# LIMITED LIABILITY PROPERTY

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*This Article offers a theory of secured credit that aims to answer fundamental questions that have long percolated in the bankruptcy and secured transactions literatures. Are security interests property rights, contract rights, or something else? Why do secured creditors enjoy a priority right that, in bankruptcy, requires them to be paid in full before other debt holders recover anything? Should we care that secured credit creates distributional unfairness when companies cannot pay their debts?*

*This Article argues that security interests are best understood as a form of "limited liability property." Limited liability—the privilege of being legally shielded from liability that would normally apply—has long been considered the quintessential feature of equity interests. But limited liability is in fact a critical feature of security interests as well. When examined closely, security interests enable their holders to assert several privileges of ownership without bearing any of ownership's concomitant burdens.*

*In seeking to explain security interests, this Article offers a comprehensive account of capital investment more generally, systematically examining the various property-like interests held in corporate capital structures. Though critics have bemoaned the inequity associated with the priority right in bankruptcy—a secured debtholder can get all its assets back in the event of a bankruptcy while unsecured creditors like unpaid employees get nothing—this priority right is an inevitable consequence of recognizing security interests as a form of direct ownership. The real problem lies in the scope of secured debt holders' limited liability protections. While equity holders enjoy limited liability, in return they are paid only after other claims in the event of insolvency. Secured lenders, by contrast, collect first, and are thus arguably overprotected. Understanding security interests as limited liability property, then, offers a more elegant way to understand capital investment at the theoretical*

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*level while also helping us recognize when and where our system of secured debt may need reform.*

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## INTRODUCTION

Ownership usually involves both benefits and burdens.[1] If you buy a car, you control the car's use and get to profit if its value rises. But you also bear the risk that the car will turn out to be a lemon, and you will face legal consequences if you ignore that burning smell and if it catches fire in a parking deck. So too with any owned asset, however big or small. If you own an oil pipeline directly, you can reap the profits created by the crude oil that passes through. But if the pipe bursts, you

1 Property scholars might describe this idea using a Hohfeldian framework, which contrasts "powers" with "liabilities." *See, e.g.*, Joseph William Singer, *The Legal Rights Debate in Analytical Jurisprudence from Bentham to Hohfeld*, 1982 WIS. L. REV. 975, 986–87.

will be on the hook for the environmental cleanup—no matter how large those costs might turn out to be.[2] In other words, to own something is to be responsible for it.

Sometimes, though, the law allows owners to enjoy ownership's benefits without facing the burdens that ownership normally entails. When it is available, *limited liability* permits an owner to profit from the assets to which it attaches while shielding the owner from any liability that asset creates. If, say, you own not the oil pipeline itself but instead hold all the shares of a corporation that itself owns the pipeline, you cannot be made to pay the costs of the cleanup out of your own pocket—even if the corporation itself goes bankrupt.[3] This protection is strong: No matter how grave the harm caused by the corporation, equity holders cannot, absent extraordinary circumstances,[4] lose more than the value of their equity interest and the attendant opportunity costs.[5]

Although limited liability is usually thought of as the province of equity investment, there is in fact another form of ownership distinguished by limited liability—one that has long gone under-recognized.[6] This Article argues that security interests, just like equity, break the normal relationship between ownership rights and liability. This argument begins with recognizing that security interests can only be understood as property rights[7]: secured lenders (those who take a

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2 As became clear in the Deepwater Horizon disaster, there are myriad possible claims and claimants arising under state common law as well as state and federal environmental and energy claims. *See In re* Oil Spill by the Oil Rig "Deepwater Horizon" in the Gulf of Mexico, 910 F. Supp. 2d 891, 900 (E.D. La. 2012), *aff'd sub nom. In re* Deepwater Horizon, 739 F.3d 790 (5th Cir. 2014) (outlining the claims brought in the wake of the oil spill). The multitude of claims is easily obscured by the mass settlements that occur after such disasters, especially since government actors negotiating those settlements rarely pursue the true, full cost of cleanup.

3 *See infra* Section III.A.

4 These extraordinary circumstances must amount to some misuse of the corporate form such that a court is willing to pierce the corporate veil and hold equity holders liable for the actions of the company. *See, e.g.*, *PAH Litig. Tr. v. Water St. Healthcare Partners L.P.* (*In re* Physiotherapy Holdings, Inc.), No. 13-12965(KG), 2016 WL 3611831 (Bankr. D. Del. June 20, 2016) (attempting to hold shareholders liable following a failed buyout).

5 There have been efforts to use fraudulent transfer law to hold shareholders liable for other parties' losses. *See* Weisfelner v. Fund 1 (*In re* Lyondell Chem. Co.), 554 B.R. 655 (Bankr. S.D.N.Y. 2016) (resolving a fraudulent transfer claim on safe harbor grounds after having allowed it to proceed against former shareholders of a formerly public company that was taken private in a leveraged buyout); *PAH Litig. Tr.*, 2016 WL 3611831 (allowing fraudulent transfer claims to proceed against shareholders).

6 Frank Easterbrook and Daniel R. Fischel observed that lenders enjoy limited liability. *See* Frank Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89, 90, 93 (1985).

7 This Article does not endeavor to definitively answer the question of whether equity and security interests are full-fledged property interests. For my argument, it is enough to say that they both have many features of property rights that make them something more property-like than the usual interests arising in contract or tort. Since these property-like features make them resemble ownership, that is the word that I am using to describe these interests even if under many theories of property these interests fail to qualify as property rights. That said, I take as fundamentally correct the Restatement of Property's position that an "owner" is "the person who has one of more interests." RESTATEMENT (FIRST) OF PROP. § 10 (AM. LAW INST. 1936).

security interest[8] in a borrower's assets as a condition of lending to the borrower) enjoy a property claim over encumbered assets. For example, a bank holding a mortgage claims to be a co-owner of that house such that no other creditor of the borrower could take that house to satisfy its claims without the bank's consent.[9] This property claim is the *sine qua non* of security interests because it alone explains their priority right—the right to be paid ahead of all unsecured creditors—that distinguishes security interests from other, riskier, forms of debt.[10]

And yet, despite this property claim, secured lenders face almost none of the liability that typically comes with ownership. They are entitled to some or all of the value of the underlying assets while wholly exempt from various forms of liability—negligent entrustment, environmental remediation, and others—that normally attach to owned property.[11] The only way to understand this state of affairs, I argue, is to recognize security interests as a form of *limited liability property*: a right to own an asset directly yet without sharing any of the liability burdens normally associated with ownership.

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This position potentially contradicts that of the U.C.C., which explains that "'[s]ecurity interest' does not include the special property interest of a buyer of goods . . . ." U.C.C. § 1-201(b)(35) (AM. LAW INST. 2001). Of course, acknowledging that taking a security interest does not generate the same kind of property right as purchasing an asset says nothing about whether security interests are a different kind of property. The better view is that our common law system, with its system of estates and generally looser notions of ownership allows both purchasers and security interest holders to be owners, albeit owners of a different scope of rights. *See* Yun-chien Chang & Henry E. Smith, *Structure and Style in Comparative Property Law*, *in* COMPARATIVE LAW AND ECONOMICS 139 (Theodore Eisenberg & Giovanni B. Ramello eds., 2016). Article 9, the state law that creates security interests in personal property, unequivocally conceives of security interests as interests in property. U.C.C. § 9 (AM. LAW INST. 2002). U.C.C. § 1-201(b)(35) defines "security interest" as "an interest in personal property or fixtures which secures payment or performance of an obligation."

8 Security interests are the property-like claims that borrowers give their lenders. U.C.C. § 1-201(b)(35) ("'Security interest' means an interest in personal property or fixtures which secures payment or performance of an obligation."). These claims entitle the borrower to foreclose on a specific, identified asset of the borrower, called the collateral or encumbered asset, if the borrower fails to adhere to the terms of the loan. U.C.C. § 9-609 (granting secured creditors the right to take possession of collateral or render it inoperable "[a]fter default"); U.C.C. 9-610(a) ("After default, a secured party may sell, lease, license, or otherwise dispose of any or all of the collateral in its present condition or following any commercially reasonable preparation or processing."). This right to foreclose means that secured lenders have *priority* over unsecured lenders in that they can take encumbered assets to satisfy their claims in full, even when other creditors can only collect *pari passu* with other unsecured creditors and often only at pennies on the dollar. To the extent that the collateral does not satisfy a secured creditor's claim, the secured creditor has an unsecured claim for the deficiency. 11 U.S.C. § 506(a)(1) (2012) ("An allowed claim of a creditor secured by a lien on property in which the estate has an interest . . . is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property . . . and is an unsecured claim to the extent that the value of such creditor's interest . . . is less than the amount of such allowed claim.").

9 The loan documents govern the terms of this joint tenancy–like arrangement, much like a prenuptial or joint-venture agreement governs the allocation of property rights in other joint tenancies.

10 *See infra* Section II.B.

11 *See infra* Section III.B.

Consider the following example: Andy owns Blackacre in fee simple and leases it to ChemCo. If ChemCo infuses Blackacre with toxic waste, even intentionally, and even against the terms of the lease it signed with Andy, Andy is still liable for the cleanup merely because he owns Blackacre. To be sure, he may have recourse against ChemCo, but if ChemCo is insolvent, Andy must pay. And Andy must pay for the cleanup even if it exceeds the value of Blackacre. If Andy spent all of his money on the clean-up costs and in doing so failed to pay Therapist, whom he frequented on account of the stress, Therapist would then have an unsecured claim against Andy. Therapist could, after various court proceedings and with the help of the sheriff, sell the newly cleaned Blackacre to satisfy his claim.

If Andy had mortgaged Blackacre to Bank before ChemCo spilled the oil, under traditional rules of lender liability, Bank would not be liable for the clean-up costs as mere holder of a security interest. The value of its collateral, Blackacre, would be reduced so it may lose money as a result of the spill, but the Bank would not have to pay additional funds for the cleanup. Its liability is limited. When Andy had restored Blackacre, Bank's collateral would be restored as well. Therapist, however, would be out of luck since Bank's security interest would have to be satisfied before his claim could be paid from the proceeds of the land. Bank would argue, and prevail, that its security interest in Blackacre gives it a priority right over all other claims against Blackacre. That is, Bank would argue that it is effectively a co-owner of Blackacre and that Therapist cannot satisfy his claim against its portion of Blackacre. This is true regardless of whether Andy files for bankruptcy or somehow stays afloat. In this way, Bank, as secured lender, gets to be an owner of Blackacre when it is beneficial to Bank, while at the same time avoiding the burdens of ownership—here, the cleanup costs.

Modern brownfield cleanup laws shift some or all of the liability that Andy faced onto Bank. While these reforms may reflect a desire for deep pockets more than a desire for a rational system of property rights, they effectively solve one of the most troubling aspects of secured lending: squaring secured lenders' priority right with their liability to third parties. This Article will demonstrate that a more rational system recognizes Bank as co-owner of Blackacre at all points in time. Taking Bank's property claim seriously means that its priority right should be as absolute as that of any other joint tenant and its potential ownership liability will be the same as well. In other words, wherever Andy, as owner, would face liability *on account of his ownership*, so too should his secured lender.

This observation—that secured creditors enjoy limited liability like equity holders—is not merely interesting for its own sake. Instead, it is one key to unlocking the enduring mystery of security interests. It is not an exaggeration to say that courts[12] and commentators[13] have struggled to explain the concept of secured lending for more than four centuries. The unanswered questions include: Are security interests property rights, contract rights, or something else? Why do secured debt holders enjoy a priority right that, in bankruptcy, requires them to be paid in full before other debt holders recover anything? Should we care that secured credit creates distributional unfairness when companies cannot pay their debts?[14]

This fundamental uncertainty has created a chorus of scholars criticizing security interests.[15] The most common focal point of criticism is secured lenders' priority right, particularly in bankruptcy.[16] But this criticism of secured lending typically rests on concerns about fairness,[17] distributional preferences,[18] arguments about "inefficiency,"[19]

12 Twyne's Case (1601) 76 Eng. Rep. 809 (barring the enforcement of security interests where the borrower retained the collateral for fear of allowing borrowers to appear to be in better financial health than they truly were).

13 *See infra* Section I.C.

14 That is, sophisticated parties who know of and plan for the risk of non-payment may nevertheless be paid in full while innocent creditors, including involuntary creditors, may receive little, if anything. *See infra* Section I.B.

15 *See infra* Section I.C.

16 *See* Edward J. Janger, *The Logic and Limits of Liens*, 2015 U. ILL. L. REV. 589 (arguing that gaps in our system of perfecting liens prevents secured creditors from having a senior claim over all of the value of a going concern); Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857, 863 (1996) (arguing that "a rule according full priority to secured claims in bankruptcy tends to reduce the efficiency of the loan arrangement negotiated between a commercial borrower and a potentially secured creditor"); COMMISSION TO STUDY THE REFORM OF CHAPTER 11, AM. BANKR. INST., 2012–2014 FINAL REPORT AND RECOMMENDATIONS 207–08 (2014) (proposing that junior creditors are entitled to receive the value of an option on the reorganized value of a firm from senior secured creditors).

17 Concerns about fairness typically fall into two categories. Some believe that secured creditors are bending the law and controlling creditors to receive more than they are owed. *See* COMMISSION TO STUDY THE REFORM OF CHAPTER 11, *supra* note 16, at 207 (explaining that in sales under Section 363, "valuation may occur during a trough in the debtor's business cycle or the economy as a whole, and relying on a valuation at such a time may result in a reallocation of the reorganized firm's future value in favor of senior stakeholders and away from junior stakeholders in a manner that is subjectively unfair"). Others have argued that the ability of secured creditors to deprive unsecured creditors of any satisfaction of their claim creates unfairness. *See* Bebchuk & Fried, *supra* note 16; Lisa M. Bossetti & Mette H. Kurth, *Professor Elizabeth Warren's Article 9 Carve-Out Proposal: A Strategic Analysis*, 30 UCC L.J. 3 (1997); Elizabeth Warren, *An Article 9 Set-Aside for Unsecured Creditors*, 51 CONSUMER FIN. L.Q. REP. 323 (1997).

18 COMMISSION TO STUDY THE REFORM OF CHAPTER 11, *supra* note 16, at 67, 207–08 (proposing to limit adequate protection to the foreclosure value of collateral and proposing to require certain senior secured creditors to pay the value of an option to junior creditors); Michelle M. Harner, *The Value of Soft Variables in Corporate Reorganizations*, 2015 U. ILL. L. REV. 509, 519 (questioning whether liens can and should cover value generated by "soft" assets such as synergies among assets, particular talents of the workforce, and relationships between the company and third parties).

19 F.H. Buckley, *The Bankruptcy Priority Puzzle*, 72 VA. L. REV. 1393, 1395 (1986) (arguing that efficiency explains the existence of secured credit); Robert E. Scott, *Error and Rationality in Individual Decisionmaking: An Essay on the Relationship Between Cognitive Illusions and the*

or observations about historical practice.[20] These criticisms do not identify what is uniquely wrong with security interests or explain how these alleged distributional pathologies differ from those created by other forms of private ownership. By identifying how secured lenders' ownership claims intersect with their enjoyment of limited liability, this Article finally articulates how secured lenders have a more favorable bargain vis-à-vis third parties than is traditionally allowed in our private law system.

Indeed, secured lenders get a more favorable bargain than equity holders since they get the protection of limited liability without subordinating their claims against the company's assets to those of other creditors. Normally, if a company becomes insolvent, equity holders are paid last because their claims over the company's assets are only indirect claims against the residuary. By contrast, secured lenders are paid first precisely because they make a direct property claim over specific assets.[21] And yet secured lenders enjoy an even stronger form of limited liability than equity holders. Their liability is capped at their investment, but only at the extent to which they are under-secured, if at all. That is, they are doubly protected from the claims of third parties.

Whether from traditional limited liability or secured lending, this reduction in liability has social costs. By encouraging investment through limited liability, we accept that some claimants will go unpaid

*Management of Choices*, 59 S. CAL. L. REV. 329, 351 (1986) (explaining that "[a]n economic justification for secured credit has continued to elude legal scholars" and arguing that "secured credit is a zero-sum transaction for the debtor"); James J. White, *Efficiency Justifications for Personal Property Security*, 37 VAND. L. REV. 473, 501-02 (1984) (arguing that secured credit is efficient because it accommodates differing risk preferences); Alan Schwartz, *Security Interests and Bankruptcy Priorities: A Review of Current Theories*, 10 J. LEGAL STUD. 1, 33 (1981) [hereinafter Schwartz, *Security Interests and Bankruptcy Priorities*] (surveying the economic justifications for secured credit and concluding that "no convincing explanation for the issuance of short-term secured debt exists"). *But see* Thomas H. Jackson & Anthony T. Kronman, *Secured Financing and Priorities Among Creditors*, 88 YALE L.J. 1143, 1149–57 (1979) (arguing that the presence of secured credit facilitates lower borrowing costs); David Gray Carlson, *On the Efficiency of Secured Lending*, 80 VA. L. REV. 2179, 2180 (1994) (arguing that security interests are efficient because "they reduce risk and thereby lower the cost of credit"). *See generally* Richard L. Barnes, *The Efficiency Justification for Secured Transactions: Foxes with Soxes and Other Fanciful Stuff*, 42 U. KAN. L. REV. 13, 16 (1993) (questioning why it matters that secured credit is or is not efficient).

20 *See* Douglas G. Baird, *Priority Matters: Absolute Priority, Relative Priority, and the Costs of Bankruptcy*, 165 U. PA. L. REV. 785 (2017) (arguing that strict adherence to absolute priority is relatively recent); Melissa B. Jacoby & Edward J. Janger, *Ice Cube Bonds: Allocating the Price of Process in Chapter 11 Bankruptcy*, 123 YALE L.J. 862 (2014) ("Some critiques of Chapter 11, and their attendant formulations of the baseline distribution to secured creditors, proceed from an unduly romanticized account of creditors' rights under state law."); Douglas G. Baird & Donald S. Bernstein, *Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain*, 115 YALE L.J. 1930 (2006) (explaining that relative priority has long coexisted with absolute priority); *see also* Mark J. Roe & Frederick Tung, *Breaking Bankruptcy Priority: How Rent-Seeking Upends the Creditors' Bargain*, 99 VA. L. REV. 1235 (2013) (arguing that deviations from absolute priority upend the creditor's bargain).

