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Title
Deconstructing the Senior Creditor

Permalink
https://escholarship.org/uc/item/89d7p3jv

Journal
UCLA School of Law Law & Economics

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Publication Date
2024

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Deconstructing the Senior Creditor

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Introduction

Fundamental to every business organization is the question of capital structure. What form will the investments in and claims against the business take? And how do those forms affect the operations of the business? Most firms will have a layered capital structure including equity and debt. Often that debt will itself be layered with tranches of secured debt that are considered senior to general unsecured or junior creditors. This existence of junior and senior debt is both familiar and puzzling to scholars of law and finance. The phenomenon of a senior class of creditor enjoying prior payment on debt in distress, possessing special enforcement rights upon default, and exercising other various control rights is well documented. But theorists have long struggled to explain why the phenomenon persists. Modigliani and Miller (1958) proved that in perfect capital markets and absent taxes and bankruptcy costs, the capital structure used to finance a project does not change its value. Thus, the choice between financing a project with equity, debt, or senior debt shouldn't matter. (Schwartz 1981). The ubiquity of debt financing—and of layers of junior and senior debt—make plain, however, that capital structures do, in fact, matter. Scholars have labored to explain why that is the case.

The vast literature on the secured debt puzzle has explored the various reasons why a business debtor would grant one creditor a security interest (the conventional means of creating senior debt), why that creditor would want that security interest, and how other creditors view the grant. (See for example Adler 1993; Kronman & Jackson, 1979; Schwartz 1981; Levmore 1982; Schwartz 1984; Kanda & Levmore 1994). Some scholars have focused on the asset-based enforcement rights that come with secured debt, others have focused on payment priority, others have focused on the control that secured debt creates in the creditor as a result of the various actions the creditor can take when distress arises. More recent scholarship has explored alternative ways that the attributes of senior debt can be created without the grant of a security interest. (Baird 2017; Casey 2015).

Often missing, however, is a discussion identifying the discrete and different rights that make up creditor or investor[1] seniority and how and why those rights might be separated or combined. In this chapter we explore those questions. Our goal is to review and understand the core components of "seniority."

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[1] Equity investments and debt are just different layers of investment, with equity being the most junior. Keeping with convention, we will refer to senior *creditors,* but one could just as easily refer to them as the most senior investors with equity being the most junior.

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Seniority can mean many things. While scholars and lawyers are aware of its nuances, they often simplify the idea of seniority into a bundled classification for analysis—creditor A is either senior to creditor B or it is not. This obscures the various discrete and separable rights that constitute seniority—creditor A may have payment preferences senior to B, and creditor B may have enforcement rights senior to A. While the law often bundles these rights together, that is not the only option. We aim to unpack seniority and explore the collection of various creditor rights that constitute it. Doing so reveals that seniority can, at least theoretically, be unbundled to create hybrid relationships that do not fit the binary nomenclature and can tell us something about the nature of the questions posed by the puzzle of senior debt.

In particular, debt is at its core the purchase of a cash flow, and seniority is the label we place on the presence of some combination of various accompanying rights: payment preferences, self-help in collection, collection from third parties, and certain other forms of control. Although these preferences and rights are often conflated into the term "senior" (and sometimes "secured"),[2] they are distinct and separable, and we analyze them as such. This conceptual unbundling allows us to see more clearly the rights that creditors might obtain, why they might obtain them, and how the law facilitates or obstructs the optimal bundling of those rights.

To proceed, first we present the types of discrete rights that debtors might grant to creditors. We try to consider the rights as a matter of first principles, leaving till later the tools by which the law implements these rights. We group the rights into payment rights, enforcement rights, and control rights. Our analysis avoids some familiar legal language such as *in rem* rights or rights being *in the property*, or the *property* versus *liability* dichotomy. We avoid familiar terms because using them tends to encourage assumptions about what bundle of rights naturally arises from the term, whereas our project is to deconstruct preconceptions about bundles of rights. Instead, we focus on the substance of the rights and obligations that parties negotiate over—if a debtor wishes to get cash from creditors, what things must she promise them?

Second, we look at the motivation behind the granting of the rights we have identified. Why might a debtor agree to grant one creditor a certain combination of rights? Why might that creditor demand that right? And why might other creditors favor or oppose the grant? Third, we look at existing law to see the bundles of rights that are feasible today and the mechanisms for altering those bundles. Fourth, we examine the bundles of rights that are unavailable under existing law. Finally, we discuss the implications and develop some thoughts on how the law could be improved and on areas for future inquiry.

I. Varieties of Rights

[2] Seniority and Priority are often conflated as well. In this article, we will use the term priority to specifically refer to payment priority, while seniority will denote the bundle of preferred creditors rights that we are deconstructing.

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A debt contract,[3] like other investment instruments, is a contract whereby the creditor buys a future revenue stream subject to various conditions and accompanied by certain other rights that are enforceable against specified persons. The same can be said of equity investments—they are just subject to a different set of default conditions and are accompanied by a different set of default rights. For example, a run-of-the-mill debt obligation is an arrangement where the debtor agrees to provide a payment stream on a set schedule that will not exceed the sum of the principal and the interest accruing until the final payment. Those payments may end up being less than that amount if the debtor becomes insolvent. An equity investment in a corporation, on the other hand, is an arrangement where the investor has the rights to certain future payments that are contingent but have no cap and also no set schedule. The equity investment also brings with it a set of default rights—such as the right to elect directors—that is not included with the debt obligation. Notably, in structuring these arrangements the parties can alter the rights not just between the debtor and the creditor but also among and between various creditors and other third parties.

The rights attaching to these transactions vary and can be altered to some extent by the parties either through contract or by other legal measures (to be discussed in Part II). The most essential right in a debt contract is the right to payment. When the debtor is solvent, the contract will usually provide for payment of a set amount on a set schedule. The more interesting questions arise when the debtor is insolvent, defaults on its obligations, and cannot pay all of its creditors the full amount. What happens to payment rights in that case?

One option is pro rata equality. With pro rata treatment, no creditor has payment priority over any other. Another option is to impose an equal race to the assets where a creditor only gains payment priority by being the first to convert its payment right to a judgment lien. A third option is to stipulate that when the debtor is insolvent, one creditor must be paid in full before other creditors are paid at all. Within that option, the parties may want to tie the value of that payment preference to the value of a particular asset or some other reference point. They may want to let some creditors collect payment from third parties. They may want to grant some creditors special enforcement rights that allow them to collect payment without resorting to court process. Finally, they may want to grant some creditors other rights to control the debtor's actions.

As we identify the various rights to which debtors and creditors might agree, it is useful to identify four main questions that arise when a debtor defaults: How much can the creditor collect—or more specifically what are the relative payment preferences between and among the debtor, its various creditors, and any third party who might also be liable? What must a creditor do to collect payment? From whom may the creditor collect payment? What rights does the creditor have to control the way parties use certain assets? The first question is about payment priority. The second and third questions deal with enforcement rights. The

[3] We will talk about debt contracts throughout this chapter. To be clear, a debtor can incur debt obligation in other ways like contracting for payment, breaching a contract, or even by committing a tort. Except with regard to that last category—which involves involuntary creditors—the distinction does not affect our analysis.

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fourth is about control rights. For each category of rights, we describe the options that parties might agree to in a world without legal impediments to such arrangements.

A. Payment Rights

Creditors contract for a sequence of one or more scheduled payments. When a debtor has promised creditors more than she can pay, some creditors will not receive the promised revenue stream. The apportionment of loss and the assignment of payment rights amount to a designation of payment priority. Higher priority creditors may recover more, shifting losses onto lower priority creditors. The question of payment priority is the conventional focus of the secured debt literature. This question consists of three components: level of priority, fixity of priority, and amount as to which there is priority.

