PRESENT AT THE CREATION:
THE SEC AND THE ORIGINS OF THE ABSOLUTE PRIORITY RULE

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INTRODUCTION

By traditional account, the absolute priority rule dates back to the railroad receiverships of the nineteenth century. Its central position in reorganization law was cemented in place by the Supreme Court's 1913 opinion in *Northern Pacific Railway v. Boyd*.[1] It turns out that none of this is true. As David Skeel and others have shown,[2] the equity receiverships embraced an altogether different priority regime that *Boyd* did little to displace. The absolute priority rule emerged only in the waning days of the New Deal, thanks in large measure to the forceful advocacy of the SEC.

The origins of the absolute priority rule have been neglected in part because it has shifted polarity over the course of time. At the time it was put in place, its advocates were the reformers anxious to protect small and powerless outsiders against the large institutions of Wall Street. Its opponents were establishment defenders of the status quo. Today, progressives are the ones most likely to question its wisdom, and conservatives are its staunchest partisans. In both cases, views of priority turn much more on background priors, rather than narrowly on the rationale underlying the competing regimes, which have to a large extent been forgotten.

While the academic articles of Jerome Frank and William O. Douglas[3] in support of the absolute priority rule are well known, less attention has been given to

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[1] 228 U.S. 482, 510 (1913) (exploring rights of unsecured creditor who had not been included in reorganization plan).

[2] *See* DAVID K. SKEEL, DEBT'S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA 123–27 (Princeton University Press 2001); *see also* John D. Ayer, *Rethinking Absolute Priority After Ahlers*, 87 MICH. L. REV. 963, 974–76 (1989) (discussing Supreme Court's varying opinions concerning absolute priority and evolution of law); Randolph J. Haines, *The Unwarranted Attack on New Value*, 72 AM. BANKR. L.J. 387, 407–14 (1998) (noting how future courts interpreted the "fair and equitable" term of art and its connection to evolving absolute priority rule); Bruce A. Markell, *Owners, Auctions, and Absolute Priority in Bankruptcy Reorganizations*, 44 STAN. L. REV. 69, 84–85 (1991) (discussing modification of *Boyd*'s holding to require all plans honor state law entitlements).

[3] Jerome Frank, *Some Realistic Reflections on Some Aspects of Corporate Reorganization*, 19 VA. L. REV. 541 (1933) [hereinafter Frank, *Some Realistic Reflections*]; Jerome Frank, *When 'Omer Smote 'is Bloomin' Lyre*, 51 YALE L.J. 367 (1942); William O. Douglas, *The Hastings Bill and Lessons Learned From the Bankruptcy Studies*, 7 J. NAT'L ASS'N REF. BANKR. 25 (1932); William O. Douglas, *Improvement in Federal Procedure for Corporate Reorganizations*, 24 A.B.A. J. 875 (1938); William O. Douglas & Jerome Frank, *Landlords' Claims in Reorganizations*, 42 YALE L.J. 1003 (1933).

the amicus brief the SEC filed[4] in *Case v. Los Angeles Lumber Products*.[5] The brief provides a lens into how those at the SEC thought about the absolute priority rule. It at once both exemplifies skillful and able lawyering and, at the same time, illustrates how much everything depends upon where one starts.

The paper begins by laying out the competing concepts of absolute and relative priority.[6] It goes on to suggest why relative priority first rose to prominence and then became suspect. The paper then focuses on *Los Angeles Lumber* and the arguments that the SEC put before the Court. The SEC was interested in the outcome of the case because the Court was required to interpret language in existing bankruptcy law that was being carried forward to new chapter X. Because the SEC had a role in enforcing chapter X, it wanted its provisions interpreted sensibly. Hence, the SEC appeared, not because it had a stake in the outcome, but because it wanted the Supreme Court to get the law right. The brief reflects how the able New Deal lawyers who wrote the brief—a small group that included Homer Kripke and Raoul Berger—thought about the absolute priority rule in particular and the reorganization process in general.

I. ABSOLUTE AND RELATIVE PRIORITY

To say that one person is entitled to payment before another might not seem to contain any ambiguity, but it does. Valuing any particular priority right requires knowing not only who comes first, but when the reckoning takes place. You and I share a lottery ticket.[7] The drawing is next week, and the ticket pays $1000 with one-in-ten probability. Under our agreement, you enjoy the first $200 and I the balance. Without more, we do not know the value of our respective interests. The value of your priority right turns crucially on whether we take stock before or after the lottery drawing.

If the lottery ticket were sold before the drawing, it would bring a price of only $100 and you would get everything. On the other hand, if you cannot force a sale and must wait until next week after the drawing to enforce your priority right, there is only a one-in-ten chance the lottery ticket is worth anything and, if it is, you will

[4] Brief for the United States Amicus Curiae at 23–24, Case v. Los Angeles Lumber Prods., 308 U.S. 106 (1939) [hereinafter SEC Amicus Brief].

[5] 308 U.S. 106 (1939).