21 To be sure, secured lenders have lower potential returns or upside risk because the comparatively lower risk associated with their investment commands lower interest rates.

even when there are affiliated parties with pockets deep enough to satisfy the claims.[22] In theory, the benefit of the additional economic activity outweighs the harm of limiting liability.[23] But there are plenty who view this tradeoff as a bad deal for society, especially when companies magnify their limited liability by layering subsidiaries into numerous judgment-proof entities.[24] These critiques apply with even greater force to secured lenders, whose ownership interests in collateral allow them to remove the collateral from the assets available to unsecured claimants while avoiding any of the liability that might be attached to this collateral.

None of this is to say that there is anything inherently troubling about limited liability in general or security interests in particular. Indeed, there are reasons to believe that secured debt is a net positive for the economy and is a key to our nation's future innovation.[25] But the problem is that we do not sufficiently understand what exactly secured debt is at the theoretical level. Nor can we explain precisely what rights it provides to its owners. Such a deeper understanding is critical before we can even seriously evaluate whether secured debt is desirable.

In identifying security interests as limited liability property, this Article offers a property-focused theory of secured debt, situating it within a larger unified theory of capital investment generally. It argues that security interests and equity interests are best understood together as complementary forms of ownership, even if they are not necessarily full-fledged property interests.[26] These ownership rights are united in part, because secured debt and equity investments both create interests that have many features of property rights—the security interest and equity interest, respectively—that are protected by limited liability.

This greater theoretical clarity can inform policy. There is growing concern among legal commentators that powerful secured lenders exercise significant control over borrowers[27] and that security interests

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22 *See infra* Section III.B.1.

23 *See infra* Section III.A.

24 *See* Lynn M. LoPucki, *The Essential Structure of Judgment Proofing*, 51 STAN. L. REV. 147 (1998) [hereinafter LoPucki, *The Essential Structure of Judgment Proofing*].

25 I have historically been critical of efforts to tinker with the rights of secured creditors to change distributional outcomes without first having a solid empirical or theoretical reason for doing so beyond notions of fairness. *See* Allison Hester-Haddad & Danielle D'Onfro, *Limiting the Background Noise: Investor Motivation and Identity in Bankruptcy*, 33 AM. BANKR. INST. L. REV. 38 (2014); Elliot Ganz & Danielle D'Onfro, *Viewpoint: Two Years After Bankruptcy Reform, Much Ado About Little*, WALL ST. J. (Dec. 8, 2016), http://www.wsj.com/articles/viewpoints-two-years-after-bankruptcy-reform-much-ado-about-little-1481211587.

26 Tellingly, security interests are sometimes called "indicia of ownership" (e.g., 42 U.S.C. § 9601 (2012)) and courts review so-called "indicia of ownership" to determine whether a transaction was intended to create a security interest (e.g., *In re Kempker*, 104 B.R. 196, 203 (Bankr. W.D. Mo. 1989)).

27 *E.g.*, Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751, 751–52 (2002) (arguing the old model of business reorganization is irrelevant because sophisticated debt investors anticipate distress and leave no assets unencumbered); Douglas G.

should therefore be reconsidered in various ways.[28] While there are arguments to support some reform of the law governing security interests—as I discuss later in the piece—any changes must proceed from a clear vision of what secured debt is, and what role it plays in the larger system of capital markets. This Article seeks to offer that vision.

The argument proceeds in four parts. Part I situates the problem and lays the theoretical foundation for the Article's thesis. There I define the three main layers of capital and competing property interests in a company. When viewed from the bottom up, we see that the competing property-like interests all proceed from equity holders' initial capital investments in companies and their decision to interpose the corporate form between themselves and their capital. From this view, secured creditors' priority rights appear to follow from their property rights, but new anomalies emerge.

Part II returns to secured credit to more fully explore the awkwardness of its priority right over other kinds of claims. For those less familiar with lending, I provide additional background around why secured and unsecured claims must coexist. I then summarize prior efforts to theorize secured debt, as well as arguments aimed at prior

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Baird & Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 STAN. L. REV. 673, 675–76 (2003) (adding data to support their claim that creditor control has constrained the ability of distressed companies to reorganize in bankruptcy); David A. Skeel Jr., *The Past, Present and Future of Debtor-in-Possession Financing*, 25 CARDOZO L. REV. 1905, 1906 (2004) (arguing that debtor-in-possession (DIP) lending, which is typically secured, is the most important governance lever in Chapter 11); Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. 1209, 1212 (2006) ("When a business enters financial distress, the major decisions--whether the CEO should go, whether the business should search for a suitor, whether the corporation should file for Chapter 11--require the blessing of the banks."); Kenneth M. Ayotte & Edward R. Morrison, *Creditor Control and Conflict in Chapter 11*, 1 J. LEGAL ANALYSIS 511, 514 (2009) (finding that the presence of over-secured creditors is correlated with asset sales in bankruptcy); Charles K. Whitehead, *The Evolution of Debt: Covenants, the Credit Market, and Corporate Governance*, 34 J. CORP. L. 641, 669 (2009) (arguing that debt disciplines borrowers not only through control covenants but also feedback provided by increasingly liquid private debt markets); Barry E. Adler, *A Reassessment of Bankruptcy Reorganization After Chrysler and General Motors*, 18 AM. BANKR. INST. L. REV. 305 (2010) (criticizing courts' willingness to honor creditors' requests for less-than-competitive fire-sales of assets); Stephen J. Lubben, *The Board's Duty to Keep Its Options Open*, 2015 U. ILL. L. REV. 817 (arguing that creditors' apparent control in bankruptcy results from problems of corporate governance and that regulating blanket liens is one solution to this problem); *see also* Sarah Pei Woo, *Regulatory Bankruptcy: How Bank Regulation Causes Fire Sales*, 99 GEO. L.J. 1615, 1632 (2010–2011) (finding that bank regulations incentivize bank lenders "to liquidate debtors in sectors where banks face high concentrations--regardless of the debtors' individual recovery values--in order to reduce unexpected losses and capital adequacy requirements").

28 *E.g.*, Juliet M. Moringiello, *When Does Some Federal Interest Require a Different Result?: An Essay on the Use and Misuse of* Butner v. United States, 2015 U. ILL. L. REV. 657, 671–73 (arguing that, given the rise of secured credit, federal policy not state law should determine the treatment of security interests in bankruptcy); Anthony J. Casey, *The Creditor's Bargain and Option-Preservation Priority in Chapter 11*, 78 U. CHI. L. REV. 759, 762, 765 (2011) (arguing that creditor control causes firms to waste assets and proposing "Option-Preservation Priority" for unsecured creditors). *See generally,* COMMISSION TO STUDY THE REFORM OF CHAPTER 11, *supra* note 16 (proposing several changes to the treatment of security interests in Chapter 11).

Article 9 and bankruptcy reform efforts.

Part III is the heart of the Article's theoretical contribution. There, I probe the most difficult aspects of security interests and find that they arise from a misalignment of limited liability with claims of direct ownership over corporate assets. I first explain the mechanics and justifications of limited liability. Modern companies use limited liability in elaborate judgment-proofing strategies to protect equity interests higher in a web of related companies such that the norm is not to pay downstream claims in full.[29] In other words, distributional justice has never been the sole goal of our system of corporate law. Turning then to security interests, I show that the security interest accomplishes the equivalent of the elaborate judgment proofing regimes used to protect equity holders. Viewed this way, the anomalous feature of security interests is not their impact on downstream creditors per se, but rather the scope of their limited liability. For limited liability purposes, secured lenders enjoy the same scope of potential loss as equity holders—liability bounded at their investment—notwithstanding their claim of direct ownership over company assets.[30]

Part IV explores the practical implications of the Article's new theory of security interests. My normative proposal flows directly from the Article's theoretical insight: we should take security interests' claims of direct ownership of assets seriously and give them the liability that follows from direct ownership. Secured lenders then would enjoy the same limited liability that any company enjoys. They could recreate their current allocation of liability through indemnification agreements. But if so, such agreements should be enforceable through contract law against contracting parties, not through property rules against innocent third parties. This proposal, to be sure, would not eliminate the distributional unfairness bemoaned by the secured transactions literature. But a consequence of normalizing the privileges and liabilities of security interest holders within our traditional framework of property ownership is that some of these distributional fairness concerns might

29 LoPucki, *The Essential Structure of Judgment Proofing*, *supra* note 24, at 149 ("[A]ll, or substantially all, judgment proofing has a single essential structure: a symbiotic relationship between two or more entities, in which one of the entities generates disproportionately high risks of liability and another owns a disproportionately high level of assets. Through the contract that unites them, the two entities allocate between them the gains from judgment proofing.").

30 The exceptions here prove the rule. Typically, secured lenders' only risk is that the value of their collateral declines below the value of the debt. Lenders do face unlimited liability—that is, liability measured by the harm and not by their investment—under a handful of statutes. For example, if lenders foreclose on and then sell goods produced in violation of the Fair Labor Standards Act. *See* Citicorp Indus. Credit v. Brock, 483 U.S. 27, 39 (1987). Creditors who exercise excessive control over their borrowers risk having their claims subordinated and in more serious cases, having the veil between borrower and lender pierced such that the lender becomes liable for the borrower's debts. *See generally* Margaret Hambrecht Douglas-Hamilton, *Creditor Liabilities Resulting from Improper Interference with a Management of a Financially Troubled Debtor*, 31 BUS. LAW. 343 (1975) (cataloging cases of lender liability).

be reduced. At the very least, we would have a more coherent way of situating security interests in our systems of private property and limited liability.

Part IV goes on to address three practical implications of this proposal for debt markets. First, any changes that increase the potential liability of lenders would certainly add costs and complexity to both loan underwriting and servicing, which might reduce overall lending. Second, shifting even the threat of liability to lenders might increase monitoring of borrowers' behavior and creditor influence in a borrower's business decisions. Where limited liability can tend to reduce the incentive to monitor liability below socially desirable levels, creditor involvement might restore it.[31] And third, since regulatory hurdles may make lenders less able than borrowers to judgement-proof themselves, shifting some liability to them might better align actual liability with the goals of both our private law and regulatory systems. It is unclear how these practical implications balance out. But in choosing to maintain the status quo, we can understand that it is the awkwardness of according secured lenders limited liability despite their direct ownership claims that should lie at the root of their perceived unfairness, not the institution of secured lending itself.

## I. Capital Property from Residual Ownership up

This Part provides a practical foundation for the theoretical and normative arguments offered later in the Article.[32] Section A begins by defining each layer of capital and previews the rights held at each level in the basic corporate capital structure. Next, Section B explores prior efforts to understand the layers of corporate capital structures generally and security interests in particular.

Business entities have three main sources of capital: equity, unsecured debt, and secured debt. Each layer, however, can contain numerous subdivisions. These sources of capital each sit at a different point in any asset's so-called priority waterfall. A longstanding rule of both the federal bankruptcy system[33] and state-law wind-up regimes[34] is

31 *See generally* Saul Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 YALE L.J. 49 (1982) (explaining how creditors may act as monitors).

32 With bankruptcy, as with so many areas of the law, it is impossible to divine what the law "is" from case law alone because there are so many exceptions, which may be driven by bad facts, bad lawyering, bad judging, and any combination thereof. Because of the noise in the case law, some discussion of the rights of secured lenders must proceed from an idealized vision of how such lending occurs and is received in courts. *See* Robert E. Scott, *The Truth About Secured Financing*, 82 CORNELL L. REV. 1436, 1440 (1997) [hereinafter Scott, *The Truth About Secured Financing*] ("The simple truth is that we will not come to understand the nature and function of secured credit in our economic system without both a sound theoretical foundation and a thorough knowledge of how particular security devices function . . . .").

33 *See* 11 U.S.C. § 1129(b) (2012) (explaining the requirements for confirming a plan of

that claims against a company's assets must be paid out according to the absolute priority rule.[35] Priority refers to the order in which claims are paid in the event that a company's liabilities exceed its assets. This structure is a waterfall because in the event of liquidation, both federal[36] and many state[37] laws require assets to be distributed according to the absolute priority rule, meaning that secured claims must be paid in full before unsecured claims, which in turn must be paid in full before equity claims can receive the residuary.[38] This absolute priority rule, "the cornerstone of reorganization practice and theory,"[39] is the backdrop against which all capital is raised and where all interests in

reorganization); Case v. L.A. Lumber Prod. Co., 308 U.S. 106, 122–23 (1939) (holding that a reorganization that did not accord full priority to senior interests failed and violated § 77B of the Bankruptcy Act); Kansas City Terminal Ry. Co. v. Cent. Union Tr. Co. of N.Y., 271 U.S. 445, 455 (1926) (explaining that under early federal equity reorganizations, "to the extent of their debts creditors are entitled to priority over stockholders against all the property of an insolvent corporation").

34 Indeed, in New York, money that would be distributed to a creditor must be paid instead to the state comptroller as abandoned property if that creditor cannot be located. It cannot be used to satisfy the claims of downstream creditors. *See* N.Y. BUS. CORP. LAW § 1005(c) (McKinney 2003).

35 The absolute priority rule means that a secured creditor is entitled "to get [its] money or at least the property" securing the debt. *In re* Murel Holding Corp., 75 F.2d 941, 942 (2d Cir. 1935); *see also* John D. Ayer, *Rethinking Absolute Priority After* Ahlers, 87 MICH. L. REV. 963 (1989) (tracing the development of the absolute priority rule along with its exceptions).

36 11 U.S.C. § 1129(b) (explaining the requirements for confirming a plan of reorganization); *see* 11 U.S.C. § 507 (detailing the order in which unsecured claims must be paid); *see also* Czyzewski v. Jevic Holding Corp., 137 S. Ct. 973, 979 (2017) ("The Code also sets forth a basic system of priority, which ordinarily determines the order in which the bankruptcy court will distribute assets of the estate. Secured creditors are highest on the priority list, for they must receive the proceeds of the collateral that secures their debts."); Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 202 (1988) ("Under current law, no Chapter 11 reorganization plan can be confirmed over the creditors' legitimate objections . . . if it fails to comply with the absolute priority rule."); *see also* 4-507 COLLIER ON BANKR. ¶ 507.02[1] (16th ed. 2017); 3 NORTON BANKRUPTCY LAW AND PRACTICE § 49:1 (3d ed. 2016). Some details of this waterfall may be constitutionally required. *See* Ayer, *supra* note 35, at 979–93.

37 See N.Y. BUS. CORP. LAW § 1005(a)(3)(A) (requiring companies to distribute assets to stakeholders "according to their respective rights"). *But see* Stephen J. Lubben, *The Overstated Absolute Priority Rule*, 21 FORDHAM J. CORP. & FIN. L. 581, 584 (2016) (explaining that "[t]he concepts behind the [absolute priority] rule inform many state laws, like prohibitions on fraudulent transfers and restrictions on dividend [payments, but the rule itself] is absent from any direct application in state corporate debt collection law . . . ").

38 Secured claims are typically only secured up to the value of their collateral. If their total claim exceeds the value of the collateral, the claim is typically bifurcated, with the portion supported by capital sitting at the top of the priority waterfall and the unsupported portion sitting *pari passu* with unsecured claims. 11 U.S.C. § 506(a).

39 Bruce A. Markell, *Owners, Auctions, and Absolute Priority in Bankruptcy Reorganizations*, 44 STAN. L. REV. 69, 123 (1991); *see also* Roe & Tung, *supra* note 20, at 1236 ("Absolute priority is central to the structure of business reorganization and is, quite appropriately, bankruptcy's most important and famous rule."). *But see* Lubben, *supra* note 37, at 584 ("[C]hapter 11 will not work under the kind of rigid absolute priority rule many academic commentators promote, and thus the rule would be certainly flouted."); Edward H. Levi & James W. Moore, *Bankruptcy and Reorganization: A Survey of Changes III*, 5 U. CHI. L. REV. 398, 408 (1938) ("The absolute theory of priority . . . is entirely unrealistic in the reorganization of a large company.").

companies and their assets are proven.[40]

This Part discusses the layers of capital from the bottom of the priority waterfall up, which happens to be the natural order in which claims against company assets attach after a company is formed. This view makes clear exactly which rights a company has available to trade with investors at each layer of its capital structure.[41]

### A. *Equity*

Every company begins with equity holders. What happens to property when its owners decide to interpose a company between themselves and said property? When investors initially organize a company, the equity holders have the most senior claim against the company's assets because they are the only claims.[42] They are also the residual owners of the company's assets. As residual owners, if the going concern dissolves, and all claims against the company were paid, they would become the owner of any remaining assets.[43] While no equity holder would have any claim over any particular remaining assets, as a class, equity holders could liquidate or divvy up assets proportionately to their ownership interests.[44]

Equity—shares, membership interests, partnership interests—is the classic ownership interest in a company. Equity holders own a fractional interest in the company. In corporations, equity holders are entitled to

40 It is hard to overstate bankruptcy's importance for understanding property rights. After all, the boundaries of rights are most relevant when they are being challenged. And nowhere are property rights more regularly challenged than in bankruptcy where—by definition—there are insufficient assets to satisfy all claims, and thus an inevitable clash of rights.

41 As will be made clear below, not all of these investors are voluntary. *See infra* Section I.B.

42 This status is temporary since modern law causes more senior claims, such as tax claims, to attach almost immediately. *See* 31 U.S.C. § 3713 (2012) (giving priority to federal tax claims for parties not in bankruptcy). Interposing the company between them and their assets changes the equity holder's property interests from one in a specific asset, to a general claim against the residuary of a company.

43 *See* CIT Group Inc. v. Tyco Int'l Ltd. (*In re* CIT Group Inc.), 460 B.R. 633, 641 (Bankr. S.D.N.Y. 2011) (explaining that shareholders as residual owners are entitled "to share in profits *with no limitation*"). For our purposes, I am discussing whichever class or classes of shares are the true residual owners of a company. It is commonly the case that most large companies have multiple classes of shares whose claims against the residuary have different priority. As will be explained in this Section, the different rights among shareholders arise pursuant to the same mechanisms as other property interests in this Section.