1. Levels of Priority

There are several options that a creditor could agree to in terms of payment priority. The most familiar option is to give all creditors pro rata recovery. Another option is to allow creditors to recover on a first-come first-served basis when distress arises. In both of these payment schemes, no creditor has any special ex ante right to payment from the debtor. Either they share equally, or they are equally part of a race to be the first to secure payment.

And yet, some creditors may wish to purchase the right to higher payment priority, which necessarily means lower priority for the other creditors.

2. Fixedness of priority

Payment priority can be either fixed or dynamic. With fixed priority, the debtor is incapable of subsequently lowering it without the creditor's consent. With dynamic priority, the debtor instead retains the option to promise another creditor even more senior status, effectively lowering the priority of the hitherto senior creditor. Creditors with fixed senior payment priority have *strong* payment priority. They have medium payment priority if they have senior but dynamic payment priority.

Table 1 displays these options:

Table 1 Payment priority

Priority Level		
Weak: No Priority	*Medium*: Dynamic Priority	*Strong*: Fixed Priority

3. *Amount as to which there is priority*

A creditor with payment priority may have that priority for all of its claim or only part of it. The proportion of a claim that enjoys priority may be fixed—a creditor might want an arrangement where the first $1 million of her claim has payment priority over other creditors, but that the remaining $2 million is treated pro rata with no special priority—or it may have a cap that fluctuates according to a formula.

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In the case of fluctuation, the creditor may want to index the payment obligation against some outside value, such as the value of certain collateral. If the collateral declines in value, the debtor's total obligation persists but the creditor's priority vis-a-vis other creditors declines.

The relevant collateral for the formula could be a *specific* asset, a *class* of assets, or some combination of the two approaches. For example, the creditor's payment priority amount might be limited by the market value of a certain piece of equipment with an enumerated serial number (specific asset), or "whatever equipment the debtor owns" (a class), or both. In the second example, the amount for the payment priority is not capped to the value of a specific assets but rather to the value of whatever assets remain in the pool or class at the relevant time. If the designated collateral dips in value, the creditor's rights are reduced and other creditors gain. If the priority amount does not decline according to some formula, it is a strong priority amount right.

Table 2 displays these options.

Table 2 Payment priority amounts

Priority Amount		
Weak:	*Medium*:	*Strong*:
Capped at value of a specific asset	Capped at value of class asset	Not capped

II. Enforcement Rights

A. Against the Debtor

When a debtor misses a payment or otherwise defaults, a creditor will want to collect on the missed payments and perhaps accelerate the payment schedule and collect future payments as well. From the creditor's perspective, its collection is less costly if it can engage in self-help measures or stream-lined collection instead of resorting to a judicial process that requires converting its claim into a judgment lien. (Badawi 2012). These collection measures may involve seizing sums of money or accounts, seizing property for auction or in satisfaction of the obligation, offsetting amounts owed to the debtor, converting property of the debtors that is in the creditor's possession, or other similar actions. The creditor will—all else equal—prefer the right to implement these measures without first seeking a judgment in court.

Even where the creditor has the right to self-help measures, the law might allow the debtor to use judicial process to halt such measures. For example, American bankruptcy law has this feature in the form of an automatic stay against creditors' collection measures. The creditor would of course prefer even stronger rights that were immune to such judicial process.

The options available to parties might be conceptualized as continuum from weak to strong enforcement rights, where a weak enforcement right requires full judicial process by

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the creditor and a strong right allows the creditor to take immediate action that is immune to judicial challenge.

Table 3 illustrates enforcement options against the debtor.

Table 3 Enforcement options

Priority Against Debtor		
Weak:	*Medium*:	*Strong*:
Requires judicial process	Suspended by judicial process	No judicial process

B. Against Third Parties

The parties will also want to designate individuals against whom the creditor can enforce its rights. The most salient option is enforcement against the debtor alone. But a creditor may want the option to recover from third parties as well. This third-party liability can take various forms. For example, the third party might become primarily liable for debts in the same manner as the debtor, liable only if the debtor misses a payment, or liable only as a matter of last resort after the creditor has exhausted all collection remedies against the debtor. Alternatively, a debtor and creditor may desire an arrangement where third-party liability is contingent on something other than the debtor's non-payment. For example, the creditor may want the ability to collect the value of an asset from anyone (including a third party) that possesses it.

Again, the rights might be placed on a continuum where the weakest rights permit enforcement against third parties only if they have taken some legally recognized problematic action, such as aiding and abetting a fiduciary breach or receiving a fraudulent transfer; the medium rights include enforcement against third-parties who have agreed to be liable; and the strongest rights would allow enforcement against even parties who have not consented – explicitly or by direct actions – to be liable for the debt.

Table 4 illustrates enforcement against third parties.

Table 4 Enforcement against third parties

Enforcement Against Third Parties		
Weak:	*Medium*:	*Strong*:
Aiding and abetting; Fraudulent transfer	Consenting third parties	Non-consenting third parties

C. Control Rights

Control rights entail the legal right to do something other than obtain payments. There are three familiar control rights: the right to choose or vote on the identity of some or all managers, the right to vote on specified transactions or business conduct, and the right to demand information.

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Creditors may want the right to directly or indirectly limit debtors in their business operations or their ability to take on new debt. These rights may be established in absolute terms, such as a promise that the debtor will not do something or a grant to the creditor of the power to make a certain decision or take a certain action. Another option is to grant the creditor veto power or voting rights, or to impose a cost on the debtor for taking certain actions. Finally, the debtor may allow the creditor to appoint certain decision makers such as a corporate director.

These control rights can be structured to bind the debtor but not a third part. For example, a creditor may have the right to lock a debtor out of certain property, without necessarily having a right to lock out third parties to whom the debtor subleased the property to. Or the rights can be created so that they directly impact third parties. If a creditor has the right to select a debtor's board, then a third party's contract signed by a board elected by the debtor's shareholders may not be valid.

Table 5 illustrates these available control rights.

Table 5 Control rights

Control Rights		
Weak:	*Medium*:	*Strong*:
None except in bankruptcy	Binding on debtor	Binding on third parties

D. Why grant senior rights?

Any one creditor will, of course, desire more rather than fewer rights. But that alone cannot explain why debtors grant special rights to one creditor rather than another. When the debtor and other creditors give up valuable rights, they will demand appropriate compensation from the favored creditor for doing so. That just shifts value from one party to another and back again, and without more there is no reason to think the debtor would bother with such an arrangement. But debtors do bother with these arrangements, and that suggests that they create value—that the grant of rights to a favored creditor is mutually beneficial to the favored creditor on one side and the debtor and her other creditors on the other. The question, then, is *why* it is mutually beneficial.

Broadly speaking, there are three explanations for how the grant of special rights to one creditor might create a benefit in which the relevant parties can share: different valuations (arising from asymmetric information or idiosyncratic preferences); cooperative investments and monitoring; and externalization. The first two reasons suggest positive value creation and can reflect the parties' attempt to make the most of specialized creditor knowledge. The third reason represents a socially costly market failure where the bargainers capture private gains by shifting the costs to external parties.

1. Different Valuations

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Sometimes parties will have different views about the value of the same asset.[4] When this is the case, a debtor can lower its total cost of credit by tying its promises made to a particular creditor to an asset on which that creditor places a high valuation (relative to the valuations held by the debtor and other creditors). The creditor will charge a lower interest rate if it is confident it will be paid first. If it is granted payment priority based on the value of an asset it thinks will be worth more than the value of its loan, it will view the transaction as low risk. Moreover, if its enforcement rights are valid against any party who subsequently comes to own that asset, it will view its position as even safer. This creates value when other creditors disagree about the value of the asset and place a lower value on the cost of the priority grant.

