are to be favored in bankruptcy law, why is there not a case for favoring them even when no bankruptcy is filed? In fact, I think one has to go a bit farther in the analysis to determine whether a shift from one set of rules to another is appropriate when the scene shifts from a single default (failure to pay the tort judgment) to a general default (failure in obligations generally). But Professor Tabb is surely right that there is no prima facie reason that the issue of financial protection of tort victims should be solely a matter of bankruptcy policy. That is, the tort-priority issue may be largely exogenous to bankruptcy law. *Control of Wealth*, *supra* note 11, at 855.

[64] *See* Jay Lawrence Westbrook, *A Global Solution to Multinational Default*, 98 MICH. L. REV. 2276, 2278 (2000).

bankruptcy law as it now exists, but there are many other examples as well.[65] This trend is consistent with the observation that chapter 11 as created in the Bankruptcy Reform Act of 1978 has served the capital markets, and society as a whole, remarkably well.

[65] Germany, like the United Kingdom, fundamentally rewrote its bankruptcy laws in the Nineties, a reform strongly influenced by United States bankruptcy law. *See, e.g., Policy Issues, supra* note 47, at 174 n.34.