[6] Academic accounts of competing priority rules go back a long time. The concepts of "relative" and "absolute" priority are first explicitly discussed in James C. Bonbright & Milton M. Bergerman, *Two Rival Theories of Priority Rights of Security Holders in a Corporate Reorganization*, 28 COLUM. L. REV. 127, 132 (1928). Missing, however, have been rigorous accounts of the differences between two. Tony Casey's recent work fills this gap and much of what follows draws from it. *See* Anthony J. Casey, *The Creditors' Bargain and Option-Preservation Priority in Chapter 11*, 78 U. CHI. L. REV. (forthcoming 2010) (manuscript at 7, on file with author) (questioning whether creditors' bargain requires alternative rule to absolute priority, based on absolute priority rule's stated goals).

[7] Casey uses this lottery example. *See* Casey, *supra* note 6, at 37 n.150 (noting secured creditors push reorganization to get sale free of junior claims, but under Option Preservation Priority, secured creditor may negotiate non-bankruptcy release based on parties' expectations of outcome, yet under absolute priority, parties may not reach any outcome because junior creditors view bankruptcy as lottery ticket).

receive only $200. Thus the value of your priority right is only $20. You have first priority in the same asset in both cases, but the value changes because the time at when it is measured changes.

There are situations in which there is no ambiguity about how priority rights are valued. Two investors agree to invest in a movie and they agree explicitly that accounts will be settled only after the movie is released and all the revenue are in. While each is free to sell their stake to someone else, neither they (nor their transferees) will receive anything until the movie is released and that all that is left is dividing up the cash. The senior investor is entitled to the first $100 of revenue, while the junior investor enjoys everything above that amount.

Let us assume that the movie will generate $200, $100, or $0 with equal probability. The value of the interests of the two investors is easy to calculate. The junior investor will receive nothing two-thirds of the time, but will enjoy $100 one-third of the time. Hence, her interest is worth $33 and she can sell it today for that amount. The senior investor will receive nothing one-third of the time, $100 two-thirds of the time. Her interest is worth $67 and she can sell it for that much.[8]

But complications are likely to arise when anything changes. Let us imagine that there is a possibility that, before the movie is released, they have to decide to bring in a new investor who would be senior to both of them. In addition to bringing additional revenue (at a cost), the new investment will reduce the variance of the expected returns. There is a smaller chance that it will be a big hit and a smaller chance that it will bomb. The senior and the junior investor together are better able to figure this out than either one alone. This potential investment, while perhaps in their joint interest, affects the two investors differently. The senior investor will favor investments that reduce the downside, even if they don't increase the expected value of the project. By contrast, the junior investor tends to avoid investments that cap the upside, even if they do in fact increase the value of the project.

To ensure that they act sensibly if this opportunity arises, the investors might provide for some mechanism to ensure that each will want to bring on the new investor if, but only if, the new investment will leave them jointly better off. The natural way to accomplish this end is to provide that, if they jointly agree to bring on a new investor senior to them, they will share in the proceeds in a way that preserves the value of their respective interests. For example, the agreement could provide that, if they bring on a new investor and restructured the deal, the senior creditor will receive two-thirds of the remaining revenue and the junior investor will receive one-third. These are the shares of expected value of their shares in the movie each will receive if the new investor is not brought on. With this sharing rule in place, each will want to bring the investor in and restructure their payoffs if, but

[8] Like the lottery ticket, the value of these interests would have been dramatically different if the senior investor had the power to insist on a sale of the movie *before* it was released and can insist that the reckoning be based on the amount that the sale yields. The film has an expected value of $100, as it has a one-third chance of being $200, $100, or $0, and it will be sold for this much.

only if, it leads to a movie that is worth, in expectation, more than $100. It is a priority rule that maximizes the overall value of the project.

This kind of sharing rule is likely to be found when parties need to align incentives when a crucial decision is made. In admiralty law, there is the rule of the general average. During the middle of storm at sea, it is in everyone's joint interest that the heaviest and least valuable cargo is dumped overboard, but the owner of this cargo will want to keep it from happening. The rule of the general average shares the losses incurred when the captain throws cargo overboard, and these losses are ratably shared by all those whose cargo is being transported.[9] The rule of the general average naturally flows from the ex ante bargain that those entrusting their cargo would have with the captain. It is in everyone's joint interest that the captain acts in a way that maximizes the value of the entire ship.[10] So, too, fixing the relative shares of the investors in the movie preserves the *value* of their priority rights and at the same time ensures that they act sensibly in deciding whether to bring on the new investor.

Investors in a movie might, of course, opt for a different rule allocating rights. The sharing rule made sense in our example; both investors together were better able to assess whether the new investor would increase the value of the project. If either investor did not need the other, we might imagine a different contract, one in which either investor had the right to buy out the other.

The contract might even provide that the senior investor could take on the new investor unilaterally merely by cashing out the junior investor for the amount that the junior creditor would receive in the event that the movie were sold to some third party. Writing such a contract poses some nontrivial ex ante valuation problems. In particular, the junior investor would need to know at the outset how likely it would be for a new investor to appear and calculate that into the return it would demand to compensate for the risk that it would not be able to enjoy the upside. But we cannot rule out such contracts. It is simply another way to account for priority rights when some sort of interim realignment is required.