Imagine that the debtor has two creditors (Bank and Fund) and two assets (A and B). Bank and Fund value Asset A the same, but Bank places a higher value on Asset B; indeed Fund believes Asset B is worthless. The Debtor can promise Bank that it will get payment priority tied to the value of Asset B. Bank will pay for this priority in the form of a lower interest rate. Fund is subordinated as to the value of Asset B. But Fund views Asset B as worthless, so it is indifferent to the priority granted to Bank and does not raise its interest rate. In this way, debtor lowers its overall cost of capital and creates value.[5]

In other scenarios, the debtor may be able to create value by granting payment priority to a creditor who places *a lower* valuation on an asset. To see why, imagine that Debtor has only one asset. Bank thinks the asset is worth 20 and Fund thinks it is worth 10. Debtor wishes to borrow 10 from each. Fund would balk at a transaction where Debtor tries to borrow from Bank and Fund on equal terms. But if Debtor ties Fund's payment priority to the value of the asset and allows Bank to recover whatever is left over after Fund gets paid, everyone will be on board. Fund thinks Bank is foolish and will not recover anything. But Bank is certain that Fund is wrong and does not raise its interest rate.

Differing valuations can also drive special grants of enforcement and control rights. A creditor who values a particular asset highly may accept a lower interest rate if its right to enforce is good against any third-party who ends up owning that asset. Similarly, a creditor whose payment is tied to the value of a particular asset may demand certain control rights that can be used to prevent the misuse, alienation, or neglect of that asset. A creditor might also demand special control rights if it has idiosyncratic preferences on certain uses of an asset.

As to the source of differentiation, creditors may hold different valuations simply because they have different baseline assumptions about the market or predictions about future events, or because they have idiosyncratic preferences about the use of an asset, but the most important source of variation will be information. Some creditors simply have more

[4] For an example and model of how disagreement on valuation can affect financial structure and the cost of capital, see Ayotte (2020).

[5] From an ex post perspective, Bank may regret its choice if Asset B ends up worthless. But that is no different from many insurance and risk-shifting transactions. From an ex ante perspective, the three parties are all better off by their own lights.

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information about an asset or can vet its worth more cheaply.[6] For example, the seller of a piece of complex equipment may be able to easily ascertain its current value. The seller knows the current market for such goods, because she is currently in communication with buyers, and recognizes the signs of faulty equipment. From recent conversations with customers, she may know what kind of cashflows such equipment can realistically generate. With this information available, the seller may be able to form a sensible estimate of value when other creditors cannot. As a result, where the true value of an asset is higher than the market's noisy estimate, the informed creditor will charge a lower interest rate than other creditors for a promise backed exclusively by that asset.

2. Cooperative Investments and Monitoring

A debtor may promise privileges to one creditor relative to others when doing so improves the situation of even the putatively disadvantaged creditors. As a result, the debtor will enjoy a discount from one creditor with no offsetting charge from others.

The most familiar example of this concerns the reduction of monitoring costs.[7] A sole creditor would bear all efficient monitoring costs, but the introduction of additional creditors creates potential problems: either redundancy as more than one creditor undertakes similar monitoring to protect its own interests, (Levmore 1982) or neglect as some risks go unmonitored either because each creditor wrongly assumes that another creditor will monitor or because their individual gains from monitoring are smaller than the costs.[8] Ideally, the same level of monitoring would occur as creditors multiply, but creditors may not be able to coordinate to optimally share the monitoring burden.

Relieving one creditor of monitoring duties can unlock substantial value in the form of improved liquidity. Some amount of monitoring costs must be paid whenever a debt interest is sold, since the new buyer will not take on faith the seller's representations of quality. Even small per-transaction monitoring costs vastly lower the liquidity of debt instruments. If these costs can be minimized or eliminated, debt can serve as a powerful transactional medium, substantially increasing its value. (Gary B. Gorton, et al. 2012). A creditor scheme which shifts all monitoring costs from one creditor to another can, thus, unlock substantial value. (Eldar & Verstein 2019). For example, asset-backed securities enjoy substantial liquidity because they are structured to be so safe and so difficult to scrutinize that no rational buyer will engage in scrutiny; they are money-like in that their value is not discounted by a long chain of future buyers' monitoring costs. All monitoring obligations are implicitly allocated to the bank or insurer that retains exposure to the assets' risks.

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[6] Several scholars have modeled the effects of asymmetric information among creditors. Bolton & Freixas (2000); Wittenberg-Moerman (2008); Ivashina and Sun (2011).

[7] Monitoring is a term that actually encompasses three distinct activities: ex ante scrutinizing the quality of a borrower or collateral ("vetting"); ex tempore monitoring the quality of the collateral and compliance with covenants ("observing"); and ex post value-preserving activity such as repossessing and selling collateral ("enforcement"). Although it is sometimes fruitful to separate these three concepts, we follow the literature in presenting them together.

[8] Alan Schwartz has argued that such neglect is unlikely. (1984) This response arguably understates the monitoring creditor colluding with the debtor, Squire (2009), and the costs of creditors monitoring one another to determine that predicted monitoring is taking place. Picker (1992).

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Assigning one creditor special rights of payment, enforcement, or control that are tied to a particular asset, facilitates such a scheme by motivating that creditor to take the lead on monitoring the asset's condition, use, and ownership. In this way, the favored creditor can take steps to make sure the asset is not wasted, misused, transferred to a third party, or allowed to depreciate in value in some other avoidable way. Because this creditor's returns are tied to the use and value of that asset, it focuses its attention on preserving the asset's value. And because it enjoys special rights with regard to the asset, its incentives are not as diluted as they would be for a general creditor.

In some case, all the creditors may recover from the same pool of assets, but the value that is created by monitoring can spill over and benefit other creditors. A creditor who monitors a factory to make sure it is not destroyed or transferred to a third party protects both the value of that specific asset as well as any broader going concern value that is created by keeping that asset together with the debtor's other assets and operations. Similarly, a creditor's payment might be tied to an asset that is worth much more than the amount the creditor is owned. That creditor might take actions to prevent the total destruction of that asset, and doing so would preserve the excess value of the asset for the benefit of other creditors. In these cases, the monitoring story works because monitoring is lumpy—a monitoring creditor cannot protect itself without incidentally protecting the other creditors to some degree.

An alternative explanation might be that giving special rights to one creditor creates incentives for the *other creditor* to provide the necessary monitoring. For example, a creditor's incentive to monitor an asset can be intensified by giving that creditor a subordinated payment right with respect to the asset. The creditor will internalize the early losses of any neglect and may take protective action long before any preferred creditor's interests are impinged.[9]

There are costs to granting these rights and the optimal grant will depend on the specific risks that need to be monitored. If a creditor's rights are linked to a particular item of collateral, the creditor may take excessive efforts to protect it. This may interfere with the debtor's operations. For example, a creditor specialized in monitoring a piece of equipment may seek to prevent the debtor from selling the equipment to faraway buyers, since monitoring may become more difficult. The creditor's efforts may lead to ossification of the debtor's business, to the detriment of the debtor and other creditors. Conversely, if the creditor's rights are linked to a category or pool of assets rather than a single item, the creditor may focus too much on the pool with too little incentive to look after any particular item. For example, a creditor who has payment priority as to all the debtor's equipment may not object as the debtor swaps one machine for another. Frequent asset substitution may

[9] In the Kronman & Jackson version of the theory, the monitor accepts a junior position (on one asset or in general). That tranche suffers losses first, which encourages active monitoring. (Kronman & Jackson 1979). In the Levmore version of the theory, monitoring efforts are lumpy, so senior creditors protect junior creditors as a side effect of monitoring intended to prevent only actions large enough to harm the senior tranche. (Levmore 1982). There is much debate and many empirical studies about which of these stories is correct. (See for example Adler 1993; Schwartz 1981; Schwartz 1984; Picker 1992; Kanda & Levmore 1994; Westbrook 2004; Roberts & Sufi 2009; Nini, Smith, & Sufi 2012). But in either version it is the need for monitoring that drives the special rights given to a "senior" creditor.

