PRIORITY IN GOING-CONCERN SURPLUS

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There is a debate about whether a corporate debtor's going-concern surplus over liquidation value, preserved by the bankruptcy process, should be distributed entirely to senior claims that are not paid in full or should, instead, be shared to some extent with junior claims. To protect the advantages of priority credit for debtors, this debate should be resolved in favor of the senior claims unless the junior claims are nonconsensual.

What is, or should be, the nature of a lien in a bankruptcy proceeding? As a tool to address this question, consider the following illustration:

> Debtor Corporation files a bankruptcy petition subject to Bank's perfected security interest in all of Debtor's assets, of any description, including all tangible and intangible property. At the time of the petition, Debtor owes Bank $600 and owes Unsecured Creditors $400; at the same time, Debtor's value as a going concern is $500, while the total piecemeal liquidation value of its assets is $300 divided evenly between physical property and intellectual property. That is, the going-concern surplus of Debtor's business is $200, which reflects a synergy among physical property, intellectual property, and the relationships among Debtor's various constituents and contractual counterparties.

Imagine that, under current law, Debtor is sold at auction (though no auction is required) as a going concern free and clear of all liens pursuant to Bankruptcy Code § 363. Whether the winning bid is for $500 in cash or Bank's lien bid of up to $600, based on its $600 claim secured by all of Debtor's assets, Bank is (at least arguably) entitled to the entire $500 value of Debtor's business.

It is this scenario that motivates recent proposals for a so-called "surcharge," through which Bank, as a secured creditor with a blanket lien, would be required to pay the estate a portion of the value it realizes

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in bankruptcy, whether through sale or reorganization.[1] Proponents of the surcharge reason that, but for the bankruptcy process, Bank would attempt to foreclose on Debtor's assets under state law and would (or might) collect no more than the assets' $300 piecemeal liquidation value. This would (or might) occur either because applicable state law did not extend liens to the synergy among assets, constituents, and counterparties, or because the dispersion of property across jurisdictions might make it impossible or prohibitively expensive to coordinate a foreclosure of property as part of a going concern. Indeed, modern federal bankruptcy law came into existence as a successor to equity receiverships, which were created to address these very problems of aggregation and coordination.[2] Under these circumstances, the bankruptcy process itself generates, or at least preserves, going-concern value, and, the surcharge proponents argue, secured creditors such as Bank should not capture the entirety of value so generated or preserved.

In this light, a surcharge of, say, ten percent of firm value distributed to cover administrative expenses (ignored above) and as a distribution to unsecured creditors can be seen as a reasonable division of value that would not exist but for the bankruptcy process. In the current illustration, assuming (for simplicity) that Debtor's business is sold for $500 cash, a ten percent surcharge would distribute $450 to Bank and $50, less expenses, to Unsecured Creditors (under the assumption, for simplicity, that Bank's deficiency claim does not share in the surcharge). This distribution is better for all than the results of a piecemeal liquidation.

It is hard to argue with the proposition that an undersecured creditor (or affiliation of such creditors) with a lien on all of a debtor's assets should pay administrative expenses. The bankruptcy process is, after all, run for the benefit of such a creditor (or affiliation). Such a position is not merely uncontroversial; it is also largely reflected in current practice. A debtor that enters bankruptcy subject to a blanket lien in support of an undersecured claim cannot maintain the process unless it receives debtor-in-possession ("DIP') financing, and often the only plausible source of such financing is the holder of the secured claim. In the provision of DIP financing, the lender agrees to pay the administrative expense of the process. To be sure, there is room for improvement. In particular, the reasonable cost of challenging the validity of a blanket lien should constitute a charge against the secured claim even if that claim ultimately withstands scrutiny (or at the least, there should be a loser-pays rule for the expenses of bringing such a challenge). But to a significant

1. The American Bankruptcy Institute's Commission to Study the Reform of Chapter 11, for example, considered proposals for a redistributional surcharge and, although the Commission did not recommend such a surcharge in form, it did recommend a distribution, under some circumstances, to junior claims even where senior claims are not paid in full. AMERICAN BANKRUPTCY INSTITUTE, COMMISSION TO STUDY THE REFORM OF CHAPTER 11 207–40 (2014).

2. Charles Jordan Tabb, *The History of the Bankruptcy Laws in the United States*, 3 AM. BANKR. INST. L. REV. 5, 21–25 (1995).

extent, it is already the case that secured creditors pay the administrative cost of the bankruptcy process.