The most salient feature of the equity receiverships of the nineteenth century was a sharing rule of the sort between the junior and senior investors in the movie deal. Nineteenth century railroads were complicated networks. The job of creating the optimal mix of lines and managing them effectively was hard. Even if one knew the routes over which one wanted to transport freight, it was not obvious which ones the railroad needed to own rather than lease. Moreover, one could enter

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[9] *See, e.g.*, Atlantica Pacifica, S.A. v. Humble Oil & Ref. Co., 274 F. Supp. 884, 898 (D. Md. 1967) (stating general average is "*prima facie* proof of (1) the losses, damages, and expenses which . . . are the direct consequence of a general average act, (2) the values attaching to such losses, damages and expenses, and (3) the computations proportioning these losses, damages, and expenses between the parties to the venture").

[10] Thomas Jackson and Robert Scott were the first to show the parallel between the rule of the general average and priority rules in bankruptcy. *See* Thomas H. Jackson & Robert E. Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain*, 75 VA. L. REV. 155, 164–78 (1989).

agreements to transfer freight or people to other lines, often without breaking bulk. Finding good managers and firing the bad ones was similarly essential. And all these decisions had to be made while the reorganization was in progress.

The reorganization of the Atchison, Topeka & Santa Fe Railway Co. ("AT&SF") provides an illustration. In late 1893, a number of events, including the death of the chairman of the board and an unexpected and severe downturn in the economy forced the investors to come together.[11] The capital structure consisted, for the most part, of senior and junior bonds and shareholders. The bonds had been issued in a previous restructuring and had never traded at par.[12] Many of the large players held equal positions in both tranches and hence were indifferent as to how one fared relative to the other.[13]

What mattered to everyone was ensuring that a large number of operational decisions were made correctly. It soon appeared that the CEO needed to be fired and a new one found. Basic decisions had to be made about the structure of the network. Should the line to St. Louis be kept or should the railroad enter into a contract with another carrier? What about the line that connected the railroad to the West Coast? Should it be abandoned?

Many decisions favored senior creditors over junior creditors or vice versa, but what mattered from the perspective of the creditors as a group (and what they would necessarily have worried about ex ante) was that sensible decisions be made and that everyone work together cooperatively.

While the legal doctrines were unsettled and vague, investment bankers and lawyers followed well-entrenched norms that treated the railroad under reorganization in the same fashion as our two movie investors who have to decide whether to bring in a new investor senior to them. Or, to use the admiralty example, the lawyers and investment bankers at the time saw the railroad as if it were a ship in the middle of the storm. Abandoning a line was like throwing overboard cargo. These norms ensured that whatever decisions were made advanced everyone's interest by giving everyone who participated in the reorganization a share of the reorganized entity whose value reflected their priority rights. The share itself rose or fell in value during the case only to the extent that

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[11] *See* Atchison, Topeka & Sante Fe Ry. Co. v. United States, 284 U.S. 248, 254 (1931) (noting suits were consolidated and brought by carriers by railroad in Western District); *Receivers for Atchison: Another Great Railroad System Succumbs to the Hard Times*, N.Y. TIMES, Dec. 24, 1893, *available at* http://query.nytimes.com/mem/archive-free/pdf?res=F30A1FFB3C5A1A738DDDAD0A94DA415B8385F0D3 (describing enormous decrease in earnings, general business depression, and death of Chairman George C. Magoun as obstacles confronting Atchison management); Douglas G. Baird & Robert K. Rasmussen, *Control Rights, Priority Rights, and the Conceptual Foundations of Corporate Reorganizations*. 87 VA. L. REV. 921, 928 (2001) (noting railroad's net earnings insufficient to pay fixed interest costs—it had outstanding debt of $164 million, and net revenues well below 4% of outstanding debt).

[12] *See* STUART DAGGETT, RAILROAD REORGANIZATION 205–09 (Houghton, Mifflin & Co. ed., Riverside Press 1908); ROBERT T. SWAINE, THE CRAVATH FIRM AND ITS PREDECESSORS 1819-1947, 502–10 (Ad Press 1946).

[13] *See* DAGGETT, *supra* note 12, at 205–19; SWAINE, *supra* note 12, at 502–10.

decisions during the reorganization made everyone better off. Hence, everyone cared only about making the right decisions.

The junior bondholders, for example, found an able young lawyer who was quick to grasp the issues facing the railroad. The senior bondholders wanted him working for them as well. Eventually he quit his law firm, and became the railroad's general counsel. Everyone was better off with him on board. Today, the inherent conflict of interest makes such a joint representation impossible, no matter how able the lawyer.[14] But during this period it was unremarkable as there was not conflict between the junior and senior investors. Here, as with respect to any decision, their relative shares of the railroad were already fixed.

In other words, during the era of the equity receivership, the reorganization changed the rights that different investors had against the railroad, *but not the expected value of those rights*. During the reorganization itself (the expenses of which were paid by the junior bondholders and the equityholders), everyone had the incentive to take steps to maximize the value of the railroad, as what they would receive in the end would be a security, much like the one they had before the reorganization, the value of which turned only on the value of the railroad as a whole.

The day the reorganization of the AT&SF started, the senior bondholders knew that there was an implicit bargain in place that would give them 60% of the value of the railroad, the junior bondholders 30%, and the equityholders 10%.[15] The reorganization respected the relative priority of each, but it did not treat the reorganization as if it were a sale that collapsed all values to the present. To return to our initial example, equity receiverships put the same rule in place that our two movie investors used to ensure they made their restructuring decision sensibly (whether to bring on a new partner).