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work to the disadvantage of other creditors, since it can allow a debtor to increase its overall level of risk.[10] (Levmore & Kanda 1994). All of this is to say that monitoring is not a one-size-fits-all proposition.

This discussion has so far focused on payment priority, but control rights can strengthen payment rights or create their own form of monitoring. For example, a creditor's state-contingent threat to exercise control over certain decisions that is triggered by debtor misbehavior or distress may bind the debtor to good behavior in such a way as to alleviate the need for close creditor monitoring. (Bolton & Scharfstein 1996). In that sense special control rights substitute for the monitoring that might otherwise be achieved through payment rights.

Likewise, rights to enforce against third parties can optimize monitoring by creating incentives for those third parties to watch over the debtor. The third party may be an even better monitor of the debtor than the creditor, and asking the third-party to answer for the debtor's obligations forces the third-party to use its monitoring skills. (Katz 1999). It is also common for parties to purchase insurance on themselves or on another entity in order to obtain the insurance company's implicit assurance of quality. The presence of an insurance or indemnification fund amounts to a limited right of recourse against a third party.

Enforcement against third parties can be an especially effective form of monitoring when there is a risk of asset substitution or diversion. For example, suppose the creditor bargained for the right to recover a certain painting from whomever owns it. This would reduce the risk that the debtor would sell the painting and direct the proceeds to a speculative investment project. Not only could the creditor recover the painting if sold, a buyer is far less likely to buy the painting if they know it is subject to this encumbrance, and the buyer is also more likely to investigate whether the debtor violates any covenants by selling the painting. Where the third party such as a buyer is in a better position to watch the debtor's performance than the creditor, it may be rational to encourage their monitoring on pain of enforcement rights.

Once again, there are costs to this third-party monitoring. First, internal to the nexus of parties, a creditor may monitor less effectively if they know that they have robust rights against third parties. The creditor may trust the third party to monitor, or she may rest content that her rights have not been hampered through the transfer in any case; other creditors relying on her monitoring for asset substitution may be disadvantaged if the monitoring does not occur. Second, broad rights against third parties burden those third parties and raise the cost of whatever conduct plausibly subjects them to liability. If it is buying an item from the debtor, enforcement rights against third parties can, thus,

[10] The debtor may swap $10 million of equipment for $10 million of equipment, the latter suitable for much riskier business. The equipment monitor will not object, though creditors as a whole now endure uncompensated increases in risk.

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discourage commerce with debtors. A highly leveraged debtor may become a pariah, unable to find counterparties despite the health of the business.[11]

3. Negative Externalization

The lumpy monitoring story is in essence a story about positive externalities. But special creditor rights can also arise because of negative externalities. The bargain by which the debtor grants special creditor rights is not one in which all creditors are consulted. If it were, then creditors would object to uncompensated arrangements that harm them relative to the default rules. When one creditor asks for advantages, other creditors would demand expensive payments to offset their increased risk. Since not all creditors are actually at the bargaining table, we cannot be confident that any agreement that follows will be Pareto efficient.

True, even creditors who are not at the actual bargaining table can raise their interest rates when they anticipate the grant of special rights that harm them. Expecting this, the debtor again should demand a commensurate price from the favored creditor and therefore only grant those special rights when the overall benefit outweighs the costs and we arrive again at Pareto efficiency. But some creditors cannot simply adjust their demands when other creditors take in slack. For example, involuntary creditors, such as the victims of a debtor's torts, are not able to demand more money from creditors who benefit from a protective capital structure. It is a free lunch for the debtor to offer senior rights to adjusting creditors over non-adjusting creditors. Suffice it to say, it may not be efficient for the debtor to externalize costs onto non-adjusting creditors without regard to the cost it imposes on them. (LoPucki 1994; Bebchuck and Fried 1996)

Moreover, when creditors anticipate the possibility of future grants of special rights and adjust their rate up to account for the debtor's option to harm them in the future (Squire 2011), the debtor will pay an ex ante price unless it can bind itself against making such a grant. The means for the debtor to bind itself would be through a negative pledge, but that may not be enforceable against the debtor when the debtor has become insolvent; such a pledge is, in any case, not binding on the beneficiary of the special rights. The debtor will thus be forced to pay for the right to impose the ex post cost on the general creditors even when it would prefer not to. In the end, the debtor bears the cost so it is not a pure "externality" but there is a welfare loss that stems from Debtor's unwaivable ability to externalize the cost of granting special rights to the favored creditor.

III. Seniority Under Existing Law

To this point, we have discussed things in the abstract. What special rights could a debtor grant to a creditor? And why might the parties arrange things to grant those rights? What remains to be discussed, is how these arrangements are created under current law. This in turn can reveal areas for potential legal reform. As we have noted above, there are

[11] Another downside is that all contractors must begin to evaluate all transactions for risks of liability to the counterparties-creditors. (Merrill & Smith 2000). That is a social cost that is not internalized by the creditors and debtor.

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costs and benefits to granting special rights to creditors. But the law does not allow parties to pick the rights a la carte. Rather it presents specific off-the-rack bundles that combine certain rights. And only some modifications to the bundles—often requiring elaborate legal mechanisms—are allowed. This bundling will not always be optimal. Where the law bundles two rights (say, payment and enforcement) a creditor who only wants one must either pay for a right she does not value or, if possible, pay to create a modification mechanism. In this section we present the three salient bundles—the unsecured loan, the security interest, and creditor ownership—and then two common altering mechanisms—contracts and entity structures—and then we present some bundles that are unavailable under current law.

A. The Salient Bundles

1. The Unsecured Loan

The first bundle of rights is the one often regarded as the background assumption, which obtains in the absence of any special promises as to enforcement, payment, and control rights. That bundle, which may be regarded as the default form of credit, is an unsecured or general loan.

Payment Priority. A general creditor has low payment priority. Outside bankruptcy, her payment rights are determined on a first-come first-served basis. Bankruptcy law converts the general creditor's payment rights to a pro rata position. These payment positions of the general creditor are dynamic in that they are subject to involuntary subordination to other creditors who negotiate for payment priority. Bankruptcy also subordinates the payment position to certain other claims including those for administrative expenses incurred in the bankruptcy process.[12]

Enforcement. The general creditor's enforcement rights are weak: they are limited to judicial process where the creditor can seek judgment and execution by obtaining a judgment lien. The unsecured creditor can only enforce their debts upon judicial actions, and those enforcement rights are further limited in bankruptcy because they can no longer seek judgment and execution separate from the general bankruptcy proceeding. Enforcement rights against third parties are weak and only include things like fraudulent conveyance actions for deliberate frustration or transfer for less than fair value at a time of insolvency.

Control. Ordinary debt has weak control rights. It provides no special control rights, though some control rights arise as a result of bankruptcy. These include the right to appoint the creditors committee, by virtue of the right to object to actions taken by the Trustee or Debtor in Possession administering the bankruptcy estate, and the right to vote on and object to plans of reorganization in Chapter 11 proceedings.