44 Morgan Ricks has recently argued that this property relinquishment—the process of owners of capital forfeiting their direct claims against that capital in exchange for claims in a company—is one of the essential roles of American organizational law. By taking a claim in the residuary of a company in place of their interest in their capital, equity holders subordinate all of their personal liabilities to claims of their company's creditors. The process of relinquishment then serves as a powerful commitment device that "eliminates the ability of co-owners (and their successors/heirs) to defect with individual business . . . and, hence, going-concern value." Morgan Ricks, *Organizational Law as Commitment Device*, 70 VAND. L. REV. 1303, 1306 (2017).

vote for the board of directors, which in turn chooses the management of a company.[45] In smaller businesses, it is common for equity owners to also manage the company; that is, for their share in the company to appear to give them a possessory interest in the company. But possession and quotidian control are not among equity's inherent rights.[46] Nevertheless, an equity interest represents a fractional ownership interest[47] over the company and therefore a residuary interest in,[48] or indirect ownership over, the company's assets. Although equity holders often cannot control the company's management directly,[49] management's fiduciary obligations to the company constrain

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45 In publicly-traded companies, this right to have the company run for the shareholders' benefit continues to be an important check on the actions of the company and its managers even as ownership becomes so diffuse that collective action problems all but eliminate any individual shareholder's ability to influence control of the company. When a company becomes insolvent and the company is unable to satisfy its higher-priority obligations, equity is no longer the residual owner of the company and therefore not entitled to have the company run for its benefit. Instead, the fiduciary obligations of the managers (even if they are one and the same people as the equity holders) shift to the creditors. *See* Quadrant Structured Prods Co. v. Vertin, 115 A.3d 535 (Del. Ch. 2015) (explaining that the directors of a balance-sheet insolvent company have a fiduciary duty to creditors); Royce de R. Barondes, *Fiduciary Duties of Officers and Directors of Distressed Corporations*, 7 GEO. MASON L. REV. 45, 63 (1998) ("The majority rule, and the law in Delaware, is that, upon insolvency, a board's duties are owed to the creditors of the enterprise."). For the purposes of this Article, I am relying on the traditional "black box" model of corporations derived from the work of Adolf Berle and Gardiner Means. *See generally* ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1st ed. 1932). Many have improved on this model over the years to recognize the realities of institutional investors and the like, but those realities do not change shareholders' formal rights, even if they do change shareholders' ability to successfully *exercise* those rights. *See* MARGARET M. BLAIR, OWNERSHIP AND CONTROL: RETHINKING CORPORATE GOVERNANCE FOR THE TWENTY-FIRST CENTURY 21 (1995). The rights of equity holders in other kinds of business associations are similar to those of stock owners.

46 The separation of ownership and control as a feature of corporate property theory has been well studied over many decades. *See* Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301 (1983); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976); *see also* BERLE & MEANS, *supra* note 45.

47 The property rights at the core of this Article are those that determine the relationships among different parties and "the sanctioned behavioral relations among men that arise from the existence of things and pertain to their use." Eirik G. Furubotn & Svetozar Pejovich, *Property Rights and Economic Theory: A Survey of Recent Literature*, 10 J. ECON. LITERATURE 1137, 1139 (1972).

48 To be sure, this is an idealized view of residual ownership. Commentators have long observed that, given the amount of debt companies can issue, the true residual claimants are somewhere in the class of unsecured bonds and trade creditors. *See, e.g.*, BLAIR, *supra* note 45, at 26.

49 Control rights vary depending on the kind of business association and there are exceptions that prove the rule. For example, shareholders in a co-op residential building acquire the right to occupy, that is, posses, a particular apartment through the purchase of shares in the cooperative company that nominally owns the building. *See* Jay Romano, *When the Owner of a Co-Op Dies*, N.Y. TIMES (Oct. 16, 2005), http://www.nytimes.com/2005/10/16/realestate/when-the-owner-of-a-coop-dies.html (explaining co-op ownership). Thomas Merrill has suggested that holders of common stock, like commercial paper and other "interests of the modern capitalist state" may not be able to "exercise any managerial control over" their property (i.e., the stock or commercial paper itself) because there "is nothing [there] to

their choices as to how to manage the company such that, in theory, they should always be acting in the equity holders' best interests. First and foremost, the duty of care[50] and the duty of loyalty[51] ultimately require board members and directors to operate companies for the benefit of the equity holders. They have broad,[52] perhaps even overly broad,[53] leeway to do so, but at the very least, they cannot engage in self-dealing. That said, even where it seems easy to identify equity holders' best interests, agency costs will often create a gap between those interests and management's actions.[54]

The law also polices overreach by creditors who would either attempt to exercise too much control over the company[55] or to drain out more than their fair share of assets, thereby usurping equity holder's indirect control rights and right to have the company operated for their benefit.[56]

As residual owners, equity holders initially have all of the upside risk as the residuary grows with the company's success. That is, there is no limit on how much they can profit if the company is a runaway success. Of course, the value of the residuary can shrink as well, but the notion that higher returns come with downside risk is hardly novel.[57]

manage." Thomas W. Merrill, *Property and the Right to Exclude*, 77 NEB. L. REV. 730, 750–51 (1998); *see also* Harold Demsetz, *The Structure of Ownership and the Theory of the Firm*, 26 J.L. & ECON. 375, 375 (1983).

50 *See, e.g.*, Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985) (explaining that the duty of care provides that "corporate directors have a fiduciary duty to act in the best interests of the corporation's stockholders").

51 *See* Leo E. Strine Jr. et al., *Loyalty's Core Demand: The Defining Role of Good Faith in Corporation Law*, 98 GEO. L. REV. 629 (2009) (explaining that the duty of loyalty requires directors to both abstain from conflicts of interest and, acting in good faith, to avoid unlawful conduct); *see also* Melvin A. Eisenberg, *The Duty of Good Faith in Corporate Law*, 31 DEL. J. CORP. L. 1 (2006) (distinguishing the duty of good faith from the duty of care and the duty of loyalty).

52 *See, e.g.*, Treadway Cos. v. Care Corp., 638 F.2d 357, 382 (2d Cir. 1980) ("Under the business judgment rule, directors are presumed to have acted properly and in good faith, and are called to account for their actions only when they are shown to have engaged in self-dealing or fraud, or to have acted in bad faith.").

53 *See* Douglas G. Baird & M. Todd Henderson, *Other People's Money*, 60 STAN. L. REV. 1309, 1323 (2008) (criticizing the business judgment rule).

54 There is a rich literature describing all the ways in which our separation of ownership and management incentivizes managers to operate companies for their own benefit rather than for the benefit of the shareholders. *See generally* John Armour et al., *Agency Problems, Legal Strategies, and Enforcement* (ECGI Working Paper Series in Law 2009) (surveying the disconnect between equity holders' rights and management's incentives).

55 *See* Margaret Hambrecht Douglas-Hamilton, *Creditor Liabilities Resulting from Improper Interference with the Management of a Financially Troubled Debtor*, 31 BUS. L. 343 (1975).

56 Fraudulent transfer law allows courts to undo certain transfers for which the debtor received less than "reasonably equivalent value" 11 U.S.C. § 548(a)(1)(B)(i) (2012). Similarly, courts occasionally recharacterize debt as equity if the capital contribution has various attributes of an equity contribution but attempts to masquerade as a debt transaction to gain priority over prior equity holders. *See, e.g.*, Bayer Corp. v. MascoTech, Inc. (*In re* Autostyle Plastics, Inc.), 269 F.3d 726, 748 (6th Cir. 2001) (recharacterizing alleged debt as a capital contribution).

57 In theory, well-functioning markets require higher rates of return as the risk of loss

The downside risk is significant, because equity owners' property rights are the first to yield when a company becomes insolvent.[58] And when there is nothing left after paying creditors—as is normally the case—this interest is wiped out[59] along with the company (through liquidation or acquisition).[60]

Equity holders' downside risk is, however, limited: it is capped at the price at which they acquired and maintained their interest, plus any additional capital contributions that they made pursuant to that interest.[61] Even if creditors are owed far more than the assets of the company, and even if the equity holders have deep pockets, they are not liable beyond the value they have put into the company. That is the benefit of limited liability.

Picturing equity holders as participants in a tenancy in common makes their property right all the clearer. Like tenants in common who own a piece of real property, they can act as a group—typically by voting—to use, change, or sell their property. As with co-tenants, equity holders may have a fiduciary obligation to each other that provides the outer limits on their rights to use and dispose of the co-tenancy's assets.[62] They are fundamentally co-owners of the corporation.

When parties become equity holders by investing their capital in a company,[63] they are purchasing a spot in this co-tenancy-like entity that

increases. *See* Robert E. Scott, *A Relational Theory of Secured Financing*, 86 COLUM. L. REV. 901, 955 (1986) [hereinafter Scott, *A Relational Theory of Secured Financing*]; Easterbrook & Fischel, *supra* note 6, at 91.

58 *See* Jensen & Meckling, *supra* note 46, at 340 (explaining how equity holders lose their claims to their firms when the claims against a firm exceed its market value).

59 Some commentators have argued recently that equity interests should be more difficult to extinguish through bankruptcy. Instead, they propose that equity holders receive an option on the upside risk of a reorganized company—that is, on a company that emerges from bankruptcy as a going concern rather than liquidating. *See* Casey, *supra* note 28 (arguing that unsecured creditors are entitled to an option on the value of a going concern and proposing that senior creditors buy out unsecured creditors' option when selling or foreclosing on a firm); AMERICAN BANKRUPTCY INSTITUTE, COMMISSION TO STUDY THE REFORM OF CHAPTER 11 207–24 (2014) (proposing that fulcrum creditors receive the value of an option equal to the redemption price of the reorganized company even when more senior creditors are not paid in full).

60 Or rather, it should disappear when a company is either liquidated or recapitalized, meaning that former debt holders receive equity interests in exchange for their higher-priority claims against the reorganized going concern.

61 This is the core of limited liability. Shareholders can lose their investment, but they are not, absent highly unusual circumstances, responsible for other losses incurred or caused by the company in which they invest. *See* Lynn M. LoPucki, *The Death of Liability*, 106 YALE L.J. 1, 38 (1996) [hereinafter LoPucki, *The Death of Liability*].

62 In closely held corporations, shareholders have fiduciary duties to each other that shareholders in publicly-traded corporations do not have. These duties to each other generally prohibit conflicts of interest that might lead to strategic behavior that would negatively impact the other shareholders. That said, even in large, public corporations, certain strategic behavior may lead to liability among shareholders. *See, e.g.*, Rexford Rand Corp. v. Ancel, 58 F.3d 1215, 1219 (7th Cir. 1995) ("Generally, imposing a fiduciary duty on shareholders in a close corporation shields minority shareholders from oppressive conduct by the majority.").

63 This discussion presumes that the company in question has only one layer of equity. If

entitles them to: (1) the residuary of the company; (2) a pro-rata share of any dividends; and, usually, (3) a vote for the directors or managers of the company whose actions will determine the residuary and other distributions.[64] The directors and managers, through this delegated authority, then control future company actions that can and do impact the value of the equity holder's claim against the company.[65] In this way, when managers and directors create rights to the company's assets that are senior to the equity interests, they do so with the consent and authority of equity holders. Individual equity holders may disagree with individual actions, but they consented to live with the choices of their managers and directors when they traded their capital for an interest in the company.

Equity holders have two paths for bringing additional capital into their company: they invite in additional equity holders or delegate to management the right to create senior claims against company assets. Some of these senior claims are the unavoidable consequences of doing business—utility bills, salaries, tax obligations, and so on. If the company wants a more significant infusion of capital, it must either issue equity interests or issue debt. With unsecured debt, a company is selling a claim against the residuary of the company. With secured debt, it is selling specific company assets that then no longer comprise the residuary. Both kinds of debt can be understood as equity holders, through management, temporarily alienating their interests in the hope of achieving better investment returns. External sources of law may limit the condition of sales,[66] but it is rare for law to render any particular property right inalienable.[67]

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there are preferred shares or other equity interests that have a preference right over the common stock, those interests proceed from the common stock.

64 Whether that right to vote is meaningful is subject to debate. *See* Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 395-97 (1983) (explaining disagreement in the literature about shareholder voting rights).

65 Easterbrook & Fischel, *supra* note 6, at 94.

66 For example, fraudulent transfer and fraudulent conveyance laws tend to limit sales for other than reasonably equivalent value. *E.g.*, MO. ANN. STAT. § 428.029(1) (West 2017). ("A transfer made or obligation incurred by a debtor is fraudulent as to a creditor whose claim arose before the transfer was made or the obligation was incurred if the debtor made the transfer or incurred the obligation without receiving a reasonably equivalent value in exchange for the transfer or obligation and the debtor was insolvent at that time or the debtor became insolvent as a result of the transfer or obligation.").

67 As Thomas Merrill observed, "[i]t takes some special conveyance or legislation to defeat the expectation that the right to exclude entails a right to transfer." Merrill, *supra* note 49, at 743.

### B. *Unsecured Claims*

Moving up the priority waterfall, the next most senior class of capital is unsecured debt.[68] Unsecured debt includes not only commercial unsecured debt and credit cards but also all unfilled contractual obligations and potential judgment creditors. These claimants can be suppliers who do not require immediate payment, employees who have accrued paid leave, contract counterparties, and tort claimants, among other possibilities.[69] Unsecured debt is unique among the layers of capital in that it is often given involuntarily when claims are not paid upon accrual.

When a company incurs unsecured claims, equity holders, through management, temporarily alienate some of their claims over the residuary of the company by creating a right to the company's assets that has priority over their claim. That is, if the company were to cease doing business, its unsecured claims would be paid before equity holders received any distribution of assets.[70] As mentioned above, there are many sources of unsecured claims, some voluntary, some not; some intentional, some not.[71]

But the effect on the capital structure of a company is the same whether it issues unsecured bonds, delays payments to vendors, or injures someone in tort.[72] From the perspective of equity, the company is ideally increasing the value of its equity interest by selling a priority claim against the general pool of assets that would otherwise comprise

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68 For the purposes of this Article, I am lumping bonds and loans together and focusing instead on whether the obligation is secured or unsecured. While there remain some differences between the bond and loan markets, the two forms of debt are economic equivalents, primarily distinguished by their regulatory obligations. *See* Elisabeth de Fontenay, *Do the Securities Laws Matter? The Rise of the Leveraged Loan Market*, 39 J. CORP. L. 725 (2014) (cataloging the convergence of the bond and leveraged loan markets).

69 In a bankruptcy, these groups would all begin as unsecured creditors. 11 U.S.C. § 506 (2012) (claims are unsecured unless they meet the statutory requirements for being treated as secured claims).

70 Equity holders may receive compensation ahead of unsecured claims if the equity interests are being extinguished through a sale or merger that intends to preserve unsecured claims. The effect of the wind-up on the original company may be the same, and indeed, the sale or merger may decrease the chances that unsecured claimants will be able to satisfy their claim, but the key difference between a dissolution and a sale is that there is a successor entity to assume the unsecured claims, which in turn permits distributions to equity to occur.

71 *See supra* Section I.B.

72 To be sure, there can be incredible variation and stratification within a pool of unsecured claims. Lawmakers may give wage and tax obligations priority over other unsecured claims. For example, 11 U.S.C. § 507, sets priorities among unsecured claims based on lawmakers' policy preferences rather than any rights stemming from contractual or property rights. For example, under § 507, domestic support and tax obligations must receive priority over other unsecured claims, even if those unsecured claims purport to be "senior" themselves or otherwise prohibit the company from incurring senior claims. In this way, any stratification within the pool of unsecured claims does not reflect any stratification of property rights within that pool of claims. 11 U.S.C. § 507.

its residuary.[73] As a company does business, it puts its capital, which would otherwise comprise equity holders' residuary, at risk in the hopes that the risk returns a profit.

But what kind of interest does the unsecured lender have in the company? Is it a property right? If it is, it must be the same kind of property right created by contracts and unliquidated liability generally.[74] Upon close analysis, it is difficult to fit unsecured debt into our traditional conception of property. Instead, through contract, they acquire a non-specific interest in the company's assets that is supported by the residual value of the company as a whole.[75] Their interest does not become a property right against a company's assets unless and until it is reduced to a lien through the judgment process.[76] For example, courts[77] and commentators[78] often insist that property ownership

73 See Rene Stulz & Herb Johnson, *An Analysis of Secured Debt*, 14 J. FIN. ECON. 501, 502 (1985) (explaining that some profitable projects will only be possible if the firm can finance it with secured debt).

74 Olivia A. Radin, *Rights as Property*, 104 COLUM. L. REV. 1315, 1336–37 (2004) (explaining that "[t]o the extent that an abrogated right is a traditional common law right, such as a tort right, these cases indicate that the court will protect it as a property interest. If the right is not clearly established or conflicts with the constitutional allocation of power, then the courts are unlikely to treat those rights as property for due process purposes"); *see, e.g.*, Landgraf v. USI Film Prods., 511 U.S. 244, 271 (1994) ("The largest category of cases in which we have applied the presumption against statutory retroactivity has involved new provisions affecting contractual or property rights, matters in which predictability and stability are of prime importance."); Preveslin v. Derby & Ansonia Developing Co., 151 A. 518, 522 (Conn. 1930) ("The defendant's right of defense . . . was a property right which vested in the defendant and for whose protection against legislative invasion in the form of a validating act or otherwise it could rely . . . upon the Fourteenth Amendment of the Federal Constitution."); N.Y. Cent. R.R. Co. v. White, 243 U.S. 188, 198 (1917) (explaining that unaccrued liabilities are subject to change, for "[n]o person has a vested interest in any rule of law, entitling him to insist that it shall remain unchanged for his benefit").

75 *See generally* James Steven Rogers, *The Impairment of Secured Creditors' Rights in Reorganization: A Study of the Relationship Between the Fifth Amendment and the Bankruptcy Clause*, 96 HARV. L. REV. 973 (1983). In *Louisville Joint Stock Land Bank v. Radford*, the Supreme Court held that for the purposes of the Fifth Amendment, secured creditors had a compensable property right in the collateral while unsecured creditors had an uncompensable contract claim against the debtor, but gave no explanation for this distinction. Louisville Joint Stock Land Bank v. Radford, 295 U.S. 555, 588–89 (1935).