Those involved in railroad reorganizations were typically bargaining not so much in the shadow of the law as under the conventions that bankers and lawyers of the day accepted. Investors could rely on them because they were repeat players whose self-interest lay in doing right by investors over the long haul. J.P. Morgan reorganized railroads, but at the same time returned repeatedly to the capital markets. His ability to find new investors required him to protect their interests

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[14] And this lawyer was exceedingly able. His partners were (and indeed remain) upset with him for leaving the firm, something few others did before or since. He left a big gap that they filled with another young lawyer, whose commitment to the firm was more long-lasting. His name was Paul Cravath. Modern bankruptcy law forbids such directing conflicting representations. *See* 11 U.S.C. § 1103(b) (2006); Interwest Bus. Equip. Inc. v. U.S. Trustee (*In re* Interwest Bus. Equip., Inc.), 23 F.3d 311, 314, 318 (10th Cir. 1994); Nancy B. Rapoport, *Turning and Turning in the Widening Gyre: The Problem of Potential Conflicts of Interest in Bankruptcy*, 26 CONN. L. REV. 913, 938–41 (1994).

[15] One can back out these proportions by looking at the value at which each security traded just before the unexpected reorganization began. There were senior bonds in the face amount of $130 million that traded at 64¼, and $85 million in junior bonds traded at 33. There were roughly a million shares of stock that traded at 14⅞. The market estimate of the value of the business was roughly $125 million. These were again roughly the amount each received in the reorganization. One should emphasize, however, that the relative priority rule was not subject to precise calculation, as norm-based regimes rarely are.

when deals went sour. He had every incentive to enforce a priority regime that maximized the return to senior and junior investors as a group. In turn, the lawyers knew that the willingness of J.P. Morgan and others to hire them in future cases would turn on whether they acted in everyone's interest in the case before them.

Only those who participated in the decisionmaking, however, received a share, and the norms of the equity receivership did not automatically give every creditor a seat at the table. Some were shut out completely for reasons that were not obvious to those on the outside. Those left out sometimes complained that they were entitled to participate as a matter of legal right, regardless of the norms, but courts were rarely called upon to confront many of the issues. Controversies were usually settled outside of court.[16] Hence the question of whether those who did not participate could be frozen out lay beneath the surface for many years. But the question eventually reached the Supreme Court in *Boyd*. The court held that the freezing out of nonparticipating creditors was not permissible.[17] The Court was careful to give these creditors only the right to participate on the same terms as everyone else:

> [We do not] require the impossible and make it necessary to pay an unsecured creditor in cash as a condition of stockholders retaining an interest in the reorganized company. His interest can be preserved by the issuance, on equitable terms, of income bonds or preferred stock. If he declines a fair offer he is left to protect himself as any other creditor of a judgment debtor, and, having refused to come into a just reorganization, could not thereafter be heard in a court of equity to attack it.[18]

A plan of reorganization must give every creditor a "fair offer" in a "just reorganization."[19] The opinion itself, however, does not confront the question of whether receivership law could continue to accept a regime of relative priority analogous to the rule of the general average. It merely insists that, in whatever priority regime existed, everyone participate. The question of exactly what priority rights each investor enjoyed was actively debated in the law reviews over the next twenty-five years.

The defenders of relative priority were themselves the lawyers who did the railroad reorganizations. Foremost among them was Robert Swaine.[20] One of the

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[16] In many cases, courts could skirt hard issues. Valuation uncertainty itself ensures that junior investors will receive something in any bargain they strike with the senior bondholders. *See* Douglas G. Baird & Donald S. Bernstein, *Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain*, 115 Yale L.J. 1930, 1935–36 (2006).

[17] N. Pac. Ry. v. Boyd, 228 U.S. 482, 508 (1912).

[18] *Id.* at 508.

[19] *Id.*

[20] Swaine was a partner at the same firm as the lawyer who represented both senior and junior creditors in the AT&SF reorganization.

foremost practitioners of his era, Swaine was a staunch defender of the status quo. From his perspective, the restructuring of a railroad was merely one type of restructuring. The need to restructure debt does not bring with it any requirement that everything be value and those who were not in the money had to be wiped out. He believed that the reorganizations worked well and benefited the investors as a group.

The legal academics of the day, many of whom became New Deal lawyers, began in an altogether different place. Consistent with academic thinking of the time, they fixed on legal principles, not norms. Reasoning by analogy, they conceived of a restructuring as a substitute for a foreclosure sale. When a debtor owns a piece of real property, the effect of a default is to trigger a foreclosure sale. Like a foreclosure sale, therefore, any restructuring should collapse all future possibilities to present value. A reorganization is a day of reckoning.[21] The value of each investors' position is determined by imagining what they would receive if there were an immediate sale.[22]

To the extent that these academics looked outside legal principles, it was not to notions of norms and the power of reputational sanctions, but rather to the sociological evidence that suggested that the existing system was not working. As Thurmond Arnold explained:

> Large fees in such situations are the rule rather than the exception. . . . The fees represent high-class boondoggling and bureaucratic red tape of so complicated a nature that it is almost impossible to say at what point they are unjustified. . . .
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> The situation is very similar to the control of a municipal government by a political machine, with the possible exception that public opinion does not permit politicians to take any such percentage of the income of the municipality which they control.[23]