2. Security Interests

The most familiar type of creditor seniority comes from holding a security interest in an asset. For most assets other than real property, security interests are governed by Article

[12] 11 U.S.C. § 507; 11 U.S.C. § 726.

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9 of the Uniform Commercial Code.[13] For real property they are governed by state mortgage law. The security interest is a bundle of creditor rights covering payment, enforcement, and control that are tied in some way to designated assets.

Payment Priority. A security interest creates strong payment rights. The lender generally takes a fixed prior payment position. The position amounts to a loan with payment priority against all other creditors equal to the lesser of the loan principal (plus accrued interest) and the value of the collateral.

Enforcement. A lender who holds a perfected security interest in an asset holds medium enforcement rights against the debtor. Upon default the lender has the right to recover from the value of the asset without resorting to judicial process. Through repossession and foreclosure, the debtor can seize the asset, sell it, and then recover payment from the proceeds. These self-enforcement rights are limited by a bankruptcy filing. Once a debtor has filed for bankruptcy and during the pendency of the bankruptcy case, a secured creditor cannot repossess and foreclose an asset without getting permission from a court. And the court is not likely to grant that permission unless the creditor shows that its payment rights are not adequately protected.[14] Moreover, the creditor's right to self-enforce against the asset may be suspended beyond the bankruptcy proceeding and the debtor will be allowed to maintain ownership and possession of the asset if the debtor proposes a reorganization plan that protects the creditor's payment rights by meeting certain statutory requirements.[15]

With respect to third party enforcement, the secured creditor has strong enforcement rights. When the security interest is in a specified asset, the lender generally has the right to enforce against third parties who come to own the asset. The buyer of an encumbered asset assumes a contingent liability. If the debtor does not fully discharge her obligations, the creditor may seek out the new owner of an asset subject to an appropriate security interest. The new owner must pay the debtor's outstanding claim or surrender the asset to the creditor. There are exceptions such as for those who buy a good in the ordinary course of business,[16] and some good faith buyers of consumer goods,[17] but the general rule is that even those who acquire the asset in good faith and with no actual knowledge of the encumbrance, may be taxed in this way. Thus, if the asset is sold or otherwise transferred to a party other than the debtor, the lender can go after the value of the asset in the hands of that party.

Control. As for control rights associated with security interests, they come in three types. The most direct is the state-contingent control over the use of the asset itself. Upon default, the security interest creates one major control right. The creditor can direct the debtor (or whoever holds the asset) to hand over the asset for sale. This state-contingent ability to dictate the use of the asset is a major right of control. And when the asset is valuable to the going concern of the debtor, it will create a second type of control: indirect control rights

[13] Some other assets are excluded from Article 9. McLaughlin (1985); Verstein (2011).
[14] 11 U.S.C. 362(d).
[15] 11 U.S.C. 1129(b). These "cram-down" provisions allow the debtor to keep the collateral if its plan of reorganization promises the creditor a stream of deferred cash payments equal to the value of the creditor's claim against the collateral. 1129(b)(2)(A)(i)(II).
[16] UCC 9-320(a).
[17] UCC 9-320(b).

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over other decisions. The debtor wishing to keep the asset may agree to let the lender dictate other decisions. Third, bankruptcy removes the other control rights but grants new control rights in the form of objections and voting rights. On a practical level, secured creditors often exercise great control in bankruptcy by influencing management in the distressed period before the filing and by negotiating control rights in exchange for new loans that provide the capital necessary to finance the debtor's reorganization. (See Baird & Rasmussen 2006; Tung 2009).

All of these control rights are powerful leverage over the debtor, but they amount to only medium control because they do not directly implicate the rights of third parties. If the debtor promises inconsistent control rights to a third party, it is not clear which party will prevail.[18]

3. Creditor Ownership

A creditor can gain seniority rights by owning the assets the debtor possesses. Three common techniques are consignments, leases, and sale-leasebacks.

In consignments and leases, a creditor supplies non-financial assets to the debtor but retains title to them. For example, automobile manufacturers "sell" cars to dealerships under title-retention schemes. In these schemes, the dealership does not own the cars on its lots, it merely possesses the cars while it tries to sell them on behalf of the manufacturer. The manufacturer only loses title at the moment the ultimate customer pays for the car. This title-retention scheme is a consignment. In a leasing transaction, the supplier-owner grants possession of assets in exchange for periodic payments.

In a sale-leaseback, the creditor contributes money to the debtor in order to "buy" an asset of the debtor's. The debtor then rents the asset back from the creditor. Functionally, the debtor's payments amount to a loan secured by the asset.

Notably, creditor ownership schemes are not always respected by courts. The Uniform Commercial Code essentially treats most consignments as a form of security interest,[19] courts frequently recharacterize sale/leasebacks as disguised security interests,[20] and sometimes bankruptcy courts even suspend the control rights associated with ownership.[21] In those

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[18] In this section, we have assumed the security interest is perfected. An unperfected security interest exists when the creditor has not taken the necessary steps to provide notice of its interest to the world—usually, this means that the creditor did not file the necessary financing statement. UCC 9-310. For the various rules on perfection for different assets under Article 9, see UCC 9-301 through UCC 9-342. The unperfected security interest generally drops the rights against third parties from the bundle. Thus, a creditor with an unperfected security interest has the right to self-enforce against the debtor, but it has no payment priority against other creditors and it has no enforcement rights against third parties. (Baird 1988). Moreover, its enforcement rights are dynamic in the sense that it would take the asset in repossession subject to the rights of any other creditors who have perfected their security interest at any time.

[19] UCC 9-102(a)(20)(defining consignment); 9-103(d) (treating consignor's interest as purchase-money security interest). See also 11 USC 362(a)(3) (subjecting consignors to the automatic stay).

[20] See for example, United Airlines, Inc. v. HSBC Bank USA, N.A., 416 F.3d 609 (7th Cir. 2005).

[21] See for example, Chrysler LLC v. Plastech Engineered Prods., Inc. (In re Plastech Engineered Prods., Inc.), 382 B.R. 90, 95 (Bankr. E.D. Mich. 2008).

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cases, ownership rights are essentially equivalent to the rights included in the security interest bundle. But when they are respected, the most important limitation on creditor-ownership is that for any given asset only one creditor can avail itself of this option at a time.[22]

Creditor ownership provides the following bundle of rights:

Payment Priority. Successful creditor ownership schemes give creditors strong payment priority over the debtor and other creditors with respect to the consigned or leased collateral.[23] None of the debtor's other creditor can make a claim on that asset or otherwise claim superior payment priority, no matter what the debtor may have promised.[24] The default rights for creditor-owners are as to the assets they have consigned or leased to the debtor, rather than as to a class of collateral or fixed sum.

Enforcement and Control

Successful creditor ownership schemes give creditors strong enforcement and control rights.[25] Because the asset is owned by the creditor, the creditor can take steps to repossess it upon default, without securing a court judgment. The use of creditor-ownership also allows the creditor to retain the asset, rather than dispose of it in a commercially reasonable manner. This amounts to strong enforcement rights against the debtor. The terms of the consignment or lease can contractually constrain the debtor's use of the asset, and these limits are likely to bind third parties. If the debtor promises unlimited control over an asset to a third-party, the fact that the debtor had only leased the asset may end up defeating the third party's rights. A sub-tenant generally cannot claim rights in excess of what the tenant had itself leased.

The creditor usually has robust rights to retake the assets even in the hands of third parties who did not consent to, or know about, the creditor-ownership arrangement. This amounts to strong third-party enforcement rights. As with security interests, this third-party right is limited where the assets were sold to a good faith purchaser.[26]

B. Altering Mechanisms

1. Modifying by Contract

Secured loans, unsecured loans, and creditor ownership schemes can be modified by contract.