76 That is, unless we extend the definition of property to include all contractual rights. *See generally* Thomas W. Merrill & Henry E. Smith, *The Property/Contract Interface*, 101 COLUM. L. REV. 773 (2001) (exploring the line between *in personam* contract rights and *in rem* property rights).

77 Int'l News Serv. v. Associated Press, 248 U.S. 215, 246 (1918) (Holmes, J., concurring) ("Property depends upon exclusion by law from interference . . . ."); Kaiser Aetna v. United States, 444 U.S. 164, 176 (1979) (explaining that "one of the most essential sticks in the bundle of rights that are commonly characterized as property . . . " is "the right to exclude others"); Dolan v. City of Tigard, 512 U.S. 374, 384 (1994) (same); United States v. Craft, 535 U.S. 274, 283 (2002) (same); Philip Morris v. Reilly, 312 F.3d 24, 51 (1st Cir. 2002) (explaining that the value of a property right "is inextricably tied to both the demand of others for access and the legal enforceability of the owner's right to exclude" such that government action impairing the right to exclude requires just compensation).

78 1 WILLIAM BLACKSTONE, COMMENTARIES ON THE LAWS OF ENGLAND 2 (1753) (defining property as "that sole and despotic dominion which one man claims and exercises over the

includes the right to exclude. But, as explained above, unsecured claims are rights to be paid from a general pool of a company's assets. There are literally no limits on how many claims against those assets can exist, nor does an unsecured creditor have an inherent right to limit whether, how, or to what extent a company incurs additional unsecured claims.[79]

For this reason, unsecured claims, unlike equity, do not resemble a kind of common property.[80] Although the company may claim that it controls who is or is not a member of the community of unsecured claims holders, its control is always thwarted by involuntary creditors. Short of going out of business, there is nothing that a company can do to protect its unsecured creditors from having their ranks diluted by tort claims. Even ceasing to operate is not enough to limit the class of unsecured creditors since there will always be recurring obligations to the state for the privilege of existing as a company.[81] The continued existence of the company necessarily means that the class of potential unsecured creditors remains open.

If they are property, unsecured claims significantly differ from more familiar forms of property in that they are not tied to a specific asset; there is no *in rem* right.[82] Defending or dissolving the entire framework of our common law system is a project for another day.[83] For

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external things of the world, in total exclusion of the right of any other individual in the universe"); Merrill, *supra* note 49, at 730 (arguing "that the right to exclude others is more than just 'one of the most essential['] constituents of property[—]it is the *sine qua non*" (emphasis added)); Henry E. Smith, *Exclusion Versus Governance: Two Strategies for Delineating Property Rights*, 31 J. LEGAL STUD. 453, 485 (2002) (arguing that "exclusion is often the first low-cost (but low-precision) cut at defining and defending a resource"). *But see* James Y. Stern, *Property's Constitution*, 101 CALIF. L. REV. 277, 302 (2013) (arguing that exclusivity, not exclusion, is the core of property because "[a] right to control is most complete and most meaningful when it is not shared with others . . . "); RESTATEMENT (FIRST) OF PROP. § 10 (AM. LAW INST. 1936) ("The word 'owner,' as it is used in this Restatement, means the person who has one or more interests.").

79 Sophisticated unsecured creditors can bargain for this right to exclude through the covenants governing their loan, but there is no presumption that such a right exists on its own. Still, the limitations of covenants illustrate how unsecured claims fail as property claims. Notably, a covenant not to create senior interests does not actually prevent the creation of senior interests. It only creates an event of default if the lender in fact creates a senior interest. Carl S. Bjerre, *Secured Transactions Inside Out: Negative Pledge Covenants Property and Perfection*, 84 CORNELL L. REV. 305, 308 (1999).

80 *See* Merrill, *supra* note 49, at 750 (discussing the right to exclude as applied to common property).

81 For example, there are regular filing fees for maintaining any company forms. Likewise, there are tax filing obligations even when no taxable income has accrued. Failure to comply with these obligations typically results in fees and fines that themselves become unsecured claims.

82 Merrill & Smith, *supra* note 76, at 834 ("The security interest gives the lender two rights that an unsecured lender does not have. First, the lender has what is called a 'property right' or 'repossessory right,' which means that upon default the lender can seize the collateral without having to resort to judicial process.").

83 It is possible that both contractual rights and tort claims are best conceived of as flavors of personal property. Such an open framework might harmonize some of the strange jurisprudence around the Takings Clause. But it might also throw our entire system of

now, it is enough to say that unsecured claims are not, on their own, property, even if the underlying contractual and tort claims are sometimes construed as property rights.

A better way to conceive of unsecured claims is as priority rights *over the claims of equity holders* against the assets of a company. There can be no unfairness when, in a wind-up or reorganization, unsecured claims receive distributions ahead of equity because equity holders chose to incur exactly this risk when they invested in a company capable of incurring such liabilities. This is true even when the liability comes from an unexpected tort claim—the possibility of incurring such claims is part of the risk that equity holders assume in exchange for their unlimited upside risk in their claim against the residuary.

But this priority right has a cost. As compared to equity holders—whose upside risk is theoretically infinite—unsecured creditors' upside has a ceiling, that which is defined in their contract or claim. Their profit is the extent to which the interest and fees that they collect exceeds the time-value of money over the term of the loan.[84]

Unsecured debt, although it primes equity holders' claims against a company's assets, presents a much lower risk to equity's interest than secured debt, or even the issuance of additional equity interests. Unsecured claimants have no claim over a specific asset of the company. If a company must sell its possessions to service those claims, it can elect to sell possessions that are not critical to its long-term health, if it has any such assets. By preserving those assets that are critical for its business, the company has a chance to continue as a going concern and dig itself out of debt—thus preserving the equity holder's upside risk by staying in business.

Unsecured debt also poses less of a threat to equity interests because unsecured creditors have a strong incentive to negotiate a compromise with a struggling debtor. Without any claim against a specific asset, unsecured creditors' expected recovery given default may be quite low as they must share a limited pool of unencumbered assets with all of the other unsecured claimants.[85] Moreover, whether in

bankruptcy into constitutional crisis if relieving a going concern of its debt overhang means extinguishing property rights that are otherwise constitutionally protected from interference. *See* Thomas C. Grey, *The Disintegration of Property*, 22 NOMOS 69, 74–75 (1980) (arguing that reducing property into a limitless set of rights denies any conceptual coherence).

84 Some lenders may be able to increase their profit considerably through the amend and extend process. This occurs when the borrower is unable to make a payment on the loan and renegotiates the terms in lieu of default. Lenders typically collect handsome fees with each round of this process. *See* Andrew G. Herr, Joyce M. Bernasek & William Corcoran, *"Amend and Extends" Emerge as New Trend in U.S. Loan Markets*, LEXOLOGY (July 7, 2009), https://www.lexology.com/library/detail.aspx?g=f39ec24a-917c-40c9-8161-720ef292a205.

85 Moreover, even if there is no secured debt in a company's capital structure, other laws may give certain other unsecured claims distributional priority over another claimant, notwithstanding contractual provisions to the contrary. *See, e.g.*, 11 U.S.C. § 507 (2012) (explaining priorities).

bankruptcy or in the state court system, the process for liquidating an unsecured claim is both time intensive and subject to waste.[86] The borrower can drag out the process, spending its limited assets down as it does so, to effectively hold its unsecured creditors hostage.

Unsecured lenders can protect themselves to some extent with covenants.[87] With covenants, the company trades some of its rights to self-control to the lender in exchange for more favorable terms or for credit that would be otherwise unavailable.[88] From equity's perspective, covenants represent a further delegation of control over their capital. If equity holders dislike the path the company is on, they can use their voting rights to try to instill debt-averse directors or managers in the future,[89] but their only way to avoid the impact of any covenants is to sell their equity interests and invest elsewhere.

When unsecured creditors are the fulcrum creditor, a handful of state laws work together to protect unsecured creditors' residual interests in the borrowers' property. Most notably, fraudulent transfer law and restrictions on dividends ensure that borrowers do not siphon assets away from creditors without replacing them with something else of value.[90] Nevertheless, unsecured claims are extremely vulnerable to non-payment. Because they can accrue through tort and other unplanned means, existing lenders cannot use contract to bar borrowers from taking on new, unsecured liabilities. To protect themselves, commercial unsecured creditors contract with the company for certain promises and, oftentimes, control rights, in exchange for their capital. If the company breaches these promises, the lender must look to contractual remedies. Lacking any direct property interest in the company's assets, they have no inherent right to self-help. This lack of any direct property interest also means that the unsecured debt can be wiped out in bankruptcy if there are insufficient assets to satisfy it before the debtor receives a discharge.

86 *See* Jacoby & Janger, *supra* note 20, at 872–73 (criticizing state court liquidation options); Ronald J. Mann, *Strategy and Force in the Liquidation of Secured Debt*, 96 MICH. L. REV. 159, 164 (1997) [hereinafter Mann, *Strategy and Force*] (finding the view among loan officers that "a decision to repossess collateral and liquidate was tantamount to accepting a loss on the loan").

87 Whitehead, *supra* note 27, at 651.

88 Henry Hansmann & Reinier Kraakman, *Hands-Tying Contracts: Book Publishing, Venture Capital Financing, and Secured Debt*, 8 J.L. ECON. & ORG. 628, 649 (1992).

89 Of course, the weight of any one equity holder's vote will vary with the number of outstanding equity interests. A small shareholder in a large company has almost no chance of implementing change through its vote.

90 *See* Robert Charles Clark, *The Duties of the Corporate Debtor to Its Creditors*, 90 HARV. L. REV. 505 (1977) (explaining limitations on borrowing); *see also* 11 U.S.C. § 548(a)(1)(B)(i) ("The trustee may avoid any transfer received less than a reasonably equivalent value in exchange for such transfer or obligation . . . .").

### C. *Secured Debt*

At the top of the priority waterfall sits secured debt.[91] Secured debt refers to a loan where, in addition to a promise to repay the principal and interest, the borrower gives the lender an interest in collateral. This interest then entitles the lender to foreclose on the collateral if the borrower fails to satisfy the terms of the loan. Secured creditors must satisfy certain formalities to perfect their security interest. It is only once they perfect their lien that their claim against the collateral is fixed in place.[92] Before then, the debt is effectively unsecured. Subsequent creditors could leap in with a prior lien[93] and, if the borrower were to file for bankruptcy, the trustee could defeat the lien altogether.[94] Although the particular steps for perfecting a lien depend on the jurisdiction and kind of collateral encumbered, the typical first step is a public filing of some kind. One common recording requirement is that the borrower and the collateral must be clearly identified so that third parties who would do business with the borrower can discover that its assets are already encumbered. Even though searching for perfection filings can be expensive and imperfect, they are universally treated as sufficient notice to the world that the encumbrance exists.[95] This filing requirement is closely related to the filing system for recording ownership of real property. Indeed, liens against real property and fixtures are typically recorded alongside deeds and transfers.

When a company issues secured debt, it again creates a claim that

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91 There are a few exceptions to the rule that secured lenders are at the top of the priority waterfall. These largely arise when municipalities place their own claims against the borrower in the first position notwithstanding the presence of earlier secured claims. For example, in many places in the United States, liens arising from unpaid taxes can prime existing liens and become the most senior security interests against property. *In re* Ecology Paper Prods. Co., 17 B.R. 281, 282 (Bankr. D. Ariz. 1982). Similarly, mechanics' liens commonly prime preexisting senior secured interests without the consent of those preexisting senior secured lenders. *See* Church Bros. Body Serv., Inc. v. Merchs. Nat'l Bank & Tr. Co., 559 N.E.2d 328, 331 (Ind. Ct. Appl. 1990) (explaining when mechanic's liens have priority over other liens).

92 *See generally* Ronald J. Mann, *First Shall Be Last: A Contextual Argument for Abandoning Temporal Rules of Lien Priority*, 75 TEX. L. REV. 11 (1996) [hereinafter Mann, *First Shall Be Last*] (explaining and criticizing regimes for protecting security interests).

93 Both liens could be perfected against the same property, but the first creditor to make the requisite filing usually has complete priority over liens in subsequent filings unless the first filer had notice of the second filer's lien at the time it made its filing. N.Y. REAL PROP. LAW § 291 (McKinney 2003). Other states do not even require the second creditor to complete their filing first to have priority. MO. ANN. STAT. § 443.035 (West 2000). And Delaware, Louisiana, and North Carolina do not even ask whether the second lender knew about the first lender's lien, relying entirely on the order in which lenders complete the requisite formalities to determine priority. DEL. CODE ANN tit. 25 § 153 (West 2014); LA. CIV. CODE ANN. art. 1839 (1985); N.C. GEN. STAT. ANN. § 47-18 (West 2005).

94 *See* 11 U.S.C. § 544 (2012) (allowing bankruptcy trustees to avoid unperfected liens). If a trustee successfully avoids a lien, the debt enters the general class of unsecured debt.

95 This notice to the world feature is important because the security interest creates a property interest that is good against the world.

has priority over the equity holders' claim against the residuary in exchange for capital. Secured debt differs from other investments because rather than being supported by the residuary of the company, the debt is supported by collateral comprised of specific assets.[96] From the perspective of equity, the creation of secured debt looks a lot like the sale of the encumbered asset. To the extent that they are encumbered, these encumbered assets are removed from the residuary of the company when the secured lender perfects its lien.[97] Depending on the terms of the loan, the company may still be able to possess and use the asset while it is encumbered, but perfection may require that the lender assume control[98] or even possession of the collateral.[99] The company then slowly repurchases the assets from the lender as it makes payments and this repurchased portion then supports the claims of unsecured lenders and equity holders.

The key feature here is that while an asset is encumbered, the company no longer has sole ownership over it. Rather, the company co-owns it with the secured creditor in proportion to the extent to which the value of the lien matches the value of the encumbered asset. If the lien exceeds the value of the asset, one can legitimately wonder whether the borrower owns it so much as merely has a right to use it. This dual-ownership complicates a secured lender's upside risk. In theory, and like unsecured debt, the upside risk is the price of the debt given in the contract. In practice, if the borrower defaults, the secured lender can foreclose on its collateral—use a credit-bid to prevail in the auction—and take over the borrower's interest in the collateral. If that interest includes unlimited upside risk, the secured lender gets that unlimited upside risk.

Even if security interests are somehow not full-fledged property rights, they only work in our private law framework if we recognize and focus on their property-like features. Otherwise, they are merely contracts to involuntarily subordinate the rights of other creditors.[100] Property rights, by contrast, regularly subordinate the rights of third parties. For example, if a company sells an asset outright, unsecured creditors are potentially worse off post-sale because the asset is no

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96 Melissa B. Jacoby & Edward J. Janger, *Tracing Equity: Realizing and Allocating Value in Chapter 11* (Brooklyn Law Sch. Legal Studies Research Papers, Research Paper No. 537, 2017) [hereinafter Jacoby & Janger, *Tracing Equity*].

97 See Merrill & Smith, *supra* note 76, at 835.

98 For example, to perfect a security interest in money held in a bank account, the lender must have control over that account. Control is typically established through a deposit account control agreement, which may restrict the borrower's ability to access funds in the account.

99 For example, security interests in shares are perfected by taking possession of the share certificates.

100 *See* Jackson & Kronman, *supra* note 19, at 1147 ("The idea that all creditors should be treated equally, regardless of the private arrangements they may have made with their debtor, has played an important role in the evolution of the federal bankruptcy system. Reported case law is replete with references to the bankruptcy 'principle' that 'equality is equity.'").

longer available for creditors to levy against and the cash may be freely spent. But, absent covenants prohibiting the sale of assets, the unsecured creditor has no right to stop or undo the sale because the borrower never had an obligation to preserve specific assets for paying their claims.[101] Instead, unsecured creditors facing a sale of assets can look only to fraudulent transfer and preference law if the sale occurred when the borrower was unable to pay its claims.[102]

Normally, parties cannot contract to directly harm a third party without incurring liability to that third party.[103] Dave and Emily cannot contract for Emily to break her contract with Fran without Fran accruing the right to seek damages from one or both of them either in contract[104] or in tort.[105] This is not to say that courts only enforce victimless contracts. Buyer may contract with Supplier to be the exclusive distributor of its widgets in a particular city. If Retailer can no longer buy those widgets, or must pay more to acquire them, then the contract between Buyer and Supplier likely harmed Retailer. As much as Retailer might dislike this arrangement, Retailer will only have recourse if it has an agreement with Supplier that is now breached or if the agreement between Buyer and Retailer triggers antitrust or unfair competition concerns. That is, since the harm of the exclusivity contract is not specifically targeted at Retailer, its rights must either lie in its own contractual claim, or because there is a specific public policy—for example, antitrust—that the contract between Buyer and Supplier violates.

Outside of security interests, borrowers generally cannot subordinate one creditor to another without the consent of the

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101 See Douglas G. Baird & Thomas H. Jackson, *Fraudulent Conveyance Law and Its Proper Domain Symposium on Bankruptcy*, 38 VAND. L. REV. 829, 836 (1985).

102 *Id.* at 830.

103 Lynn LoPucki described security agreements succinctly as an "agreement between A and B that C take nothing." Lynn M. LoPucki, *The Unsecured Creditor's Bargain*, 80 VA. L. REV. 1887, 1899 (1994) [hereinafter LoPucki, *The Unsecured Creditor's Bargain*].

104 Decolator, Cohen & DiPrisco, L.L.P. v. Lysaght, Lysaght & Kramer, P.C., 756 N.Y.S.2d 147, 150 (N.Y. App. Div. 2003) ("It is well settled that in order to have standing to challenge a contract, a nonparty to the contract must either suffer direct harm flowing from the contract or be a third-party beneficiary thereof." (citation omitted)).

105 For example, the tort of intentional interference with business advantage "permits recovery for interference with business relationships or expectations even in the absence of a legally binding agreement or where the expectations of the parties are only the subject of an unenforceable contract." Smith v. Superior Court of L.A., 198 Cal. Rptr. 829, 836 (Cal. Ct. App. 2d 1984). The elements of intentional interference with business advantage are:

> (1) An economic relationship between the plaintiff and some third person containing the probability of future economic benefit to the plaintiff; (2) knowledge by the defendant of the existence of the relationship; (3) intentional acts on the part of defendant designed to disrupt the relationship; (4) disruption of the relationship; and (5) damages proximately caused by the acts of defendant.