Courts seldom confronted the differences between Swaine and the New Deal lawyer-academics. Parties tended to reach negotiated outcomes. But matters came to a head when a specific provision of reorganization law had to be interpreted. Congress had enacted a reorganization statute in 1934, and it required, *inter alia,*

[21] *See* Royce de. R. Barondes, *Reorganizations and Stochastic Collateral Value*, 11 S. CAL. INTERDISC. L.J. 193, 197 (2002) (noting creditor may not always be assured it will receive equally favorable treatment in reorganization as it would in liquidation); Douglas G. Baird & Thomas H. Jackson, *Bargaining After the Fall and the Contours of the Absolute Priority Rule*, 55 U. CHI. L. REV. 738, 761 (1988) (noting reorganizing firm is "typically insolvent"); Baird & Rasmussen, *supra* note 12, at 946 (suggesting use of absolute priority as starting point of reorganization).

[22] *See* Baird & Bernstein, *supra* note 16, at 1939–41 (discussing valuation of creditors' interests); Lucian Arye Bebchuk, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775, 775–76 (1988) (examining general concept underlying chapter 11 reorganization); Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J. LEGAL STUD. 127, 131 (1986) (noting valuation of immediate sale determined by agreement between parties at time of contribution).

[23] THURMAN W. ARNOLD, THE FOLKLORE OF CAPITALISM 258–59 (Yale University Press 1937).

that two-thirds of each class of claimant approve the plan, and that the plan be "fair and equitable."[24] The Supreme Court had never used "fair and equitable," and, in the absence of judicial interpretation, did not resolve whether the new bankruptcy legislation embraced absolute or relative priority,[25] but when called upon to interpret these words, the Court would have to resolve the different conceptions of priority. This question came to the Supreme Court finally in *Los Angeles Lumber Products*.

II. LOS ANGELES LUMBER PRODUCTS AND THE SEC

In filing its amicus brief in *Los Angeles Lumber*, the SEC was representing the public interest, and indeed its argument was put forward in exactly this fashion. The head of the SEC at the time was Jerome Frank, the staunchest advocate of absolute priority of the New Deal lawyer-academics of the day. He locked on the foreclosure analogy and had a strong belief that the existing system should protect outside investors but failed to do so. As he put it, "Courts of equity have a tradition of aiding the helpless, such as infants, idiots and drunkards. The average security holder in a corporate reorganization is of like kind."[26] Any brief the SEC filed would be consistent with his views.

Moreover, the lawyers writing the brief would employ the arguments that they think most likely to persuade. In this instance, one member of the Court—William O. Douglas—had views that closely corresponded with Jerome Frank's. Douglas had himself headed the SEC and had picked Frank to succeed him. Douglas's list of the people who most shaped his view of the law contained only six names, and one of them was Jerome Frank.[27] And together, Douglas and Frank had already written an article that fiercely pushed for absolute priority and against relative priority.[28]

But how an argument is presented still tells a lot about how the people making it viewed the world and shows what they understood and what they did not. The part of its brief of most interest is the section that reviews the "public interest in

[24] For David Skeel's fine account of the emergence of modern reorganization law out of the equity receivership, see David A. Skeel, Jr., *An Evolutionary Theory of Corporate Law and Corporate Bankruptcy*, 51 VAND. L. REV. 1325, 1353–76 (1998); David A. Skeel, Jr., *The Rise and Fall of the SEC in Bankruptcy* 31–32 (Univ. of Pa. Law Sch. Inst. for Law & Econ., Working Paper No. 267, 1999), *available at* http://ssrn.com/abstract=172030.

[25] Commentators faulted the legislation on exactly this ground. *See* Edward H. Levi, *Corporate Reorganization and a Ministry of Justice*, 23 MINN. L. REV. 3, 6, 18 (1938). After rehearsing how the fair and equitable test leaves "uncertainty as to how much the intermediate class may demand," Levi later notes that the "failure of chapter X further to elaborate the standards for a 'fair and equitable' plan seems to be a mistake." *Id.* at 6–7, 18–19.

[26] Frank, *Some Realistic Reflections*, *supra* note 3, at 569.

[27] *See* WILLIAM O. DOUGLAS, GO EAST, YOUNG MAN: THE EARLY YEARS; THE AUTOBIOGRAPHY OF WILLIAM O. DOUGLAS 182 (Random House, Inc. 1974).

[28] Douglas & Frank, *supra* note 3, at 1012–13 (arguing absolute priority rule is not limited to equity receiverships and is "clearly" applicable to sales in bankruptcy proceedings).

economic aspects of the doctrines involved."[29] This section of the brief begins with the assertion that

> [t]his Court has several times declared that the condition of participation by junior interests in a reorganization plan is the prior satisfaction of all senior claims. This has been called the doctrine of "absolute priority." . . . [N]o deviation from this principle of fairness has appeared in the decisions of this Court, and very little express deviation from it is apparent in decisions of lower courts. However, while paying lip service to the rule, the lower courts have at times exhibited a tendency to sanction plans which circumvent the rule.[30]

This argument is not quite right. In its earlier cases, the Court had not specified what constituted "satisfaction" of a senior claim. The opinions were consistent with the idea that they had to be paid in full, as absolute priority required, but they were also consistent with the idea that they could be "satisfied" with only the share to which relative priority would entitle them. One could as easily have written that no deviation from relative priority had appeared in the Court's decisions and that lower courts, to the extent that they had confronted the question, tended to favor relative over absolute priority.