Payment Priority. When it comes to payment priority, a creditor cannot obtain priority over other creditors by simply listing that as a condition of the loan. Such promises are not binding on anyone who is not party to an explicit agreement. (Hansmann & Kraakman 2000).

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[22] Creditors could, however, organize themselves into an owning group.
[23] In re Crouthamel Potato Chip Co. Inc., 6 B.R. 501 (1980)
[24] Pachter, Gold & Schaffer v. Yantis, 742 F. Supp. 544, 545-46 (W.D. Ark. 1990)
[25] See for example, Chrysler LLC v. Plastech Engineered Prods., Inc. (In re Plastech Engineered Prods., Inc.), 382 B.R. 90, 95 (Bankr. E.D. Mich. 2008).
[26] UCC 2-403(1)-(2).

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Thus, if the debtor makes a promise to one creditor that it will not take on new debt of equal or greater payment priority, that promise—commonly referred to as a negative pledge—does not invalidate the terms of a loan agreement that the debtor enters into with a subsequent creditor. The negative pledge only subjects the debtor to claims of contract breach. But the payment rights of the original creditor will not be enforceable against the new creditors.[27] In this way contracts are not effective for increasing payment priority.

And while the general creditors take an equal position in a race for the assets or a pro rata share with other general creditors in bankruptcy, this status is dynamic in that the debtor is free to issue senior and subordinated debt. And there is no way for the general creditor to insist that her rights remain equal or pro rata as other creditors join the mix. (Eldar & Verstein 2019). Those with weak payment priority against the debtor cannot improve their position by contract.

Contractual language can alter the amount over which there is payment priority. The choice between a security in a particular asset and security in a pool alters payment rights. Payment rights based on a particular asset fluctuate with the value of a particular asset. Class-based priority interests over a pool of assets, like a security interest in inventory, fluctuate with value of the stock of assets in the class.

In other jurisdictions, like the United Kingdom, an even broader type of payment priority against the debtor is possible. This is achieved through a floating charge in the United Kingdom, but this approach is not practicable in the United States. (Jacoby and Janger 2014). Under the floating charge, a lender has payment priority as to the value of all of the debtor's assets at the time of enforcement, but not with respect to particular assets that the debtor has sold. This structure can allow assets to come in and out of a broad pool. Something akin to the floating charge over some pools might be constructed in the United States through the use of legal entities but doing so brings major costs with it. (Casey 2015).

Enforcement. A creditor can obtain third-party enforcement rights by asking for a third-party guarantee of the loan. By a surety contract, a specified third party can make itself primary liable on the same terms as the debtor. Similarly, a guarantee of payment will make a specified third-party liable as soon as the debtor misses a payment, while a guarantee of collection will render the specified third party liable as a matter of last resort after enforcement against the debtor has proven unsuccessful.[28] But It is otherwise difficult to strengthen enforcement rights by contract. The UCC restricts efforts to secure stronger enforcement rights.[29] Contractual agreements cannot alter the rules that apply in bankruptcy. *Ex ante*, the debtor cannot waive its right to file a bankruptcy petition and trigger the automatic stay, (Rasmussen 1992) nor can the creditor waive its right to exercise

[27] That is not to say that negative pledges are pointless. To the extent debtor violations of a pledge can be observed, they will constitute defaults and lead to acceleration of debt. To the extent the debtor is solvent, it will want to avoid such a default. Some have questioned whether the threat of negative pledge enforcement is credible. A recent model suggests that it is in certain circumstances. (Donaldson, Gromb, & Piacentino 2019).

[28] See, e.g., *New York City Dept. of Fin. v. Twin Rivers, Inc.*, 920 F. Supp. 50, 53 (S.D.N.Y. 1996).

[29] For example, UCC § 9-610 requires the repossessing creditor to dispose of the asset in a commercial reasonable manner. This rule is mandatory. § 9-602(7).

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control by joining the unsecured creditors' committee.[30] Most courts view a debtor's waiver of the protection of the bankruptcy code as void.[31] Thus, the parties cannot by agreement alone opt out of the effects of bankruptcy law.[32]

Enforcement rights can, however, be somewhat weakened by contract. A creditor who agrees not to collect except if certain procedures are followed is generally bound by that agreement, even if the default relationship would have let them foreclose or recover assets without (or despite) judicial intervention. And a secured creditors with an appropriately perfected interest can unilaterally waive her right to enforce against the debtor, but she cannot pre-commit to doing so automatically. (Eldar & Verstein 2019).

Contractual language can also weaken third-party enforcement. A secured creditor can take a security interest in a class or pool of assets. For example, a security interest conferring rights in reference to a specific piece of equipment can be rendered effective over a shifting pool of collateral by stipulating that the interest attaches only to proceeds from the equipment. Doing this changes the enforcement rights. The creditor now has enforcement rights against the proceeds of the equipment. Thus, if the debtor sells the equipment, the right to enforce does not travel with the equipment. Rather, the debtor's can only enforce against the party in possession of the proceeds of the sale—in most cases that will be the debtor. This lowers the enforcement rights from strong to medium.

Another example of an interest in a pool that limits third-party enforcement occurs when the lender takes an interest in the debtor's "inventory." Buyers of goods in the ordinary course of business take inventory free of any security interest,[33] and as a practical matter, inventory is regularly bought and sold in the ordinary course of business, and so the lender does not have the ability to enforce against most third parties who buy assets from the debtor's inventory. The result is that the lender possesses enforcement, payment, and control rights against the debtor but not against third parties. The law therefore imposes a mandatory rule that enforcement against inventory *is* a pool-based right against the debtor; creditors do not gain third-party enforcement rights against holders of particular units of the inventory, and they cannot obtain this right by contracting with the debtor.

Creditor ownership defaults to strong enforcement rights against third parties – the creditor can collect its property even in the hands of third parties. But this right can be waived contractually by specifying that the creditor ownership will be over a pool of assets rather than a specific asset. Bailments of fungible assets, such as securities and grain, often

[30] Ex post, creditors do frequently make deals waiving their rights in exchange for consideration. (Ayotte et. al 2017).
[31] *See, e.g., In re Thorpe Insulation Co.*, 671 F.3d 1011, 1026 (9th Cir. 2012).
[32] Rather, the main strategies for doing so involve the use of legal entities to prevent bankruptcy filings altogether. (Baird & Casey 2013). These entity structures usually involve subsidiaries with limited creditors and specially selected directors to control the decision to file for bankruptcy. These mechanisms are discussed in III.B & C.
[33] UCC 9-320(a).

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follow this pattern.[34] The bailor cannot bother third parties who come to own specific securities or grain since the bailor's rights reside in the remaining and dynamic pool.

Control. Creditors can bargain to obtain control rights by contract. They can request rights and covenants binding on the debtor, which amount to medium control rights. Creditors have somewhat less ability to waive their default control rights. If a creditor wants the enforcement right to seize an asset upon default, exercise of that right necessarily entails a control right – control over what to do with the asset. Likewise, the creditor's indirect control over decisions derives from the threat of foreclosure and that threat cannot be unbundled from the right to foreclose. A creditor with the right to withdraw vital assets and money from the debtor always *has* that power to dictate how the debtor must conduct its business – regardless of whether that power is exercised. (Nini, Smith, & Sufi 2012; Ayotte & Morrison 2009; Roberts & Sufi 2009).