*Id.*

subordinated lender.[106] Imagine that a borrower has two unsecured loans, but one of them purportedly requires the borrower to pay that debt before making any other debt payments. If the borrower makes all the payments, this provision offends no one. Of course, this kind of provision is aimed at the times when the borrower lacks the cash-flow to make its payments as they come due. If and when the borrower skipped payments to the involuntarily subordinated lender, provided that other conditions are met, that lender could file an involuntary bankruptcy petition against the borrower.[107] No bankruptcy court would respect a loan provision unilaterally claiming priority over other debt, absent the full formalities of a security interest.[108] Unsecured lenders must rely on contract—specifically inter-creditor agreements—to effectuate different priority rights. Without an inter-creditor agreement, if the borrower makes payments to one lender while withholding payments to the other, the unpaid lender may recover some of those payments in a preference action.[109]

If security interests are merely contractual rights, there is little to distinguish them from the unenforceable unilateral priority clause in the contract above. Borrowers can create security interests without the consent of other creditors. But once created, borrowers cannot subsequently subordinate the rights of a secured creditor without its consent. Unlike with unsecured debt, the presumption with secured debt is not that it is paid *pari-passu*, but rather that it is paid in the order in which it was perfected.[110] While the line between contractual rights and property rights is increasingly vague, this perfection process, and the rights that it triggers, are undeniably property-like.

The role of secured debt in capital structures has shifted considerably in recent decades as it has become the dominant form of small business lending.[111] The changing role of secured credit is due to both changes in the laws facilitating its creation and changes in

106 Hideki Kanda, *Debtholders and Equityholders*, 21 J. LEGAL STUD. 431, 436–37 (1992). (explaining the absence of "preferred debt").

107 11 U.S.C. § 303 (2012).

108 *See* William E. Hogan, *Unperfected Security Interests and the "Floating Lien"*, 44 TEX. L. REV. 713, 713–14 (1966). Moreover, even if the loan did claim to be a secured loan, the bankruptcy trustee could seek to boot the debt back into the pool of unsecured debt unless each and every perfection formality was met. *See* 11 U.S.C. § 544 (granting trustees power to avoid unperfected security interests).

109 11 U.S.C. § 547(b) (permitting the bankruptcy trustee to avoid transfers to creditors made within ninety days of bankruptcy that would otherwise allow that creditor to recover more than it would recover under the absolute priority rule).

110 *See* Alan Schwartz, *A Theory of Loan Priorities*, 18 J. LEGAL STUD. 209, 209 (1989); Mann, *First Shall Be Last*, *supra* note 92.

111 *See, e.g.*, Mark Jenkins & David C. Smith, *Creditor Conflict and the Efficiency of Corporate Reorganization* (2014) (unpublished paper), https://ssrn.com/abstract=2463700 ("Secured debt represented less than 45% of the debt of Moody's-rated firms filing for bankruptcy in 1991; by 2012, secured debt accounted for more than 70 percent of the debt of Moody's-rated bankruptcy filers.").

sentiments towards secured debt.[112] Notwithstanding these changes, the core has been mostly stable: the contract between the lender and the borrower defines the lender's expected upside risk,[113] which comprises interest and fees defined in the loan agreement. In exchange for a lower interest rate, the borrower gives the lender a security interest, which is a claim against specific assets of the borrower. When certain conditions occur—typically nonpayment or failure to cure a material default—the security interest entitles the lender to liquidate the encumbered assets to satisfy its claim, thereby giving it a distributional priority over unsecured claims up to the value of its collateral. For example, an auto lender who takes a security interest in a vehicle can repossess that vehicle if the borrower defaults on the loan. As Judge Learned Hand long ago put it, a security interest entitles a lender "to get [its] money or at least the property" securing the debt.[114]

Since a secured creditor's interest is in identifiable assets, it typically travels with that asset, or the proceeds of that asset, until the value of the asset is itself destroyed.[115] For example, a lien on a personal property becomes moot if the property is destroyed in a fire although the underlying debt may remain valid as *unsecured debt*. If the property were sold out of state without the lender's consent, the lien would remain attached but the lender would have to take certain steps to maintain perfection.[116] The key feature is that the security interest is, at least in part, an *in rem* right unlike other claims against the company.[117]

## II. The Problem of Secured Debt

### A. *Explaining Two Layers of Debt*

Understanding why both equity and debt exist is comparatively

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112 *See infra* Section II.B.

113 A lender's upside risk is typically capped at its expected interest and fees less any underwriting and servicing costs and the relevant time-value of the money lent. In rare cases, secured lenders may prefer to foreclose on an asset instead of being paid back in full. *See* Hester-Haddad & D'Onfro, *supra* note 25 (discussing loan-to-own strategies). In these so-called loan-to-own cases, the lenders are trying to circumvent their capped upside risk and, by stepping into their shoes of equity holders, obtain equity's unlimited upside risk. *See In re* Free Lance-Star Publ'g Co., 512 B.R. 798, 806 (Bankr. E.D. Va. 2014) (explaining a creditor's loan-to-own strategy). Certain kinds of convertible debt similarly allow secured lenders to trade their secured position for better upside risk by converting their claim to equity. *See* Michelle M. Harner, *Activist Distressed Debtholders: The New Barbarians at the Gate?*, 89 WASH. U. L. REV. 155, 165–69 (2011) (cataloguing loan-to-own strategies).

114 *In re* Murel Holding Corp., 75 F.2d 941, 942 (2d Cir. 1935).

115 *See generally* Jacoby & Janger, *Tracing Equity*, *supra* note 96 (explaining how security interests attach to assets and the limits of asserting security interests against the proceeds of the original collateral).

116 U.C.C. § 9-316(a)(3) (AM. LAW INST. 2012).

117 Merrill & Smith, *supra* note 76, at 833–43.

simple. As discussed above, equity holds the upside risk in any venture. As entrepreneurs seek equity investments, they must sell part of their own stake in the company or dilute their interest by issuing additional shares, unless the company is sufficiently sophisticated to justify multiple classes of equity.[118] Entrepreneurs who need cash but who wish to maintain control and to avoid reducing their upside risk can avoid diluting their control by choosing debt.[119]

The more puzzling question is why we need both secured and unsecured debt.[120] Modigliani and Miller famously posited that if bankruptcy costs are zero and tax policies are neutral, capital structure should not influence firm value and therefore firms should not rationally prefer one form of financing over another.[121] Of course, bankruptcy costs are not zero, and tax policies are neither neutral nor consistent between firms. Nor are firms consistently rational actors in the face of these costs. Companies and investors have idiosyncratic preferences just as the people that comprise them do. Accordingly, the choice between secured and unsecured debt can likely be explained by lenders' varying preferences for risk and control.

Any loan, whether it backs a business venture or helps purchase a house, entails some risk that the borrower will not repay in full. Lenders have three levers for manipulating their exposure to that risk: collateral, covenants, and price. Collateral, as shown above, helps lenders reduce their downside risk by raising their expected recovery given default.[122]

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118 Companies that have raised capital beyond the initial investors or have begun issuing stock options to employees typically have both preferred shares and common shares. Preferred shares typically pay a regular dividend that must be paid before any dividends can be paid on the common shares. If the company were to liquidate, preferred stock may have priority over common stock. In most cases, preferred shares are non-voting shares, making them effectively like unsecured debt, but without a cap on the value that must be repaid. To protect existing shareholders, corporate law typically requires companies to issue new equity at the fair market value of existing equity. Kanda, *supra* note 106, at 434.

119 Many companies never even get to this choice. Their only option is secured debt because they are insufficiently creditworthy to borrow unsecured or have not sufficiently proven their idea to attract venture capital. *See* Steven L. Schwarcz, *The Easy Case for the Priority of Secured Claims in Bankruptcy*, 47 DUKE L.J. 425, 447–48 (1997).

120 The fact that most companies have a mixed capital structure has perplexed commentators for some time. *See* Scott, *The Truth About Secured Financing*, *supra* note 32, at 1437 (lamenting that nineteen years into the debate about the social value of secured credit, there was still no theory of finance explaining why firms sometimes issue secured debt); *see also* White, *supra* note 19; Schwartz, *Security Interests and Bankruptcy Priorities*, *supra* note 19, at 1 (arguing that the variety of debt and equity instruments is relatively poorly understood).

121 Franco Modigliani & Merton H. Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 AM. ECON. REV. 261, 268–71 (1958).

122 That said, given the transaction costs associated with selling collateral, and the risk that a court could find a lien to be invalid or unperfected, few if any lenders rely exclusively on expected recovery given default when deciding to lend. Scott, *A Relational Theory of Secured Financing*, *supra* note 57, at 944–45. While recovery given default may not have driven lending decisions in earlier generations, *id.*, for non-investment grade companies (that is, those with a real risk of default), it currently is a key driver of company's credit ratings and in turn, the cost of their debt. LOAN SYNDICATIONS & TRADING ASS'N, THE TROUBLE WITH UNNEEDED

Recovery given default is the value that the lender expects to receive should the borrower default on the loan. It typically reflects the value of the collateral, the priority of the liens, as well as macroeconomic conditions such as the overall default rate.[123] Unsurprisingly, companies whose balance sheets reveal cash-flow risks or whose industries are either very competitive or in secular decline get shut out of the unsecured debt markets.[124]

These companies prove their creditworthiness by offering collateral. Collateral protects lenders by decreasing the borrowers' ability to acquire additional debt payable from the same pool of assets.[125] If the gilded age of Silicon Valley has shown us anything, it is that emerging or growth companies can consume enormous sums of capital before becoming profitable. Collateral is one of the only ways that investors can ensure their priority in the company's capital structure and protect against dilution.[126] While bringing in secured debt that primes the original unsecured lender may be a breach of the original loan agreement, that breach will not undo the new lender's security interest in the collateral. The original lender's only recourse would be against the borrower, who incidentally now has fewer assets against which the original lender can execute its claim.

The second lever, covenants, allows lenders to control negotiated aspects of the borrower's behavior, ostensibly to prevent the borrower from intentionally increasing its risk. For example, covenants often bar borrowers from entering into bet-the-company joint ventures without lender consent. Covenants can also ensure that the lender is the first to know—and therefore in the best position to negotiate its exit—if the borrower's risk profile has changed.[127] The most common covenants are

BANKRUPTCY REFORM: THE LSTA'S RESPONSE TO THE ABI CHAPTER 11 COMMISSION REPORT 28 (2015) (studying a sample of 855 issuers rated BB- through B by Standard & Poor's and showing that companies with a lower expected recovery given default paid more for their debt).

123 *See* Edward I. Altman, *Default Recovery Rates and LGD in Credit Risk Modeling and Practice: An Updated Review of the Literature and Empirical Evidence* (2006) (unpublished paper), https://pdfs.semanticscholar.org/f079/20544cb9d2ba1daf21fbfa5419bff48ade5d.pdf (reviewing credit risk modeling).

124 Before the development of sophisticated valuation techniques, most lending was secured since lenders lacked the tools needed to accurately and efficiently assess the risk in a potential borrower's balance sheet. *See* Scott, *A Relational Theory of Secured Financing* , *supra* note 57, at 940–41, 943 (explaining that newer and smaller firms "cannot offer prospective lenders proof of capable management or a solid base of existing assets . . . " such as manufacturing equipment, a form of collateral that firms were more likely to possess to offer lenders to obtain financing); Ronald J. Mann, *Explaining the Pattern of Secured Credit*, 110 HARV. L. REV. 625, 668–74 (1997) (exploring why stronger companies rarely choose secured debt while weaker companies often choose it).

125 *See* Scott, *A Relational Theory of Secured Financing*, *supra* note 57, at 944–45.

126 Investors can contract for these rights, but any remedy for a violation is going to lie in contract, not against the subsequent investor, especially if the subsequent investor made its investment in good faith. Bjerre, *supra* note 79, at 315.

127 For example, covenants can require the borrower to comply with "all laws, rules, regulations and orders of any Governmental Authority applicable to it or its property" and

measures of the borrower's financial health.[128] These covenants allow the lender to declare an event of default, and therefore accelerate its debt, before the company becomes otherwise insolvent. The mere threat of acceleration typically forces the borrower to negotiate an amendment or release with the lender. In turn, the lender typically increases the price of the loan.[129] And if renegotiation fails, acceleration gives the lender a larger claim against the borrower in bankruptcy.[130]

The price of capital is the most visible lever by which lenders control their risk. As their expected recovery given default decreases, they must charge more in interest and fees to make up the shortfall. Borrowers who do not expect to default can offer collateral to buy down the price of the loan. It is thus no surprise that a majority of small businesses use secured credit. One survey of about 500,000 small businesses found that sixty-two percent had secured debt.[131] From the perspective of a borrower with no intention of defaulting, collateral and covenants can seem like free ways to reduce their cost of capital or to gain access to capital altogether.[132]

All of the variation in debt contracts described above are driven by contracts. The company, theoretically for the benefit of the equity holders, contracts with lenders for capital. Through contract it can trade away future income (price), control (covenants), and property rights (collateral). The key takeaway about the relationship between secured versus unsecured debt is that the secured lender receives a property-like interest not received by the unsecured lender. This property-like interest, in turn, makes the loan a different animal both for theoretical

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notify the lender if it breaches the covenant such that the lender may know of the borrower's regulatory compliance failures before the applicable regulator does. *See* MICHARL BELLUCI & JERMONE MCCLUSKY, THE LSTA'S COMPLETE CREDIT AGREEMENT GUIDE 344–54 (2017).

128 Common financial covenants require the borrower to maintain revenue not less than a designated percentage of total indebtedness or to maintain a minimum amount of liquidity. *See id.* at 312–27. The riskier the loan and the tighter the credit market, the more onerous these covenants will be. *See* Richard Barley, *Heard on the Street: Shining a Light on Covenants*, WALL ST. J. (July 21, 2014), https://www.wsj.com/articles/heard-on-the-street-shining-a-light-on-covenants-1405938538.

129 For many non-investment-grade borrowers, amend-and-extend is how they do business until the terms of their debt become too unbearable or the lender determines that the risk is unacceptable at any price. *See* David Henry, *The Time Bomb in Corporate Debt*, BUS. WEEK (July 15, 2009) (describing how the now-defunct Blockbuster bought itself more time by extending its debt).

130 *In re* General Growth Props., No. 9-11977, 2011 WL 2974305, at *4–5 (Bankr. S.D.N.Y. July 20, 2011).

131 *See* ALAN SCHWARTZ & ROBERT E. SCOTT, COMMERCIAL TRANSACTIONS: PRINCIPLES AND POLICIES 547 (2d ed. 1991).

132 This is especially true when there is a "flight to safety" among investors. In such times, it is common to see previously creditworthy companies unable to find attractive capital and for terms of the capital they can raise to become increasingly burdensome as the overall economic outlook sinks, even when there are no other changes in the fundamental business of the company. *See* Min Zeng & Nick Timiraos, *Nervous Investors Flee to Treasurys*, WALL ST. J. (Jan. 6, 2015), https://www.wsj.com/articles/u-s-government-bonds-continue-to-strengthen-1420552119.

and constitutional purposes.

## B. *Making Sense of Priority*

While it is easy to explain why lenders, and sometimes even borrowers, like secured credit, it is far more difficult to explain why secured credit should enjoy the priority right that makes it so attractive. As Lynn LoPucki puts it, "[s]ecurity is an agreement between A and B that C take nothing."[133] If security interests were merely contractual rights, they might be less puzzling. Usual limitations on contract could dictate whether, if at all, we enforced security agreements against various downstream creditors. After all, normally, we do not let two people agree with each other to deprive a third person of their property. But security interests have too many attributes of property interests to fit comfortably within a contractual framework.

The challenge of situating security interests into our understanding of property is longstanding. This is in part because defining "property" and then determining what it means for something to be "property" is a massive intellectual problem with centuries of its own literature. The one constant in the history of security interests is that they have always faced skepticism as to whether, and to what extent, they should exist.[134] It remains difficult to explain why larger and more sophisticated parties claim enormous portions of the assets of a failed enterprise, leaving its smaller vendors, and other creditors such as workers and tort victims, with little if anything. There can be little surprise then, that secured lenders have always been dogged by the perception that they take more than their fair share.[135] To many, the priority right violates principles of distributional justice.

One reaction to this perceived unfairness was to view security interests as a form of theft. The "secret lien" consumes the assets of a party that still appeared healthy to potential business partners, leaving unsecured creditors with enormous claims against an insolvent company. America inherited a wary view of secured credit from England where non-possessory interests in property were often deemed fraudulent.[136] In 1601, the canonical *Twyne's Case* held that,

133 LoPucki, *The Unsecured Creditor's Bargain*, *supra* note 103, at 1899.

134 Some of this skepticism arises from simple revulsion at the terms of early security interests. From the Sumerians to more recently than we might hope, borrowers pledged their own freedom and that of their family along with their real and personal property. *See* DAVID GRAEBER, DEBT: THE FIRST 5,000 YEARS 85, 127–30 (2011) (tracing the history of human bondage as collateral and currency). That a farmer's children should be sold into slavery when rain fails to fall hardly leads to feelings that the system is right and good.

135 *See* BRUCE H. MANN, REPUBLIC OF DEBTORS: BANKRUPTCY IN THE AGE OF AMERICAN INDEPENDENCE (2009).

136 To be sure, out of necessity, security interests were more broadly accepted in the early America than in England, except to the extent that debt itself was seen as contrary to Christian

notwithstanding value given, a creditor could not claim to be a bona fide purchaser of collateral if the "seller" retained possession of the collateral.[137] Early American courts were similarly concerned that the invisibility of liens made them ideal vehicles for fraud against debtors' business partners or prospective purchasers of the collateral.[138] Indeed, some of the earliest equitable rights available to debtors—such as the right of redemption[139]—are meant to balance the power of secured creditors.[140]

Beginning in the 1970s, as Article 9 of the Uniform Commercial Code and the Bankruptcy Code stood on the verge of reform, new normative theories of security interests emerged as commentators grappled with the apparent conflict between our normal modes of analyzing property and our desire for some semblance of distributional fairness.[141] At one level, this view is driven not by ideologically charged premises but by the relatively controversial view that innocent parties not be forced to bear unexpected losses.[142]

The property rights of secured creditors have remained unclear in part because Article 9,[143] which governs the creation of security interests in most personal property, has undergone several rounds of reform

values. *Id.* at 56.