The brief then urges that the facts of *Los Angeles Lumber* are straightforward, and that, therefore, the abuses at work are easy to identify: "Here, unobscured by complex detail, can be seen the devices by which stockholders, faced with the consequences of the risk-taking position which they have voluntarily assumed, have sought to invoke nebulous considerations and to bargain, sometimes successfully, with valueless rights against the real claims of the bondholders."[31] This is where the trouble begins. In stating that the rights of the equityholders are "valueless," the argument assumes that the restructuring is the equivalent of a sale. Whether a restructuring is the equivalent of a sale is the issue before the Court. The brief reflects thinking that is locked in a paradigm that treats reorganizations in the same fashion as a foreclosure or any other liquidation: "In cases of liquidation no one questions the right of senior security holders to full payment before any distribution of assets to junior interests. Reorganization is an alternative for liquidation . . . . But it presents no occasion or excuse for a different treatment of priorities."[32] They could not see any reason for treating a reorganization differently from a foreclosure and hence needed to offer no justification for asserting that they should be treated

[29] SEC Amicus Brief, *supra* note 4, at 13–23.
[30] *Id.* at 13–14.
[31] *Id.* at 15.
[32] *Id.* at 16–17.

the same. But the facts of the case itself provide a reason for thinking that a restructuring is not the same as a foreclosure.[33]

A reorganization and a foreclosure are not perfect substitutes for one another and do not have to be treated the same. *Los Angeles Lumber* shows how a reorganization makes sense even when a foreclosure is not even possible. The firm filed its bankruptcy petition in 1937. The firm was insolvent, but it had not defaulted on its bonds, and no interest was owing on them until 1944. The bondholders had no ability to declare a default. Nevertheless, a restructuring was in everyone's interest. *Los Angeles Lumber* was a shipyard that specialized in naval vessels. As a world war was in the offing, there was plenty of potential government business. But to obtain it, the firm needed a surety bond, and that required it to deleverage its capital structure.

Los Angeles Lumber presents facts that parallel those in our hypothetical involving the two investors in a motion picture in which both investors had to agree on whether to bring in a new investor, but had no ability to square accounts before the movie was released. The issue here was whether to create a new capital structure that would allow it to acquire the surety bonds it needed to do government work, but the basic question was the same. Junior and senior bondholders needed to work cooperatively to maximize the value of the business and the senior bondholders, under the explicit terms of their agreement, had no ability to act unilaterally. They could not declare a default. More importantly, they would not foreclose even if they could. Their best course was to rearrange the capital structure in a way that allowed them to obtain the surety bond and thus continue the same business and same management team, with its considerable upside.

In the typical reorganization, there has been a default and the senior lender enjoys the option of foreclosing. The secured creditor, however, often wishes to keep the business intact, even though it means continuing to share ownership of it with junior investors and keep alive the option value of their interests, interests that are underwater and that would be wiped out in a liquidation. Whether a reorganization is more like keeping a business going than a liquidation is the question that the Court confronted in *Los Angeles Lumber*. The lawyers at the SEC thought the question had an obvious answer, but those who actively practiced in the field—including Robert Swaine and some of the most able lawyers of the day—did not.

The exchange of briefs between the plan proponents and the SEC shows how the lawyers were aware of the peculiar facts, but not the larger picture. For the SEC's lawyers, the peculiar facts of the case were not relevant. When the Court was

[33] These facts are set out in *In re* Los Angeles Lumber Prods. Co., 24 F. Supp. 501, 504–06 (S.D. Cal. 1938), *aff'd*, 100 F.2d 963 (9th Cir. 1939), *rev'd*, 308 U.S. 106 (1939) (providing financial history of Los Angeles Lumber Products Company and its subsidiaries). Further background on the case can also be found in 2 ARTHUR STONE DEWING, THE FINANCIAL POLICY OF CORPORATIONS 1304–10 (The Ronald Press Co., 5th ed. 1953) and in Robert K. Rasmussen, *The Story of Case v. Los Angeles Lumber Products: Old Equity Holders and the Reorganized Corporation*, *in* BANKRUPTCY LAW STORIES 147–75 (Robert K. Rasmussen ed., Foundation Press 2007).

confronting the larger question of how to interpret "fair and equitable," the Court had to offer a single interpretation and hence one that applied to the mine-run of cases. On the other side, the lawyers pressed for some recognition that their facts were different and therefore warranted special treatment. Neither side understood that this was an exception that "proves" the rule in the sense that it tests and exposes the inherent weaknesses in it. The facts of this case make manifest, at least in hindsight, that the connection between foreclosure and restructuring was not a necessary one.

In all of this, the brief reflects a view that we can see elsewhere among lawyers at the SEC. They believed that absolute priority was the only way to respect contractual priority.[34] They followed the lead of the legal academics of the day who start from a doctrinal perspective (a reorganization is a foreclosure). The time when legal academics would see self-enforcing norms as a substitute for legal rules was many decades away. Hence, they did not see how a regime like relative priority that was entirely based upon norms could be coherent.