Regardless of what the law *allows,* the law *discourages* these contractual control rights by creditors, exposing them to the possibility of lender liability or equitable subordination if they take or use intensive control and sometimes invalidating instruments or agreements that give the creditor control over decisions such as whether the debtor will file for bankruptcy. Lender liability is perhaps an odd area of the law. The doctrine has been recognized in the case law for decades,[35] but cases imposing such liability are rare. And yet, as Rasmussen has explained, its viability is real enough that "it remains standard practice for law firms to remind their clients to avoid situations that could lead to a lender liability suit." (Rasmussen 2018). Equitable subordination—where a bankruptcy court reduces a creditor's payment priority as a result of its actions—is more common and presents a strong deterrent against the exercise of certain levers of creditor control.[36]

2. Entities and Structural Seniority[37]

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[34] E.g. Elliott on Bailments at 36(1929) ("But it is held that the rule [requiring specific delivery] does not apply to stocks , for there is no conceivable reason why another stock certificate of precisely similar character is not the precise equivalent of the one bailed, though in the case of ordinary bailments there may be special reasons for desiring the return of the specific chattel."); Timothy C. Harker, Bailment Ailment: An Analysis of the Legal Status of Ordinary Demand Deposits in the Shadow of the Financial Crisis of 2008, 19 Fordham J. Corp. & Fin. L. 543, 555–56 (2014) quoting 78 AM. JUR. 2D *Warehouses* § 23 (2014) ("When a grain producer deposits his fungible goods with a warehouse, "the general rule is that a bailment is created by such a deposit ... even though [the] grain belonging to the warehouse and various other owners is from time to time added to the common mass, and sales and deliveries are made therefrom.").

[35] *See, e.g., State National Bank of El Paso v. Farah Manufacturing Co*., 678 S.W.2d 661 (Tex App. 1984).

[36] Equitable subordination is specifically provided for in the bankruptcy code at 11 U.S.C. §510(c).

[37] Most people talk of "structure *priority*." We avoid that phrase in keeping with our choice to focus on elements rather than labels that may obscure them. Entity structure demonstrates the importance of this approach. Entity structure can create other senior rights including enforcement, (Casey, 2015), and control (Baird & Casey, 2013). The term "structural priority" often leads one to focus exclusively on payment rights, but creditors can use entities to obtain enforcement or control rights *without* payment rights: they can lend to a subsidiary (over which they take enforcement and control rights), but they waive payment priority by allowing that subsidiary to cross-guarantee other

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Organizational law can be used to grant or alter creditors' rights. (Hansmann & Kraakman 2000). The ostensible debtor forms an entity and causes the entity to both own the collateral and incur the indebtedness. An unsecured or secured loan can be made to a debtor's subsidiary (which the debtor formed to hold the collateral) rather than the debtor. An owner-creditor can lease, bail, or consign the collateral to the subsidiary rather than the debtor.[38]

Payment Priority. Medium payment priority (dynamic priority) can be achieved by stacking up entities. A debtor may place assets within a subsidiary and allow the would-be senior creditor to lend to the subsidiary. If the debtor defaults with only one creditor of the subsidiary, that creditor will have a better position than all the other creditors who have loaned money to the parent. Before the subsidiary can pay any money up to the parent and its creditors, the subsidiary must pay its own creditor – the senior creditor.

The creditor's placement within the corporate structure gives it structural payment priority. This priority is dynamic in the sense that the debtor could add more creditors as peers to the creditor by allowing the other creditors to lend to the subsidiary (or having the subsidiary guarantee the parent). The senior creditor can even drop to relatively low priority if the debtor causes its subsidiary to form another subsidiary, to which its assets are then transferred, and which then borrows from other creditors.

Enforcement and Control. Entity structures can be used to modify control and enforcement rights over assets that exist when distress arises. Commonly, the parties will create a subsidiary legal entity for the purpose of giving a specific creditor the ability to control whether the assets within that entity are subject to the rules imposed by the bankruptcy code. By limiting the number of creditors of the new entity or giving a creditor rights in choosing directors, the debtor can give the creditor significant control over the decision to bring that entity into bankruptcy. The parties can further strengthen the creditor's control and enforcement rights by securing the creditor's loan with a stock pledge that transfers full control over the entity—and its assets—to the creditor upon default. Together, these techniques create strong enforcement rights and control rights against the debtor.[39]

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subsidiaries. This combination is quite common. The term "structural priority" tends to imply that waiving payment priority would undo all of the benefits of the structure. "Structural seniority" leaves open the question of what sort of other rights the structure may create.

[38] Creditor-owners enjoy substantial rights when their status is respected by courts, making the added benefits of entity structure trivial (dynamic priority over past-due payments, perhaps). But creditor-ownership is often disregarded by courts or recharacterized as mere secured creditor status. In such case, the benefits of separating the collateral into its own entity may be desirable. The use of creditor ownership alongside an entity structure therefore exhibits redundancy – a "belt and suspenders" response to legal uncertainty.

[39] As discussed above the law does create risks for creditors who exercise this level of control through lender liability and equitable subordination. Moreover, directors who serve the interests of creditors or any particular investor face the risk of direct fiduciary liability. *See, e.g.,* Frederick Hsu Living Tr. v. ODN Holding Corp., 2017 WL 1437308, at *1 (Del. Ch. 2017).

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These bankruptcy remote entities circumvent bankruptcy's default control and enforcement rights. This gives the creditor greater direct control over the use of assets and greater indirect power that comes from the threat of withdrawing a useful asset from the debtor's business. (Baird & Casey 2013). It also allows the creditor to limit the control rights that other creditors might obtain. (Casey 2015).

On the other hand, entity structures do little to improve enforcement rights against third parties. An entity's creditors – like all general creditors – only recover from third parties who receive collateral through a fraudulent conveyance or who voluntarily agree to accept liability. Additionally, these structures only create dynamic priority in the pool of assets owned by the subsidiary. This is medium payment priority. Thus, the bundled rights and possible modifications can be summarized as shown in Tables 6–7.

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Table 6 Bundled right

Strategy	Enforcement (debtor)	Enforcement (third)	Payment Priority	Priority Amount	Control
Ordinary Contract	Weak	Weak	Weak	N/A	Weak
Security Interest	Medium	Strong	Strong	Weak or Medium	Medium
Creditor Ownership	Strong	Strong	Strong	Weak	Strong

Table 7 Modifications

Strategy	Enforcement (debtor)	Enforcement (third)	Payment Priority	Priority Amount	Control
Contractual modification		Medium		Medium	Medium
Entity structure	Strong		Medium	Medium	Strong

IV. Unavailable Bundles

The survey so far has laid out the rights parties might want, why they might want them, and how they might get them under current law. But there are some combinations of desirable rights that are difficult or impossible to achieve in practice. This section describes several of those unavailable bundles.

Payment Priority Indexed to Going Concern. It is difficult under American law to index a claim to the going concern value or, to put it another way, the value of the synergies arising out of a business above the replacement cost of the component assets. Creditors often attempt to do so, but efforts to take a security interest in all assets (including such synergistic surplus) leave gaps in the waterfall. (Jacoby & Janger, 2018). The gaps arise for various reasons. Most directly, Article 9 does not explicitly provide for obtaining a security interest in going concern value. Moreover, Article 9 includes an express provision that "a description of collateral as 'all the debtor's assets' or 'all the debtor's personal property' or using word of similar import does not reasonably identify the collateral."[40] This presents a drafting challenge when parties are attempting to create security interest in all assets including going concern value but must describe things granularly without excluding anything. Finally, gaps may arise from challenges to perfecting liens across various types of assets and over assets that quickly turnover as well as challenges in tracing proceeds.

[40] UCC 9-108(c).