137 Twyne's Case (1601) 76 Eng. Rep. 809.

138 *See* Clow v. Woods, 5 Serg. & Rawle 275, 279, 283 (Pa. 1819) (invalidating a lien for being a "secret matter"); First Benedict v. Ratner, 268 U.S. 353, 359 (1925) (same).

139 The right of redemption allows the former owners of property to repurchase the property within a certain window following a foreclosure sale. *See* Peugh v. Davis, 96 U.S. 332, 337 (1877) (explaining equity of redemption).

140 Fears of sanctioning fraud also led early courts to adopt an intricate matrix of formal requirements for the perfection of liens. Secured lending remains one of the few areas of modern U.S. law that both requires a myriad of non-intuitive formalities and then requires strict compliance with them. *See* Official Comm. of Unsecured Creditors of Motors Liquidation Co. v. JP Morgan Chase Bank, N.A. (*In re* Motors Liquidation Co.), 777 F.3d 100 (2d Cir. 2015) (holding that a mistake made by a paralegal at Mayer Brown while preparing the UCC financing statements made JP Morgan's $1.5 billion dollar lien on General Motor's assets unsecured even though both parties at the time expected the loan to be secured and there was no claim that any party had relied on the loan being unsecured); *see also* Douglas Baird & Thomas Jackson, *Information, Uncertainty, and the Transfer of Property*, 13 J. LEGAL STUD. 299, 300–01 (1984) (explaining that legal rules around property transfer must balance protecting owners against protecting would-be owners).

141 *See generally* Schwartz, *Security Interests and Bankruptcy Priorities*, *supra* note 19 (collecting commentaries).

142 *See, e.g.*, Grant Gilmore, *The Good Faith Purchase Idea and the Uniform Commercial Code: Confessions of a Repentant Draftsman*, 15 GA. L. REV. 605, 612 (1980) ("In a society that recognizes property as something more than theft, you do not go around lightly destroying property rights; you must have a compelling reason for awarding A's property to C. Even in a contract-oriented law, you do not go around lightly telling people who have been tricked, cheated, and defrauded that they must nevertheless pay up in full . . . .").

143 Merrill & Smith, *supra* note 76, at 833–43 (explaining that part of the difficulty of defining the property rights of security interest arises because they are clearly also contractual interests).

since the 1950s.[144] Where there had previously been uncertainty whether any particular lien would survive judicial scrutiny, Article 9 made a bevy of commercially necessary, but heretofore uncertain, security interests "safe" and "judge-proof."[145] In doing so, it reduced the risk in secured debt meaning that lenders could satisfy their expected recovery given default needs at lower interest rates. Although Article 9 generally expanded secured lending, it initially enjoyed support from unsecured creditors who had often found themselves at the wrong end of what felt like a secret lien.[146] The main criticism of Article 9 was that it was a "sell-out to the vested interests at the expense of the public interest" insofar as it repealed many of the statutorily and judicially promulgated limitations on secured lending.[147]

The newfound certainty for secured lenders created by Article 9 marked the path away from asset-based lending towards all-assets lending.[148] The logical consequence of this expansion is the practice of lending to a holding company and taking a security interest in the equity of the operating company, which is presumably where both the value and the substance of a corporation lies. In the event of default, the lender can foreclose on the equity of the operating company and become the owner of the going concern.[149]

As the scope of the secured lenders' property rights began to resemble the scope of equity holders' rights, it became less clear why secured credit should benefit from the absolute priority rule in the event

144 These changes quickly influenced secured lending the world over and did so right as corporate finance became a global endeavor. Article 9's global influence is difficult to overstate. It was adopted with modifications as the Canadian Personal Property Security Acts and reforms to secured lending worldwide have tended to bring those laws closer to American secured lending. R.M. Goode, *Is the Law Too Favourable to Secured Creditors?*, 8 CAN. BUS. L.J. 53, 54 (1984); *see also* Padma Kadiyala, *Impact of Bankruptcy Law Reform on Capital Markets in Brazil*, 8 INV. MGMT. & FIN. INNOVATIONS 31, 32 (2011) (explaining the impact of bankruptcy reform in Brazil); Tomas Richter, *Reorganizing Czech Businesses: A Bankruptcy Law Reform Under a Recession Stress-Test*, 20 INT'L INSOLVENCY REV. 245, 247–48 (2011) (tracing the Czech Republic's efforts to base its insolvency laws on Chapter 11); Steven J. Arsenault, *The Westernization of Chinese Bankruptcy: An Examination of China's New Corporate Bankruptcy Law Through the Lens of the UNICTRAl Legislative Guide to Insolvency Law*, 27 PENN ST. INT'L L. REV. 45, 57 (2008) (surveying China's modernization of its bankruptcy laws).

145 Grant Gilmore, *The Secured Transactions Article of the Commercial Code*, 16 LAW & CONTEMP. PROBS. 27, 30 (1951).

146 *Id.*

147 *Id.* at 34.

148 It accomplished this by allowing companies to easily encumber after-acquired property that would otherwise not have been covered by an earlier-in-term security interests. This shift allowed companies with revolving inventory to use that inventory as collateral. U.C.C. § 9-204(a) (AM. LAW INST. 2012) (security agreement may provide that obligations are to be secured by after-acquired collateral); § 9-204(c) (obligations covered by security agreement may include future advances).

149 *But see* Anthony J. Casey, *The New Corporate Web: Tailored Entity Partitions and Creditors Selective Enforcement*, 124 YALE L.J. 2680, 2719–20 (2014) (explaining that security interests do not always work to permit creditors to foreclose on a project-by-project or entity-by-entity basis in a world in which cross-liability provisions are common).

of liquidation.[150] This view that secured lenders should not be able to capture all the proceeds of foreclosure, especially when the scope of the underlying security interest is broad, reflects skepticism towards security interests as property rights. Nevertheless, Article 9 facilitated an explosion in secured lending, and with it, an explosion in companies entering bankruptcy with few unencumbered assets.[151]

Article 9 also simplified the processes by which secured lenders exercised their rights in the event of default.[152] It eliminated the public auction requirement and allowed foreclosing lenders to sell their collateral almost immediately where previously there were waiting periods that inevitably gave borrowers room to negotiate.[153] A new

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150 Scholars have fiercely debated whether there is a good theoretical justification for security interests' priority privilege under Article 9 and bankruptcy law. *See* Paul M. Shupack, *Solving the Puzzle of Secured Transactions*, 41 RUTGERS L. REV. 1067 (1988); Buckley, *supra* note 19; Scott, *A Relational Theory of Secured Financing*, *supra* note 57; Thomas H. Jackson & Alan Schwartz, *Vacuum of Fact or Vacuous Theory: A Reply to Professor Kripke*, 133 U. PA. L. REV. 987 (1985); Homer Kripke, *Law and Economics: Measuring the Economic Efficiency of Commercial Law in a Vacuum of Fact*, 133 U. PA. L. REV. 929 (1985); Alan Schwartz, *The Continuing Puzzle of Secured Debt*, 37 VAND. L. REV. 1051 (1984); Schwartz, *Security Interests and Bankruptcy Priorities*, *supra* note 19; White, *supra* note 19. Indeed, concerns that security interests were becoming less about funding specific acquisitions and more about gaining an advantage over less sophisticated parties dogged even the principal draftsman of Article 9. As Grant Gilmore explained:

> Considerations of policy and common sense suggest that there must be a limiting point somewhere. Borrowers should not be encouraged or allowed to hypothecate all that they may ever own in the indefinite future in favor of a creditor who is willing to make a risky loan now . . . . And ways should be found to penalize a lender who, after allowing his borrower to pile up an intolerable weight of debt, then claims all the assets of the insolvent estate, leaving nothing to satisfy other claims.

GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 7.12 at 248–49 (1965) (footnotes omitted).

151 White, *supra* note 19; *see also* LoPucki, *The Death of Liability*, *supra* note 61 (explaining how the percentage of liquidations in which there was a distribution to unsecured creditors fell from twenty percent in 1976—a number that already reflected some of the impact of Article 9—to five percent in 1992).

152 Modern bankruptcy practice has almost entirely replaced state-law foreclosure for going concerns. As a result, these changes now largely impact the backdrop against which companies negotiate, rather than actual foreclosure practice. One of the effects is that without cases, state foreclosure law has not had the opportunity to develop around modern secured lending practices, therefore it is the theoretical projection of what would happen under state law that governs practice, rather than actual state law. This development has many detractors who view secured lending practice as having gotten ahead of both state foreclosure law and Article 9 itself in recognizing blanket liens and other forms of total lender control over going concerns. Janger, *supra* note 16 (arguing that our current perfection regimes do not allow for truly blanket liens); Michelle M. Harner, *The Value of Soft Variables in Corporate Reorganizations*, 2015 U. ILL. L. REV. 509, 512–13 (arguing that the things that create an entity's going concern surplus are not traditionally things that can be encumbered).

153 Gilmore, *supra* note 145, at 35. There is always the threat that borrowers facing foreclosure will elect to destroy the collateral to spite the lender who would otherwise repossess it. The longer the period between foreclosure becoming obvious and the change in possession occurring, the more time the borrower has in which to destroy the collateral. *See* Michael M. Phillips, *Buyers' Revenge: Trash the House After Foreclosure*, WALL ST. J. (Mar. 28, 2008), https://www.wsj.com/articles/SB120665586676569881.

standard—"commercial reasonableness"—replaced the rules that had previously given borrowers leverage to challenge liens.[154] This simplified foreclosure process made it clearer that borrowers only tenuously owned their encumbered assets.

Borrowers' tenuous ownership over their encumbered assets is best illustrated by the fine line between sales or leases and security interests.[155] One way to think of a security interest is as a sale to the lender under which the seller has the right to repurchase its interest in the collateral from the lender within a certain period of time. This resemblance is so strong that teasing out the line between security interests, which are subject to perfection requirements and cram-down in bankruptcy, and so-called "true sales,"[156] which render assets bankruptcy-remote, continues to vex courts.[157] Indeed, this close relationship between sales and security interests is so pervasive in the common imagination that people often say that the bank "owns" their house if it is merely mortgaged. Many security interests are outwardly indistinguishable from sales, particularly when the lender perfects its security interest by taking possession of the collateral.[158]

Not long after the adoption of Article 9, Congress took up the process of modernizing federal bankruptcy law,[159] making it more transparent, predictable, and creditor-friendly.[160] The importance of

154 There was considerable hesitation around treating commercial and consumer credit alike, especially with respect to foreclosures, but ultimately the desire for a consistent and broad foundation for secured lending prevailed. Gilmore, *supra* note 145, at 45.

155 *See* Steven L. Harris & Charles W. Mooney Jr., *When Is a Dog's Tail Not a Leg?: A Property-Based Methodology for Distinguishing Sales of Receivables from Security Interests That Secure an Obligation*, 82 U. CIN. L. REV. 1029, 1040–43 (2014) (criticizing the multi-factored tests used to identify security interests for the uncertainty that they create in the market).

156 In complex securitization deals, issuers and lenders alike will turn to law firms for formal opinions of counsel that the contemplated asset transfers are "true sales" and not secret liens. *See generally* Jonathan M. Barnett, *Certification Drag: The Opinion Puzzle and Other Transactional Curiosities*, 33 J. CORP. L. 95 (2007) (explaining the role of legal opinions in complex transactions).

157 *See, e.g.*, *In re* Commercial Loan Corp., 316 B.R. 690, 700 (Bankr. N.D. Ill. 2004) ("Whether to deem a transaction a sale or a loan when a financial asset[—]a right to payment[—]has changed hands is an old legal problem for which there has never been an easy solution.").

158 The more familiar situation has the seller, or borrower, retaining possession of its collateral, but there are significant examples to the contrary. Consider cash collateral. Typically, bank lenders require that cash collateral be kept in an account over which they have control at their office. *See* U.C.C. § 9-312 (AM. LAW INST. 2012) (requiring lenders to have control over and possession of cash in order to have a perfected security interest). Similarly, pawn shops usually take possession of the collateral against which they are lending.

159 Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (1978).

160 The Bankruptcy Reform Act of 1978 created the modern Bankruptcy Code. Most notably for our purposes, it created Chapter 11, making it easier for businesses to file and maintain control over their reorganization. Under the prior Bankruptcy Act, companies could voluntarily file for bankruptcy protection, but the Securities and Exchange Commission then oversaw the administration of the process and trustees were required in the largest cases. *See* Emmet McCaffery, *Corporate Reorganization Under the Chandler Bankruptcy Act*, 26 CALIF. L. REV. 643 (1938). Enabling debtors to remain in possession of their business and making the

bankruptcy to understanding security interests cannot be overstated. Bankruptcy is the proving ground for security interests.[161] After all, when there is only one party making a claim against an asset there is little dispute about who owns it (or at least, owns its value). Bankruptcy makes stark the zero-sum game of capital structures. This reform reinvigorated the debate around the nature of security interests.

Commentators tended to fall into two main camps. On the one hand were those who took a property-based view of security interests. This camp includes the Reporters for the Permanent Editorial Board of the Article 9 Study Committee, Stephen L. Harris and Thomas W. Mooney.[162] Harris and Mooney were the first to offer an explanation of security interests that used the "well-accepted rights of property owners" to use and alienate their property as a point of departure.[163] They fault both the debate about whether security interests are efficient and the parallel debate about whether security interests are a distributional evil for using the ambient skepticism about security interests as the baseline for their analyses.[164]

Instead, Harris and Mooney propose that classic vanilla property ownership should be the baseline.[165] Beginning with Svetozar Pejovich's four elements of property ownership—(i) the right to use; (ii) the right to capture benefits; (iii) the right to change; and (iv) the right to transfer the first three rights for a price—they embrace the broader property literature that theorizes that private property is essential both to liberty and to efficiency by encouraging resources to be allocated to those who value them most.[166] All of the benefits of private property arise from an owner's ability to alienate that property more or less as they see fit.[167] For this reason, property theory generally validates owners' decisions to alienate their property, even if doing so may reduce the pot against

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process more transparent also made it more appealing and filings increased.

161 *See* Steven L. Harris & Charles W. Mooney, *The Article 9 Study Committee Report: Strong Signals and Hard Choices*, 29 IDAHO L. REV. 561, 563 (1993).

162 *See* Steven L. Harris & Charles W. Mooney, *A Property-Based Theory of Security Interests: Taking Debtors' Choices Seriously*, 80 VA. L. REV. 2021, 2047–66 (1994) [hereinafter Harris & Mooney, *Security Interests*].

163 *Id.* at 2047–53.

164 *Id.* at 2037. They dub the two main bodies of scholarship about security interests the Efficiency Literature and Sympathetic Legal Studies. The former, as the name suggests, is concerned primarily with whether security interests are efficient relative to other methods of raising capital. *See id.* at 2042–45. The latter is primarily concerned with the relatively large share of debtors' assets that secured credit is able to claim in bankruptcy. *Id.* at 2045–46.

165 *Id.* at 2052.

166 *Id.* at 2048–49; *see also* SVETOZAR PEJOVICH, THE ECONOMICS OF PROPERTY RIGHTS: TOWARDS A THEORY OF COMPARATIVE SYSTEMS (1990). Harris and Mooney are among the first, if not the first, debt and bankruptcy scholars to look to the classic property literature as the source of their theory of security interests. They draw on the familiar sources of Milton Friedman's *Capitalism and Freedom*, Hume, Margaret Radin's *Property and Personhood*, and the chestnuts of the law and economics literature such as Charles J. Goetz, *Law and Economics* (1984) and R.H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON 1 (1960).

167 Harris & Mooney, *Security Interests*, *supra* note 162, at 2048–49.

which creditors can recover.[168] Indeed, solvent owners can alienate their property in a number of ways that may harm future creditors, including choosing to pay some claims but not others.[169] The main check on this practice has always been preference and fraudulent transfer law,[170] which is a far from perfect remedy. Legislative proposals to ban asset sales by leveraged but solvent companies have never been on the table, yet security interests face persistent skepticism.[171] Finding no reason that security interests are inherently different from other forms of property, they conclude that "the law should honor the transfer or retention of security interests on the same normative grounds on which it respects the alienation of property generally."[172]

Harris and Mooney had a significant victory with the 1990s revisions to Article 9, which ushered in a second revolution in liens. Harris and Mooney took it as their "first principle" that Article 9 should facilitate secured lending, believing that "the transfer of an effective security interest ought to be as easy, inexpensive, and reliable as possible."[173] The revised Article 9 more or less removed any concerns about the validity of blanket liens,[174] while protecting security interests from avoidance actions brought by a bankruptcy trustee.[175] The revised Article 9 implicitly endorsed the property view of security interests and expanded their scope accordingly.

Opposing the Harris-Mooney view were many commentators who questioned the efficiency and fairness of security interests.[176] Few of those participating in the debate around Article 9 staked out an

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168 *Id.* at 2037–41.

169 *Id.* at 2037. Choosing among creditors is the norm in business. Companies may agree to prepay certain suppliers, perhaps for a discount, but use their clout to demand that others accept quarterly, or even less frequent, payment. These delayed payments are often low-interest, if not interest-free loans allowing companies to use the cash that would have paid the supplier on other ventures.

170 *Id.* at 2054.

171 Lurking in the scholarship that Harris and Mooney dub the "Efficiency Literature and Sympathetic Legal Studies" is the idea that unless someone can prove that security interests are a net positive to society, the law should not recognize them. *Id.* at 2044.

172 *Id.* at 2051.

173 *Id.* at 2021.

174 To the extent that there remain serious difficulties in creating blanket liens, those arise from the gaps in our three main systems for perfecting liens: U.C.C. filings, real estate filings, and intellectual property filings. *See generally* Janger, *supra* note 16 (cataloging the technical difficulties of creating blanket liens).