Similarly, the characteristics of various investment contracts appeared to these lawyers far more discrete and distinct than they do to today's lawyers whose education includes Modigliani and Miller.[35] For example, the brief observes that "[s]enior security holders invest at low interest or fixed dividend rates, foregoing participation in any extraordinary profits of the enterprise in reliance on the greater assurance of safety provided by their contract."[36] They have assumed that the equityholders will "bear the risks of the enterprise" and "in the event of financial reverses they will be made whole before provision is made for the risk-bearing junior interests."[37] It is wrong to think that equityholders are the ones who bear risk. All investors bear risk. The question is whether they are compensated for the risks that they are running.

To the extent senior investors find themselves in a relative priority world rather than an absolute priority world, they need a higher interest rate to give them a market return on their capital and junior investors a correspondingly lower one. But all investors in equilibrium should get a market return. Relative priority carves up the pie differently than absolute priority to be sure, but, without more, you cannot say whether it increases or reduces the size of the pie.

The brief then advances another argument in favor of absolute priority. Too often businesses leave reorganization with a balance sheet that is still top-heavy with debt. The brief then asserts that this has been a result of a failure to respect

[34] Abe Fortas was another great lawyer at the SEC who shared this view. *See, e.g.*, Abe Fortas, Assistant Dir. of Pub. Utils. Div., SEC, Address Before a Legal Seminar at the Hotel Astor, 6 (July 14, 1938), *available at* http://www.sec.gov/news/speech/1938/071438fortas.pdf ("[T]he *Boyd* case was a message to the profession that . . . the doctrine of the sancitity [sic] of contracts is not abrogated by the equity reorganization procedure.").

[35] *See, e.g.*, Franco Modigliani & Merton H. Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 AM. ECON. REV. 261, 268–71 (1958) (explaining independence of firm's market value from its capital structure by use of mathematical formulas).

[36] SEC Amicus Brief, *supra* note 4, at 16.

[37] *Id.*

absolute priority.[38] If multiple tiers of debt need to be included in the new capital structure, the new reorganized corporation will have too much debt.[39] This problem arises only when limits are placed on the ability of a reorganization plan to transform more senior securities into more junior ones of the same value. At the time, it was thought such limits existed.[40] One tended to give old creditors debt, because one has to give comparatively more if junior securities are to substitute for more senior ones. Justice Douglas explained this idea a few years later in *Consolidated Rock Products v. DuBois*:

> [W]hile creditors may be given inferior grades of securities, their "superior rights" must be recognized. Clearly, those prior rights are not recognized . . . if creditors are given only a face amount of inferior securities equal to the face amount of their claims. They must receive, in addition, compensation for the senior rights which they are to surrender.[41]

A bond backed by collateral is inherently worth more than a share of stock. One is backed up by a hard asset with a certain value, and the other is not. As between a bond that trades for $100 and a share of stock that trades for $100, one always prefers the former because the return is more certain. A bond is inherently worth more than a share of stock for the same reason that a pound of lead weighs more than a pound of feathers.[42] At least so reasons Justice Douglas.

As silly as this logic may be, one cannot fault the argument of the lawyers here. Given that "step-ups" were thought required, one would expect to have top-heavy capital structures. If step-ups were a part of the picture, an absolute priority regime does indeed have an advantage over relative priority.

The next argument is that departures from absolute priority give junior security holders securities that are valueless: "It is patently undesirable to place upon the market securities which represent little more than the paper upon which they are written. Such valueless securities create the risk of fraud upon future purchasers, and are particularly susceptible to use as media for market manipulations."[43] Nothing, however, requires that securities of the reorganized business have little value. If the junior interests are worth little, they should be given little. There is no requirement that the securities they hold be valueless. They could be given valuable securities, but very few of them.

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[38] *See id.* at 18.

[39] *See id.* (discussing how instead of eliminating existing claims, each creditor granted participation rights, causing "top-heavy" debt).

[40] *See* Consol. Rock Prods. v. Du Bois, 312 U.S. 510, 528–29 (1941) (indicating rights of senior creditors should not be ignored without fair compensation).

[41] *Id.*

[42] My late colleague Walter Blum loved to take students down this Socratic path when teaching *Consolidated Rock*. Today's students are more economically sophisticated and not as credulous, at least so one hopes.

[43] SEC Amicus Brief, *supra* note 4, at 20.

The next argument focuses on the power that junior interests exercise in the reorganized firm and how this is itself problematic:

> [T]he reorganization machinery permits the holders of valueless interests to perpetuate themselves in control. . . . Not only is it patently inequitable to allow the holders of a valueless equity to retain so valuable an interest in the corporation, but it is a commonplace of corporate finance that the perpetuation of controlling common stock interests without asset value invites manipulation . . . .[44]

For reasons explained above, it is wrong to think that alternatives to absolute priority require old equity to have control, and asserting that the old equity is valueless merely restates the conclusion that its option value can be ignored in a reorganization.

It is also wrong on the facts. Reorganizations, at least those of an earlier era, often ensured that, even if the equity was preserved, voting trusts and the like were often put in place to ensure that creditors were able to exercise the levers of control. It makes the common mistake of assuming that only shareholders exercise the levers of control. Creditors commonly exercise control, before, during, and after bankruptcy.