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There are significant arguments for allowing payment priority linked to going concern value. (Adler, 2015) The law could easily allow this by making it an explicit option within Article 9. The costs of doing so are likely small as there would be no significant search costs that do not already exist with other security interests and the debtor would have the choice whether to grant the interest or not.

Fixed Pro Rata Priority. There is no system by which creditors can obtain fixed pro rata priority. It is impossible for a debtor to credibly promise a creditor that she will stand equal with all other creditors. If C1 is unsecured, the debtor can always give a security interest to later creditors. If C1 is secured, then C1 stands above all creditors except those to whom C1 grants partial subordination, which C1 may opt to opportunistically withhold. Elaborate mechanisms involving trustees and agents may allow a partial solution, but the result is at best costly. It is surprising that the law allows fixed or rule-based senior status (through security interests), dynamic senior status (through structural seniority), and dynamic pro rata payment priority, but not fixed pro rata payment priority.

Stand-Alone Third-Party Enforcement Rights. The law does not allow enforcement against all designated third parties regardless of explicit consent without the other rights of a security interest. A creditor can contract with specific third parties for guaranties, or it can take a security interest that enables it to enforce against a third party who comes to possess an asset. But what if a creditor wants the ability to enforce against any third party who does business with the debtor—regardless of whether that party takes a specific asset and regardless of whether the creditor has a security interest? For example, a first-in-time creditor may want to bind the world against engaging in transactions that increase the risk profile of the debtor's business. Or it may want to be sure that the debtor does not enter into specific contracts. To enforce that right, the creditor will want to be able to enforce its rights against third parties who transact with the debtor in ways that cause the debtor to breach its obligations.

There are reasons to be cautious about such transactions, since they raise third-party information costs, (Triantis 2013), but there is no obvious reason to prohibit such a transaction altogether. Nor is there any reason that the right to enforce such a promise should be tied to a specific asset or other seniority rights.

Adler and Kahan have suggested that the law should provide a mechanism to enable strong third-party enforcement. They envision a system in which an entity might place certain commitments in its charter – say, to take on no further debt – for which investment bankers and others would be liable if they took steps to frustrate. (Adler & Kahan 2013). This system would work much the same way that Article 9 does by providing notice of the obligation to the anyone who takes the time to check. The primary cost of doing this will be the search costs to those transacting with the debtor. This might be alleviated by having automatic exclusions for small creditors or other parties for whom the search cost would be significant.

*Enforcement against debtor***.** Most efforts to contract out of bankruptcy protections are invalid. A debtor cannot contractually authorize a creditor to disregard the automatic stay, for example. The wisdom of allowing parties to opt out of bankruptcy has been hotly debated,

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and it is not feasible to rehearse or resolve that literature within this chapter. Still, as noted above, the law already allows some bankruptcy-proof enforcement waivers through creditor ownership or entity structure. But some of those strategies are subject to recharacterization. Those conditions and formalities serve a signaling function – reducing the risk of error and opportunism that might make enhanced enforcement unfair or inefficient. (Baird & Casey 2013). It is therefore fair to say that bankruptcy opt-out is available to a greater degree in cases where it is more likely to be efficient. This is a case where the law's bundling serves a logical purpose to some degree. Further expansions of bankruptcy remoteness where important conditions and formalities are likewise observed would likely be consistent with those same purposes.

Control Rights. Creditors that ask for explicit control do not always find that control honored. For example, the right to select a director for an affiliate's board, alongside a unanimity requirement for directors to file for bankruptcy, would give a creditor control over the initiation of voluntary bankruptcy. Courts often refuse to effectuate this control effort.[41]

Moreover, explicit control rights create risks for a creditor. Rasmussen (2019). Creditors who obtain formal control rights can be liable if a court later determines that they misused that control.[42] A controlling creditor may also lose its payment priority in bankruptcy through equitable subordination.[43] This leads to greater emphasis on informal control mechanisms that are more costly to implement, and more costly for outsiders to identify. Rasmussen argues that these limitations on contracting are unlikely to be efficient.

V. Implications and Conclusion

The rhetorical posture of this chapter has been deconstruction. We used two strategies to destabilize familiar ways of thinking about seniority in order to spur insights into the functional foundations of seniority. First, the chapter identified three desirable categories of senior rights—payment, enforcement, and control—prior to identifying the four salient bundles that confer combinations of senior rights. The choice to present the axes of seniority first, prior to any discussion of how the law creates and combines them, focuses the reader on the functional output the parties want to achieve, rather than on the "natural" entailment of any particular approach.

Second, we abstained from talking about rights *against*, *in* or *to* collateral, even though much of the law and commentary uses this language. Instead we talked exclusively about the rights against persons (including third-parties, against whom many "property" entitlements may be enforced). We discussed the rights of creditors against one another and

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[41] See, e.g., *In re Lexington Hosp. Grp., LLC*, 577 B.R. 676, 679-81, 684-86, 688 (Bankr. E.D. Ky. 2017); *n re Lake Mich. Beach Pottawattamie Resort LLC*, 547 B.R. 899, 911 (Bankr. N.D. Ill. 2016)

[42] See, e.g., State National Bank of El Paso v. Farah Manufacturing Co. 678 S.W.2d 661, 666-67 (Tex. App. 1984), appeal dismissed per stipulation. See also K.M.C. Co. v. Irving Tr. Co., 757 F.2d 752, 759 (6th Cir. 1985).

[43] 11 U.S.C. § 510(c) (2012) ("[T]he court may . . . under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest . . . .").

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against the debtor.[44] Thus, a creditor does not have enforcement rights against an asset – she has enforcement rights against a specific party or all parties, entitling her to take possession of the asset. The alternative approach tends to bias analysis in favor of the status quo. Why does a security interest entail enforcement rights against third parties? The question may seem silly if we agree that a security interest is an interest *in* the property: if it's *in* the property, it is obviously enforceable against whomever holds it. But if we recognize that a security interest is a bundle of distinct rights against distinct persons, nothing follows formalistically from metaphorical "attachment" to an asset.

This move away from formalism can help to identify what is at stake in the seniority puzzle. The analysis in the preceding sections begins with the question of a debtor's capital structure and analyzes creditor seniority in terms of the specific rights of payment, enforcement, and control that parties seek to contract over when creating that structure. Capital structure and the debates about structure and senior rights are ultimately about the division of enforcement, payment, and control rights among the relevant parties in certain states of the world. Casting things in terms of property and entity partitions can obscure these foundational questions, and make it difficult for parties to adopt capital structures that do not fit into neat packages.

The harm from this perspective is evident, as questions about socially optimal bundles of rights are get lost in questions about legal formalities. For example, in debates about the bankruptcy treatment of security interests and going concern value, the meaningful question is whether or not it is socially optimal to allow a creditor to take a payment preference indexed to the value of the pool of all the debtor's assets. But, as Baird (2015) points out, much of the debate in courts and in scholarship focuses on the uninteresting semantic question about who is "entitled" to the going concern value. This draws attention toward formal questions about property rights, legal entities, and the scope of a security interest and away from questions about the incentives behind the capital structure the parties are creating.

We suspect that our analysis supports greater tolerance for unbundling and customization, though any particular proposal must be scrutinized for externalities and the value of standardization. (Merrill & Smith 2000). More generally, a discussion of seniority conducted solely in terms of decomposed rights against persons suggests that the law could itself be composed of those elements. One could imagine an Article 9-like registry and notice system where a creditor chooses from among these rights. Even if some bundles are prohibited, it would be an advance in clarity and simplicity if the law were formulated in terms of rights-outcomes, rather than those outcomes being emergent properties of a handful of path dependent bundles.

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[44] Ours was therefore a Hohfeldian analysis, in which all rights correspond to duties of identifiable persons.

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