175 *See* G. Ray Warner, *The Anti-Bankruptcy Act: Revised Article 9 and Bankruptcy*, 9 AM. BANKR. INST. L. REV. 3, 18 (2001) (arguing that the drafters of Article 9 exceeded the proper bounds of uniform law drafters when they proposed changes that "enhance[d] the priority rights of secured creditors" despite the lack of consensus about whether secured credit is efficient or a social good). *But see* G. Ray Warner, *Is Revised UCC Article 9 an Anti-Bankruptcy Act? Yes*, 28 OKLA. CITY U. L. REV. 537 (2003) (arguing that the Article 9 revision process was agenda-driven); Alvin C. Harrell, *Security Interests in Deposit Accounts: A Unique Relationship Between the UCC and Other Law*, 23 U.C.C. L.J. 153 (1990) (defending Article 9).

176 *See* Jay Lawrence Westbrook, *The Control of Wealth in Bankruptcy*, 82 TEX. L. REV. 795, 838 (2004) (tracing the literature arguing against the efficiency of secured credit).

explicitly anti-property view of secured credit, but their normative preferences are functionally incompatible with appreciating security interests as property rights. This disconnect is most apparent in proposals to limit the priority of security interests.[177] Professors Bebchuk and Fried separated the underlying property rights from the remedies traditionally associated with those rights.[178] Bebchuk and Fried divided secured creditors' rights into a "repossessory right"—the right to seize the collateral more quickly than if unsecured—and a "priority right"—the right to levy against particular collateral before any other creditors.[179] They then argue in favor of limiting creditors' priority rights since, in light of creditors who cannot bargain for their relative security, according absolute priority tends to encourage inefficient and potentially harmful use of security interests.[180] While Professors Bebchuk and Fried find that their partial priority proposal is "consistent with fundamental principles of contract law,"[181] they cannot say the same for the fundamental principles of property law. A property right is a right against the world.[182] By definition, it cannot depend on the identity of third-party claimants irrespective of those claimants' own property rights.

Similarly, the wave of carve-out proposals beginning with Elizabeth Warren's seminal work subordinated concerns about formal legal interests to concerns about distributional fairness.[183] Carve-out proponents questioned whether the reach of security interests should extend so far as to allow borrowers to lend against all of their property, leaving few, if any, unencumbered assets for unsecured claimants.[184] Even if a security interest unequivocally reached all of an asset's value, Warren and others found this security interest to be such an affront to distributional equity that it should be cut short so that there would be something leftover for others.[185] Her proposal mandated a twenty percent carve-out in the enforceability of security interests so that there

177 *See, e.g.*, Bebchuk & Fried, *supra* note 16, at 861; Bossetti & Kurth, *supra* note 17.

178 *See* Bebchuk & Fried, *supra* note 16, at 861.

179 *Id.*

180 *Id.* at 895–97.

181 *Id.* at 866.

182 *See* James Y. Stern, *The Essential Structure of Property Law*, 115 MICH. L. REV. 1167, 1179–80 (2017).

183 Warren, *supra* note 17.

184 *Id.* Some early case law suggested that a cushion should remain available for unsecured claims. *See, e.g.*, Benedict v. Ratner, 268 U.S. 353 (1925); Zartman v. First Nat'l Bank of Waterloo, 82 N.E. 127 (N.Y. 1907) (refusing to enforce a blanket lien that purported to cover after-acquired property). Article 9 explicitly overturned these cases. *See* U.C.C. § 9-205, cmt. 2 (AM. LAW INST. 2012).

185 Warren, *supra* note 17, at 323 (proposing a twenty percent carve-out in Article 9). Others proposed limiting the carve-out to cases in which there was insolvency and unsecured creditors, which would typically be, but need not be in bankruptcy. Lynn M. LoPucki, *Should the Secured Credit Carve Out Apply Only in Bankruptcy? A Systems/Strategic Analysis*, 82 CORNELL L. REV. 1483 n.11 (1997).

would always be something left for judgment lien creditors.[186] These proposals sought to "assure[] that trade creditors, tort victims, employees, and other unsecured creditors who also contribute to the life of a business will have some access to the assets of that business if it is unable or refuses to pay its debts."[187]

Many carve-out proponents appear to reject the notion that security interests are property rights in the collateral, although they do not always say so explicitly.[188] At best, these commentators treat security interests differently than other forms of private property, which are generally alienable even when doing so creates distributional injustice, unless that injustice is so grave as to run afoul of fraudulent transfer law. For example, companies can sell all of their assets then enter leasing arrangements without triggering widespread moral opprobrium. It is unclear why encumbering assets should be any different.

Recently, several commentators have reopened the debate about the role of priority at a more fundamental level. Stephen J. Lubben has argued that the role of absolute priority has been widely overstated.[189] He explains that the rule only got its name in a 1936 article and then as only "one possible bankruptcy rule, which the Supreme Court had occasionally seemed to endorse in corporate reorganization cases going back to the middle Nineteenth Century."[190] Instead, he argues that priorities are much more flexible in our system of reorganization and that reorganization often requires senior creditors to yield some of their priority to continue the debtor's quotidian operations.[191] Similarly, Douglas Baird recently argued that, in part, in light of its weak pedigree, the absolute priority rule is the wrong point of departure for understanding competing claims against a company's assets in bankruptcy.[192]

But neither the alleged newness of the rule nor its uneven application necessarily mean that priority is not one of the core rights of

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186 Warren, *supra* note 17, at 323.

187 *Id.*

188 Elizabeth Warren argued that, when faced with an insolvent entity, claims should be settled by a bankruptcy judge with broad equity to do what is right to preserve the company as a going concern. *Id.* at 326. As Douglas Baird noted, the implicit assumption in Warren's proposal is that, contrary to the dominant wisdom in corporate law scholarship, there is a link "between who has rights to the assets of a firm and how those assets are used." Douglas G. Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren*, 54 U. CHI. L. REV. 815, 819–20, 819 n.5, 820 n.6 (1987) (describing how Warren's view conflicts with Modigliani and Miller's hypothesis that "owners of a firm (but for agency costs) share the same goals").

189 Lubben, *supra* note 37, at 581–85 (explaining that the absolute priority rule is only relevant at Chapter 11 plan confirmation, at which point it has already been breached several times).

190 *Id.* at 586.

191 *Id.* at 605.

192 *See* Douglas G. Baird, *Priority Matters: Absolute Priority, Relative Priority, and the Costs of Bankruptcy*, 165 U. PA. L. REV 785 (2017).

secured creditors. After all, security interests are largely creatures of state statutory law.[193] When those statutes were passed is largely irrelevant. Similarly, that bankruptcy courts do not always respect secured creditors' priority rights may be evidence that the court or the Federal Bankruptcy Code under protects those state-created rights. It cannot prove that those rights do not exist. And finally, unsecured interests could be subject to alternative priority rules notwithstanding secured lenders' rights to first priority in the event of insolvency.[194]

Theory aside, one constant in the history of security interests in the United States is that whatever legal rights a lender may have, politics periodically renders them unenforceable,[195] especially with respect to consumers. But political unenforceability does not change the underlying property rights.[196] If anything, it makes the need to understand them more urgent.[197]

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193 The three most significant sources of security interests are Article 9, real property mortgage recordation laws, and the various motor vehicle registration laws, all of which are state laws.

194 For example, 11 U.S.C. § 507 (2012) sets out the order in which unsecured creditors are paid based on the nature of the debt.

195 Deviations from the absolute priority rule tend to occur on a one-off basis, responding to particular crisis—real or perceived—in a particular industry. For example, secured creditors of an insurance company could find themselves competing with a regulator with a strong incentive to ensure that policyholders are paid in full. Mark G. Peters, *Issues for Secured Creditors in Insurance Insolvency*, LAW360 (Nov. 17, 2010, 3:36 PM), http://www.law360.com/articles/206753/issues-for-secured-creditors-in-insurance-insolvency.

196 In more recent times, the federal government has more or less forced lenders to compromise their enforcement rights by enacting mortgage modification programs and other forms of borrower relief. The largest of these programs, HAMP, was voluntary for lenders although the government-backed entities insuring many mortgages required participation for the loans it insured. While both the government and the effected lenders may act as if such programs are mandatory, their legality is actually an open question, but not one that any lender would ever ask a court to answer due to reputational concerns and the need to preserve, to the extent possible, friendly relations with its regulators. Such programs are dubious because if we take security interests seriously as property and as property arising under state law, the federal government cannot retroactively force lenders to give some of that property away by modifying the face value of the loan. To be sure, the federal government may force lenders to do any number of things as a condition of receiving other benefits, but it cannot require lenders to destroy its property without an opportunity to be compensated for that property (as is the case when a company divests parts of its business to satisfy antitrust concerns). Louisville Joint Stock Land Bank v. Radford, 295 U.S. 555, 589–90, 601–02 (1935) (holding that Congress violates the Fifth Amendment when it retroactively takes creditors' "substantive rights in specific property").

197 This urgency is especially acute given the current calls to reform the Bankruptcy Code. *See generally* COMMISSION TO STUDY THE REFORM OF CHAPTER 11, *supra* note 16 (proposing various reforms).

## III. SHARES AND SECURITY INTERESTS AS LIMITED LIABILITY PROPERTY

We have seen above that equity interest and security interest are both property-like rights. While neither is as theoretically pristine as fee simple ownership, in both, the rights holders own a non-exclusive interest in a company's assets that is good against the world. Equity holders own the residuary. Secured creditors own the collateral up to the value of their security interest.

But traditional notions of ownership come with risk and responsibility not seen in either equity interests or security interests. Normally, owners are responsible for harm that their possessions or property may cause. For example, real property owners are liable both to guests and even to certain trespassers for certain dangers on their property.[198] The measure of their liability is the harm.[199] It is possible, even likely, that their liability as owners can and will exceed the value of their property.[200]

Modern corporate, insolvency, and secured transactions law has created two enormous exceptions to the general rule that property owners are liable for the harm caused by their property. The first exception, explained in Section A below, is the familiar form of limited liability enjoyed by equity holders in most modern companies. Section B then examines how insolvency rules amplify limited liability such that judgment proofing becomes an effective strategy for enjoying the upside risks of ownership while firmly capping the downside risks.

The second exception to the rule that property owners are liable for

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198 *See, e.g.*, Ruocco v. United Advertising Corp., 119 A. 48, 50 (Conn. 1922) ("[A]n owner of property abutting on a highway rests under an obligation to use reasonable care to keep his premises in such condition as not to endanger travelers in their lawful use of the highway; and that if it fails to do so, and thereby renders the highway unsafe for travel, he makes himself liable, although the consequent injury is received upon his own land and not on the highway."); Humphrey v. Glenn, 167 S.W.3d 680, 684 (Mo. 2005) (explaining that Missouri has adopted an exception to the "no duty" rule, instead making property owners liable to known trespassers for concealed hazards that the owner creates or maintains); RESTATEMENT (SECOND) OF TORTS § 335 (AM. LAW INST. 1979) (same). Because the presumption that property owners are liable to those injured on their property is so strong, legislatures have passed statutes immunizing property owners from ownership liability to encourage them to allow the public on their lands. *See, e.g.*, CAL. CIV. CODE § 846 (West 2015); Klein v. United States, 235 P.3d 42, 51 (Cal. 2010) (explaining that section 846 was meant to "encourage owners who might otherwise fear liability to grant access to their property." (citations omitted)).

199 *See* City of Shawnee v. Cheek, 137 P. 724, 736 (Okla. 1913).

200 The most dramatic example of this phenomenon is environmental liability. A grungy lot in an industrial neighborhood may have very little value on the market, but its owner may nevertheless be liable for millions of dollars of clean-up costs. That the property would never sell for that much money does not limit the liability. Similarly, the owner of an old, high-mileage Honda is as liable as a Mercedes owner for damages caused by that vehicle. *See* Maturo v. Comm'r of Dep't of Envtl. Prot., No. CV910313753S, 2008 Conn. Super. LEXIS 763, at *81–82, *85–87 (Mar. 19, 2008) (holding that an environmental abatement order that exceeds the value of the affected property is a valid exercise of the police power and therefore not a taking).

the harm caused by their property belongs to security interests. Section C below will show that secured creditors enjoy the limited liability of equity holders but have the added benefit of a distributional priority over other claimants since they have a distinct property interest in their collateral, as opposed to a property interest in the company. That is, while they enjoy many features of "ownership" over their collateral, they do not bear the responsibilities that traditionally come with ownership. And indeed, their limited liability is even stronger than that of equity holders, as claimants injured by the collateral can never make claims against the assets of the lender generally.

### A. *The First Principles of Limited Liability*

Liability is the primary means by which private law regulates the actions of both natural persons and corporate persons.[201] While a limited set of wrongs create rights to specific performance, disgorgement, or other more property-like remedies, a majority of claims reduce to liabilities.[202] Liability then has been broadly justified by the incentives that it creates to internalize risk and prevent harm to others.[203]

Limited liability, as the name suggests, sets a hard cap on the liability that a person can incur. In its most basic form, limited liability protects a company's equity holders from being personally responsible for liabilities that the company may incur. Not all business organizations enjoy limited liability, but many of the most common forms do, namely corporations, limited liability companies, and, to a certain extent, limited partnerships.[204] In these kinds of companies, the equity holders cannot lose more than the capital they contributed in exchange for equity interest. In a large public company, limited liability caps shareholders' liability at the purchase price of their shares. In a smaller company, the cap may grow over time if, as a condition for remaining an equity holder, the equity holder must contribute

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201 *See* LoPucki, *The Death of Liability*, *supra* note 61, at 3–4.

202 As Calabresi and Melamed famously observed, liability rules and property rules are two ways to protect entitlements. *See* Guido Calabresi & Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089, 1092–93 (1972).

203 GUIDO CALABRESI, THE COSTS OF ACCIDENTS: A LEGAL AND ECONOMIC ANALYSIS 69–73 (1970); RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 139, 143 (2d ed. 1977).

204 The limited partners of a limited liability partnership enjoy limited liability while the general partner faces unlimited liability. UNIF. LTD. P'SHIP ACT § 404(a), § 303 (NAT'L CONFERENCE OF COMM'RS ON UNIF. STATE LAWS 2001). In regular partnerships, the partners are all personally responsible for the partnership's liabilities. Such partnerships have become the exception precisely because limited liability is such a valuable protection. Jones Day is famous among current "BigLaw" firms for remaining a true partnership while most others became limited liability partnerships or other liability-protecting entities. *See The Value of a True Partnership*, JONES DAY, http://www.jonesday.com/atruepartnership (last visited Feb. 1, 2018).

additional capital. Regardless of the corporate form, the protection remains the same: creditors are entitled to claims against the assets of the company but not against the assets of the owners of the company unless they can pierce the corporate veil.

For entrepreneurs and businesses alike, the appeal is obvious: equity investments have unknowable upside risk but a cabined and known downside risk.[205] Without limited liability, GM's shareholders would be personally liable for the damages caused by its faulty ignition switches, and Exxon's shareholders would likely still be making payments to clean oil out of Prince William Sound.

Indeed, it is rare for equity holders to lose anything beyond their principal investment,[206] even if they have already recovered more than that investment in dividends and other distributions to shareholders.[207] Since limited liability became available for almost any enterprise, unlimited liability has largely become a relic.[208]

There is a hard truth to limited liability: to the same extent that limited liability exists to protect entrepreneurs from personally ruinous

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205 *See* Phillip I. Blumberg, *Limited Liability and Corporate Groups*, 11 J. CORP. L. 573, 616 (1986) (explaining that limited liability changes the risk calculation for entering into a business venture).

206 And, of course, opportunity costs.

207 The exceptions to this rule typically involve preference actions or fraudulent transfer claims arising from bankruptcy proceedings and typically involve the claim that the debtor corporation was transferring money away from its creditors to its equity holders while insolvent. Even then, the action sounds in disgorgement rather than typical liability. Equity holders typically cannot be made to turn over more than they received, regardless of the harm caused. Easterbrook & Fischel, *supra* note 6, at 90.

208 Corporate limited liability dates to at least the Romans but spent much of its early life as a privilege for the well connected. As recently as the colonial era, shareholders investing in companies incurred unlimited personal liability for the company's debts. In the age of debtors' prisons and limited, if any, access to personal bankruptcy protection, the stakes for investing were very high. Unsurprisingly, once limited liability was introduced, capital flooded in as investing became a much less risky endeavor. Jurisdictions competing for capital quickly introduced limited liability to prevent investors from going elsewhere. *See The Key to Industrial Capitalism: Limited Liability*, ECONOMIST (Dec. 23, 1999), http://www.economist.com/node/347323. In the United States, with the rise of the limited liability company in the second half of the twentieth century, smaller businesses could enjoy limited liability without the administrative (and tax) burdens of incorporating or using the specialized limited partnership forms that many states had promulgated. Limited liability companies (LLCs) have in effect become a catch-all, enabling businesses that previously were excluded from limited liability protection to enjoy it. Germany pioneered the limited liability company model when it allowed the creation of Gesellschaft mit beschränkter Haftung (GmbH) in 1892. Much of Europe and South America quickly adopted similar laws. The United States, however, did not see its first LLCs until Wyoming passed its Limited Liability Companies Act in 1977. WYO. STAT. ANN. § 17-15-103 (West 1977). Just twenty years later, in 1997, all fifty states recognized LLCs, the National Conference of Commissioners on Uniform State Laws had promulgated its Uniform Limited Liability Company Act, and the Internal Revenue Service issued guidance officially allowing LLCs to choose their tax status. 26 C.F.R. § 301.7701–3 (1997). For corporate lawyers, it is almost certainly malpractice to fail to advise clients to take on the shield of limited liability given the low barriers to entry. For most endeavors, regardless of the potential contract, tort, or environmental risk, obtaining limited liability protection is as simple as filing a two-page form with the relevant secretary of state and paying a fee of less than $500.

claims, it limits the rights of claimants—aggrieved contracting parties, tort victims—to realize corrective justice.[209] Limited liability is about cutting off the private law remedies at a legal boundary rather than plumbing the depths of causality and responsibility. These private law remedies are about transferring resources that "simultaneously represent the plaintiff's wrongful injury and the defendant's wrongful act . . . " from the defendant to the plaintiff.[210] Limited liability cuts these remedies off at the corporate form notwithstanding the seeming absurdity of insisting either that the corporation rather than some natural persons committed the wrong or that a deeper-pocketed parent company bears no responsibility for the harm.