The brief concludes by arguing that absolute priority brings certainty and relative priority does not:

> Finally, we direct the attention of the Court to the stimulus which uncertainty as to relative rights gives to obstructionist tactics. If the basis for the treatment of contract rights is unsettled, reorganization ceases to be an orderly process of allocating assets in accordance with priorities. . . . Especially where senior securities are widely dispersed and the valueless equity securities are compactly held . . ., the threat of protracted litigation often becomes an important factor in the formulation of the plan.[45]

Obstructionism and delaying tactics are bad, of course, and clear rules are better than ones that are opaque. But it does not follow that a regime that departs from absolute priority is unclear. Moreover, especially if a particular body of investors is dispersed, it becomes important to have a regime in place that gives those in control the right set of incentives. Again, to return to the facts of *Los Angeles Lumber*, a strict rule of absolute priority gives the concentrated shareholders no incentive to reorganize the business to obtain the surety bond. Unlike a relative priority regime,

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[44] *Id.* at 21.
[45] *Id.* at 22–23.

an absolute priority regime ensures that any shareholders who trigger it will be wiped out.

III. ASSESSING THE SEC AND THE ABSOLUTE PRIORITY RULE

What then do we make of the SEC's brief? The consequence of the brief, or at least the consequence of firmly embedding the absolute priority rule in the law of corporate reorganizations, was of a piece with the other changes that the SEC brought about in reorganization law in the 1930s, changes that were largely for the worse. They undercut the ability of large firms to reorganize in bankruptcy, and, through the Trust Indenture Act,[46] made it hard for them to restructure outside as well.

But criticizing the brief is something we should do cautiously. There have been times when it is has been easy to take the SEC to task for hewing too narrowly to a view of the world that had been rejected elsewhere. The SEC, for example, has been criticized for failing to take account of the academic literature that showed how information is incorporated into capital markets. Frank Easterbrook and Daniel Fischel have complained that, if the SEC were more attentive to such things, they would have given Ray Dirks a medal rather than have prosecuted him.[47] But this is emphatically not the problem here. In assuming that the only coherent priority rule is absolute priority, the lawyers writing the brief in *Los Angeles Lumber* reflect the academic wisdom of the day. Jerome Frank and William O. Douglas were widely respected academics in their own right. To the extent that we think lawyers should listen to contemporary academic wisdom, we should want them to pay attention to what Frank and Douglas thought, even if they were not their boss and judge respectively. The brief also sensibly invokes Berle and Means and talks sensibly about the problems that arose when those who are out of the money are in control: they have the incentive to "avail themselves of emoluments and indirect benefits" and "create asset value by speculative schemes."[48] Even if those writing the brief had turned explicitly to economists, what they would have found would have reinforced everything they said.[49]

Those who worked at the SEC likely shared Frank and Douglas's belief that absolute priority protected the innocent public investor and that the relative priority rule did not. Once one begins with the foreclosure paradigm and this starting belief, it is hard to see how, when forced to choose between relative and absolute priority, one should expect the regulators to decide differently. We cannot expect regulators

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[46] Trust Indenture Act of 1939, 15 U.S.C. § 77bbb (2006) (requiring, *inter alia*, appointment of trustee to protect securities creditors).

[47] *See* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 267 (Harvard Univ. Press 1991) (describing how Ray Dirks uncovered "one of the largest securities frauds in recent years").

[48] SEC Amicus Brief, *supra* note 4, at 21.

[49] *See, e.g.*, Norman S. Buchanan, *The Economics of Corporate Reorganization*, 54 Q. J. ECON. 28, 40 n.6 (1940) (stating academics overwhelmingly favor absolute priority rule).

to make a choice on the basis of academic wisdom of a future generation. Lawyers must do the best they can with what is known at the time.

What likely drove the SEC's lawyers had little to do with the theoretical challenge of the sort with which this paper began—linking the question of priority to the question of when and how to value the rights of the respective parties. The shape of the debate about absolute priority turned not on the merits of the priority rules themselves, but two deficits in the way that law was conceived. First, legal principles were seen in isolation from any other forces driving the behavior of the parties. A contemporary academic looking at a small group of players like J.P. Morgan who repeatedly goes back to the same investors would entertain the possibility that his efforts in a reorganization was in their interests, rather than against them. Moreover, today's academic would think that, even if reorganizations were costly, outside investors were not likely to pay the price. They should, in expectation, be getting a reasonable return on their capital. As long as the expenses were known (as they were), they should take them into account.[50]

One might be tempted to find here a conservative lesson for the government regulator: First, do no harm. Given that experts are not always right, one should be reluctant to take action. There are dangers to regulating any market, as one can never be sure, even if one possesses all the cutting-edge academic wisdom, that everything is as it appears. Lawyers, like everyone else, suffer from the cognitive bias of being overly confident about what they know.

But the lesson here is perhaps not for the regulators, but for the academics. The failure here was not the young lawyers at the SEC. They had to make a choice between absolute and relative priority, and they made the best choice they could, given what they knew. The fault lay rather with those who taught them. They were the ones overconfident about what they knew. It is possible that contemporary academics are both wiser and less overconfident. But perhaps we should not be so sure. As Mark Twain observed, "It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so."

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[50] Empirical work bears this out. Outside investors who held a diversified portfolio of these instruments over the long term outperformed the market as a whole. *See* W. BRADDOCK HICKMAN, CORPORATE BOND QUALITY AND INVESTOR EXPERIENCE 338, 509 (Princeton Univ. Press 1958).