The controversial element of the surcharge proposal is any return on unsecured claims when a secured claim is not paid in full. There is a surface appeal to the surcharge proponents' approach even here. To elaborate on their position, the bankruptcy process is supplied by the federal government and as such, the proponents claim, should not enhance the value of a security interest, which is a creature of state law. Indeed, this argument is consistent with the Supreme Court's reasoning in *Butner*,[3] which establishes that bankruptcy priority is determined by state law entitlements unless the Bankruptcy Code expressly provides otherwise.[4] The distinction between federal and state law is clear enough, but is also of questionable relevance to policy.

A policy assessment in support of the surcharge proposal must address the question of *why* a blanket lien should not be permitted to encompass a debtor's entire going-concern value as a matter of federal law. In the scenario presented here, bankruptcy law merely fills a gap in state law insolvency processes that render them ineffective in the preservation of going-concern value. There is (or may be) no affirmative decision by any state to limit the priority of a secured claim to piecemeal liquidation value. Any surcharge that exceeds what is necessary to cover administrative expenses could thus be seen needlessly to undermine the priority established by a debtor and its creditors when the debtor chose to grant a blanket priority lien to a single creditor (or consortium of creditors).

The finance literature is replete with potential efficiency benefits—and consequent reduction in the cost of capital—from a broad, undiminished lien, most significantly, a bond between the debtor and creditor against the debtor's pursuit of excessive risk that might be financed by subsequent loans from other creditors.[5] The idea here is straightforward. A financially distressed debtor subject to a blanket lien may find it difficult or impossible to obtain new financing for unduly risky, inefficient projects that the debtor's managers might want to pursue in a perhaps desperate attempt to achieve a reversal of fortune; such inefficient projects so avoided may simply be a continuation of business ventures when retrenchment is the better course. Although the overhang of a lien that chills new financing at the time of a debtor's financial distress may hinder the debtor's pursuit of efficient projects, as well as inefficient ones, the prospect of such a hindrance is a factor the debtor can weigh in the balance as it decides the extent to which it will encumber its assets initially.

3. Butner v. United States, 440 U.S. 48 (1979).

4. *Id*. at 55.

5. *See* Elazar Berkovitch & E. Han Kim, *Financial Contracting and Leverage Induced Over—and Under—Investment Incentives*, 45 J. OF FIN. 765 (1990); *see also* Barry E. Adler & George G. Triantis, *Absolute Priority Redux* (working paper 2014) (collecting sources) [hereinafter Adler & Triantis, *Absolute Priority Redux*]; Barry E. Adler & George G. Triantis, *The Aftermath of* North LaSalle Street, 70 U. CIN. L. REV. 1225 (2002) (same). *See generally* Barry E. Adler & Marcel Kahan, *The Technology of Creditor Protection*, 161 U. PA. L. REV. 1773 (2013).

To be sure, there are those who nevertheless believe that full priority for secured credit may be counterproductive. It is contended, for instance, that such priority increases creditor administrative and monitoring costs and inefficiently transfers value from small and nonconsensual creditors who cannot adjust to inferior priority.[6] But for reasons addressed elsewhere,[7] such arguments too casually dismiss the efficiency benefits of robust priority or overstate the impediments to consensual creditors' adjustment, and other than for nonconsensual claims—which, as the result of unwilling credit, should (but do not) have highest priority—the arguments in support of limited priority are not entirely persuasive, or at least are insufficiently persuasive to justify a mandatory restriction on priority for secured claims.

It can be argued, then, that bankruptcy law should facilitate, not undermine, a debtor's ability to grant a lien in a going-concern surplus. This would imply that any surcharge be limited to cover administrative expenses, consistent with current Bankruptcy Code § 506(c).[8]

Additionally, there could be functional difficulties in the application of a distributional surcharge. Consider again the above illustration, but imagine that Debtor's going-concern value is not \$500, but \$320. Assume that the disposition of Debtor's assets would require only a modest (but necessary) administrative expense, whether such disposition occurred through a state law foreclosure proceeding, a sale under the Bankruptcy Code, or a chapter 11 reorganization. Under these conditions, given a ten percent bankruptcy sale surcharge, Bank would favor piecemeal liquidation of Debtor's assets under state law. This is so because (ignoring the administrative expense for ease of calculation) liquidation under state law would yield Bank a \$300 return and Unsecured Creditors nothing, while a going-concern sale subject to the surcharge would yield Bank \$288 and Unsecured Creditors \$32 (assuming for simplicity, as above, that Bank's deficiency claim does not share in the surcharge). This means that Bank would not finance a bankruptcy sale, and if the surcharge applied to a reorganization (where it could be based on judicial valuation), Bank would not finance that process either, but would instead advocate for dismissal of the bankruptcy case and inefficient liquidation of Debtor's assets under state law. Perhaps a surcharge could be made flexible to assure a secured creditor such as Bank at least its liquidation entitlement—thus addressing the incentive for inefficient liquidation—or perhaps a deal could be struck between a secured creditor and unsecured creditors to avoid a wasteful liquidation. But such a flexible surcharge could prove difficult to administer, and such a deal could prove difficult or impossible to reach.

6. *See* Lucian A. Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy,* 105 YALE L.J. 857 (1996) (developing the transfer point); Richard Squire, *The Case for Symmetry in Creditors' Rights*, 118 YALE L.J. 806 (2009) (making each of these points).

7. Adler & Triantis, *Absolute Priority Redux*, *supra* note 5.

8. 11 U.S.C. § 506(c) (2012).

Where an obstacle to a bankruptcy surcharge is that the holder of a blanket lien balks at the provision of administrative expenses for a bankruptcy sale or reorganization, a court could consistent with current statute—per Bankruptcy Code §§ 364(d) and 506(c)[9]—or under revised law, provide that a new lender take a lien-priming security interest in a debtor's assets to the extent of such expenses. Effectively, the surcharge itself could serve as security for the provision of such expenses. But it is not clear that such funds would be readily available even under these conditions, especially where time is of the essence.

Another practical difficulty with a surcharge is presented by the case where there is no creditor with a blanket lien. Modify the above illustration so that instead of one $600 claim secured by all of Debtor's assets, there are two claims held by different secured creditors—one claim, for $300, backed by Debtor's physical property, worth $150 in liquidation, and one claim, also for $300, backed by Debtor's intellectual property, also worth $150 in liquidation. So modified, this illustration presents no one creditor with even an arguable claim to Debtor's going-concern surplus, and administrative expenses aside, a court might, under current law, have the secured creditors' deficiency claims and the unsecured claims share that surplus ratably. (Ignored, for simplicity, is the prospect that the secured claims might be strategically combined in anticipation of bankruptcy.) Under these circumstances, even those sanguine about a surcharge's distributional effect in the presence of a blanket lien might find it difficult to defend a surcharge that increased the take by unsecured creditors beyond the share of surplus to which they are entitled even without a surcharge.

A surcharge could be designed not to apply in the absence of a blanket lien, but unlike in the simple current illustration, it might not always be easy to determine when such a lien is deemed to exist. Consider, for example, a complicated debtor with multiple divisions and a secured claim covering all assets in some, but not all, divisions. Would the surcharge apply in such a case? If so, to what extent? How would the lines be drawn? As observed above, a flexible surcharge could be difficult to administer.

Of course, one could address these potential difficulties with an alternative to a surcharge as a means to limit the priority of blanket liens. Recall the premise for a distributional surcharge: under applicable nonbankruptcy law, the holder of a blanket lien would not capture a viable debtor's going-concern surplus, which would simply be lost in piecemeal liquidation. Given this, following the Butner principle and the bifurcation rules of current Bankruptcy Code § 506(a),[10] one might simply limit a secured claim's priority to the piecemeal liquidation value of its collateral. In the initial version of the above illustration, then, Bank would have a $150 security interest in Debtor's physical property and a $150 se-

9. *Id.* §§ 364(d), 506(c).
10. *Id.* § 506(a).

curity interest in Debtor's intellectual property, this notwithstanding that the contracts between Debtor and Bank, and the related filed financing statements, provide Bank a security interest in all of Debtor's property of every description. Now Unsecured Creditors would share ratably with Bank's deficiency claim in Debtor's going-concern surplus.

There is, however, a practical difficulty with this approach as well. The holder of a blanket lien, such as Bank in the current illustration, could not credit-bid for all of a debtor's assets in a going-concern sale, as a lien subject to a liquidation-value ceiling would not cover the entire value of those assets. Where potential purchasers face liquidity constraints, the absence of a credit-bid could delay, perhaps inefficiently, the bankruptcy process' disposition of assets.

Perhaps more importantly, just as there is reason to doubt the wisdom of a distributional surcharge on a secured claim, there is reason to doubt the wisdom of a liquidation-value ceiling on blanket liens. As noted above, expansive liens may serve debtors as a tool in the acquisition of low-cost capital, and low-cost capital, in turn, benefits the economy. It is not clear why the law should seek to limit this tool.

This is not to say that undiminished priority in the hands of a single creditor will always be efficient or just. As mentioned, the law inappropriately denies priority for nonconsensual claims. Moreover, as noted, even among consensual claimants, priority to early lenders can lead to inefficient investment decisions when a debtor is insolvent or nearly so. But as a general matter, an assessment of the benefits and costs of full priority are best left to the contracting process between the debtor and its investors. There is, in any case, insufficient reason for a legal rule, such as the proposed surcharge, that would have the law deviate from absolute priority among investors.