The impact of limited liability can be multiplied by layering limited liability entities within a single conglomerate.[211] For example, a consumer products company may put each of its brands in a separate subsidiary under a single parent company. If one subsidiary produces a toxic product that injures consumers and incurs liability beyond its means, the injured consumers cannot look to the assets of the other subsidiaries to satisfy their judgment. The parent may, for reputational or other concerns, elect to move sufficient funds into the troubled subsidiary to satisfy the claim, but it need not. It could elect to put the troubled subsidiary into bankruptcy and force the injured consumers to accept a small fraction of their judgment.

The consequence of limited liability is, of course, that companies, especially smaller companies, may pay far less than the true value of their liabilities, except to the extent that they are insured.[212] It does not matter that a company may have enriched other companies or individuals, who now could satisfy its liabilities. It seems as though the tradeoff between limited liability enabling entrepreneurship and enabling unfairness is inescapable.

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209 I am envisioning an explicitly Aristotelian notion of corrective justice in which the relationship between the victim and the malefactor is central. *See* ARISTOTLE, 5 NICOMACHEAN ETHICS ch. 4 (349 B.C.).

210 ERNEST J. WEINRIB, THE IDEA OF PRIVATE LAW 56 (rev. ed. 2012).

211 LoPucki, *The Essential Structure of Judgment Proofing*, *supra* note 24, at 151. *But see* James J. White, *Corporate Judgment Proofing: A Response to Lynn LoPucki's the Death of Liability*, 107 YALE L.J. 1363 (1998) [hereinafter White, *Corporate Judgment Proofing*] (showing that few large companies had made themselves judgment proof by the mid 1990s); Alan Schwartz, *Products Liability, Corporate Structure, and Bankruptcy: Toxic Substances and the Remote Risk Relationship,* 14 J. LEGAL STUD. 689, 690 (1985) [hereinafter Schwartz, *Products Liability, Corporate Structure, and Bankruptcy*] (cataloging bankruptcy companies that planned on managing future tort risks through operating subsidiaries).

212 This theoretical gap between what a company can actually pay and the harm that it may create is the source of the moral hazard problem that has drawn many commentators. *See* Easterbrook & Fischel, *supra* note 6, at 103–04; Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879, 1881 (1991); Schwartz, *Products Liability, Corporate Structure, and Bankruptcy*, *supra* note 211, at 690.

### B. *A System for Not Paying Claims*

#### 1. Judgment-Proofing

Given the ubiquity of limited liability,[213] our legal system's reliance on liability can make its goals appear more performative than practical.[214] As explained above, limited liability typically cabins liability to the operating company, which may or may not have any meaningful assets of its own.[215] Limited liability reduces the chances that any given plaintiff will receive a full recovery. The reasons are twofold. First, while liability rules are relatively easy to enforce in court, they only generate judgments, which are much more difficult to enforce. In an ideal world, once the plaintiff wins a judgment for damages, the defendant satisfies that judgment by making payment in full to the plaintiff. This ideal hardly reflects what happens when plaintiffs receive judgments. Putting aside the issues of delay and the time-value of money—all of which are eminently relevant given that the appeals process can take years—the process of collecting a judgment not paid voluntarily is a lawsuit unto itself. If the defendant does not voluntarily pay in full, enforcing the judgment requires separate proceedings, often in different courts, to levy against assets, garnish wages, or otherwise compel payment. These transaction costs are only sometimes recoverable.[216] And this collection procedure assumes that the defendant has assets or income useful for satisfying the debt.[217]

Second, defendants of all stripes are routinely judgment-proof,

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213 Easterbrook & Fischel, *supra* note 6, at 90.

214 Lynn LoPucki probably described it best when he said that discussions over who should be liable for what were tantamount to debating "the arrangement of the deck chairs on the Titanic." *See* LoPucki, *The Death of Liability*, *supra* note 61, at 4.

215 *Supra* Section III.A.

216 The American rule typically militates that each party pay its own costs even in collection actions. *See* Hardt v. Reliance Standard Life Ins. Co., 560 U.S. 242, 252–53 (2010) ("Our basic point of reference when considering the award of attorney's fees is the bedrock principle known as the 'American Rule': Each litigant pays his own attorney's fees, win or lose, unless a statute or contract provides otherwise." (citations omitted)). There is one enormous, but accidental, exception in the consumer debt market, which has arisen because consumer contracts typically require that consumers pay collection costs, and even when they do not, consumers regularly default on collections claims in small claims court, meaning that they forfeit their right to object to paying for these transaction costs. *See, e.g.*, *Security Instruments*, FANNIE MAE , https://www.fanniemae.com/singlefamily/security-instruments (last visited Mar. 1, 2018) (requiring borrowers to "pay all . . . expenses [incurred] in enforcing this Security Instrument, including, for example, reasonable attorneys' fees, property inspection and valuation fees, and other fees incurred for the purpose of protecting Lender's interest in the Property and rights under this Security Instrument"); Markell, *supra* note 39, at 123.

217 Individual defendants may have assets, typically the family home and certain retirement accounts, which are statutorily exempt from levy by creditors absent a finding of fraud or other malfeasance on the part of the debtor. *See* Law v. Siegel, 134 S. Ct. 1188, 1196 (2014) (explaining California's exemption laws and the extraordinary remedy of surcharging the exempt property).

meaning that they have no assets against which an award for damages can be enforced.[218] Companies use several mechanisms to render themselves judgment-proof, each aimed at ensuring that the operating company—that is, the entity facing customers and therefore the entity most likely to incur liability—has limited assets.[219] The parent acts as a holding company for the subsidiaries. The intermediate subsidiaries do not typically own any hard assets. Finally, the operating company enters agreements with the intermediate subsidiaries to rent the assets or obtain services from them. The operating company then uses these assets or services to support what the layperson might consider the business of the company. As a result, the entity doing business typically owes much of its revenue to other subsidiaries or the parent itself. Its cash flows up the corporate structure almost as fast as it comes in. At the same time, it owns few, if any, of the trappings of its business. Should a customer prevail in a lawsuit and attempt to collect a judgment against the operating company, there may be a small amount of cash against which the customer could satisfy the judgment, but little else.

It might be wishful thinking to imagine that an operating company even has a small amount of cash available to satisfy judgments. Professor Lynn LoPucki identified several legal structures in addition to limited liability that work together to render even seemingly profitable companies completely judgment-proof: secured credit, national sovereignty, and third-party ownership of property.[220] All of this is to say that the norm in corporate liability is that there are few if any assets available to satisfy unsecured claimants. That is, while a court may hold a judgment-proof entity liable in an action, the practical effect for the plaintiff is often as if no liability existed.[221] To be sure, the liability may impose other costs on the defendant—it may cause reputational harm or even cause an event of default under a commercial credit agreement[222]—but these consequences do not flow from the defendant's liability to the plaintiff.

In this way, judgment-proofing is a strategic choice aimed at maximizing the effects of limited liability.[223] The first layer of limited

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218 Steven Shavell, *The Judgment Proof Problem*, 6 INT'L REV. L. & ECON. 45, 45 (1986).

219 LoPucki, *The Essential Structure of Judgment Proofing*, *supra* note 24, at 151.

220 LoPucki, *The Death of Liability*, *supra* note 61, at 4. In LoPucki's framework, a debtor is judgment-proof when its secured debt exceeds the liquidation value of its assets. *Id.* at 14.

221 The exception here is that a plaintiff unable to satisfy a judgment may be able to drag the responsible entity into an involuntary bankruptcy proceeding. *See* 11 U.S.C. § 303 (2012). That said, involuntary petitions are exceedingly rare precisely because few entities have sufficient unencumbered assets to make such a filing worthwhile. Susan Block-Lieb, *Why Creditors File So Few Involuntary Petitions and Why the Number Is Not Too Small*, 57 BROOK. L. REV. 803, 844 (1991).

222 *See* White, *Corporate Judgment Proofing*, *supra* note 211, at 1384 (explaining that "the indirect costs of damage to one's reputation in the business community" are sufficiently "onerous" to prevent businesses from becoming strategically insolvent in the face of liability).

223 Easterbrook & Fischel, *supra* note 6, at 117.

liability ensures that the entrepreneurs behind any endeavor would not lose their shirts. Subsequent layers protect the company itself.

The net effect of layered limited liability is that there is nothing left over for the very same parties that Professors Bebchuk and Fried identify as non-adjusting creditors.[224] Individuals and even smaller, less-savvy businesses may not perceive the layers of limited liability—if they are even familiar with the concept of limited liability itself—and as a result, may interact with these entities expecting that they will be made whole if one of the entities harms them. They may perceive deep pockets where there are none. Some of these interactions may be voluntary, but the majority will be involuntary—just consider how many commercial vehicles drive by you on any given day.[225] Although the injustices are obvious, as a society we have decided that the economic benefits outweigh these injustices. And so, the ideal of our liability system has become the exception rather than the rule thanks to limited liability.

### 2. The Limits of Limited Liability

Limited liability and, to a lesser extent, judgment-proofing do have an important, yet difficult to access, safety valve in veil piercing. That is, courts can disregard one or several layers of corporate structuring to hold parent companies and even shareholders liable for the actions of limited liability entities.[226] In this way, courts can recreate unlimited liability.

Although there are a couple of different theories available to courts for piercing the corporate veil,[227] the common thread is that one of the upstream parties—the parent company or shareholders—itself failed to observe the separateness of the corporate entities so much so that to allow it the benefit of limited liability would be to allow it to commit something just shy of actual fraud.[228] Somehow, the upstream party

224 Bebchuk & Fried, *supra* note 16, at 891.

225 There are parallel examples of non-adjusting claimants with each of the structures of judgment-proofing identified by Professor LoPucki. *See generally* LoPucki, *The Essential Structure of Judgment Proofing*, *supra* note 24 (explaining how judgment-proofing impacts innocent third parties).

226 *See generally* Robert B. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 CORNELL L. REV. 1036 (1991) (explaining when veil-piercing occurs).

227 *See* Mobil Oil Corp. v. Linear Films, Inc., 718 F. Supp. 260, 271 (D. Del. 1989) (describing the difference between pure agency theory and alter ego theory).

228 *See* Trs. of Nat'l Elevator Indus. Pension, Health Benefit & Educ. Funds v. Lutyk, 332 F.3d 188, 194 (3d Cir. 2003) (affirming the requirement of injustice or fundamental unfairness in defendant's use of the corporate form, but rejecting efforts to require proof of actual fraud); Am. Bell, Inc. v. Fed'n of Tel. Workers of Pa., 736 F.2d 879, 886 (3d Cir. 1984) ("In addition to gross undercapitalization, these factors are failure to observe corporate formalities, nonpayment of dividends, the insolvency of the debtor corporation, siphoning of funds from the debtor corporation by the dominant stockholder, non-functioning of other officers or directors, absence of corporate records, and the fact that the corporation is merely a facade for

must have exercised such dominion and control over the defendant entity that the court cannot recognize even the pretense of separateness.[229] But these are high bars. Certainly, a corporate parent can set the agenda for its subsidiaries. It can even create the subsidiaries for the explicit purpose of containing potential liability. It can have continuous branding throughout its lines of business, even if they are technically under the purview of separate entities. Even if the MBAs at the helm of the parent company know that most consumers do not perceive the separateness of its companies, that alone is not enough to justify piercing the corporate veil. While courts will not endorse outright fraud to guarantee the smooth functioning of business, the line is not terribly far from fraud.[230]

### C. *Applying Limited Liability to Security Interests*

It is hopefully now clear that the effect of a company creating security interests in its assets is hardly different from it selling the collateral then leasing it back, a common judgment-proofing tactic. Why then are sales morally neutral economic transactions while security interests are the continued focus of hostility?

Some of the wrath seems misplaced. For most unsecured creditors, judgment-proofing has the same effect on their recoveries against insolvent companies as security interests.[231] It makes no more sense to require a carve-out for unsecured creditors than it does to require purchasers to assume some liability to a seller's creditors in the event of default. Especially if management is wasteful with the proceeds of the sale, the result will be the same: there are fewer hard assets post-sale against which creditors can satisfy their judgment.

If the seller of an asset then leases it back from the purchaser—as is often the case with machinery, photocopiers, and such—a sale can conceal this lack of assets from other, less sophisticated creditors much in the same way that a security interest does. To be sure, sophisticated parties find out about sale/leaseback transactions by doing their own diligence before contracting with companies.[232] Similarly, the

the operations of the dominant stockholder . . . .").

229 *Mobil Oil Corp.*, 718 F. Supp. at 271.

230 Teller v. Clear Serv. Co., 173 N.Y.S.2d 183, 187–88, 190 (N.Y. Sup. Ct. 1958) (explaining that dividing the assets of a large taxi conglomerate among numerous small companies allows "the true owners of most of the large fleets of taxicabs [to use] a corporate device to defraud the public").

231 LoPucki, *The Essential Structure of Judgment Proofing*, *supra* note 24, at 153.

232 Sale-leaseback transactions involving land will generate records of ownership just as security interests are recorded. *See In re* OMNE Partners II, 67 B.R. 793, 796 (Bankr. D.N.H. 1986) (explaining that with the recorded deed, there was "[n]o misleading of creditors dealing with the debtor"). Since there is no need to record any kind of "deed" with the purchase of personal property, sale-leaseback transactions may indeed be less visible to the public than a

partitioning of assets into distinct, judgment-proof subsidiaries is sometimes invisible to unsophisticated counterparties.[233]

Consider the case of a taxi mogul. Over the years, a very successful taxi mogul might amass a fleet of dozens of taxis and, if in a city like New York, an equal number of taxi medallions (i.e., permits to operate a cab). His assets are the cars, the medallions, and maybe some basic office supplies. If he held all these assets in a single company and if one of his drivers injured a pedestrian, the pedestrian could collect a judgment against those assets generally. The pedestrian nevertheless may not be able to collect the full judgment and be made whole since the vehicles and medallions could be encumbered, but there might be little pieces of equity scattered throughout the company against which the pedestrian could collect. But this is not how taxi companies operate. Instead, the taxi mogul can separate his cars and medallions into a myriad of small companies.[234] Typically, both the vehicle and the medallion are encumbered.[235] As a result, accident victims must sue not a large, successful taxi operation but a very small company with no assets available for unsecured claimants. As one New York court explained, "the state and the city are unwitting accomplices of a legalized racket to avoid liability for payment for the negligent maiming and killing by taxicabs."[236] This is a well-oiled system for not paying claims.

This system may be less effective at cutting off liability if the medallions and vehicles were sold outright to a holding company rather than encumbered. When an asset is sold outright, even if it is leased back to the original owner, the new owner of that asset becomes liable for certain harms caused by that asset. There are various tort actions, notably negligent entrustment, that our squashed pedestrian could bring against the holding company as owner of a taxi.[237] Indeed, the victim would have two potential sources of recovery: the operating company

properly recorded security interest. That said, before entering a material contract, sophisticated businesses require their counterparties to disclose their other material agreements so that they can evaluate the true solvency of their counterparties. And in a commercial debt contract, the borrower would almost certainly have to represent and warrant that there were no material agreements other than those disclosed, and then covenant not to enter new material agreements without the consent of, or at least notifying, the lender.

233 *Teller*, 173 N.Y.S.2d at 187–88, 190.

234 *See* Christopher Drew & Andy Newman, *Taxi Owners Deftly Dodge Claims of Accident Victims*, N.Y. TIMES (May 24, 1998), http://www.nytimes.com/1998/05/24/nyregion/taxi-owners-deftly-dodge-claims-of-accident-victims.html#story-continues-1 (explaining this elaborate judgement-proofing regime and its consequences in detail).

235 *Id.*

236 *Teller*, 173 N.Y.S.2d at 190.

237 *See, e.g.*, Tellez v. Saban, 933 P.2d 1233, 1239 (Ariz. Ct. App. 1996) (holding that a rental car company could be held liable for negligent entrustment when it failed to ensure that drivers were properly licensed). Indeed some states have even codified negligent entrustment into their vehicular codes as one means to force vehicle owners to be responsible for their property. *See, e.g.*, CAL. VEH. CODE § 17150 (West 2017).

that leased the vehicle and the holding company that owned the vehicle. To be sure, the victim suing the vehicle owner does not have a direct claim against the vehicle owner for her injuries. Nevertheless, she was supposed to be protected by one more safeguard—the duty of property owners to exercise reasonable care over their property—and if that failed, would have one more source of recovery.

Similarly, if a pedestrian was maimed by leased equipment while passing a construction site, he may be able to claim against the equipment owner for any defect that caused his injury[238] or for negligent entrustment if the operator was unqualified to be using the equipment. Depending on his line of business, he might be happy to learn that the equipment was leased since the equipment supplier might have much deeper pockets than the construction company. The pedestrian would have access to these deeper pockets because he could claim against the assets of the lessor generally.[239] Limited liability would prevent him from claiming against the owners of the equipment rental companies or related companies. But, critically, the value of his claim would not be limited by the rental company's relationship with the construction company.[240]

The opposite is generally true when it comes to security interests.[241] If our pedestrian friend is maimed by the construction company's

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238 8A AM. JUR. 2D *Bailments* § 103 (2015).

> If the property which is the subject of a bailment for hire is of such nature that its use threatens serious danger to others unless it is in good condition, there is a positive duty on the part of the bailor to take reasonable care to ascertain its condition by inspection. Furthermore, the bailor's duty to exercise reasonable care to see that the bailed property is safe and suitable for its known intended use may, in the case of property that is a dangerous instrumentality if improperly used, require the bailor to warn the bailee of the dangers inherent in improper operation, and to make inquiry as to the bailee's ability to operate it.

*Id.*

239 Of course, the lessor could partially control its liability by engaging in the same judgment-proofing tactics discussed in Section III.B, *supra*.

240 *Accord* Smith v. Clark Equip. Co., 483 N.E.2d 1006, 1008 (Ill. App. Ct. 1985) (estate of deceased victim brought personal injury claims against a forklift manufacturer and the company that rented the forklift to the victim's employer). A rental agreement between the owner of heavy equipment and a construction company would almost certainly require the construction company to indemnify and hold harmless the rental company, but such provisions would not prevent the pedestrian from claiming against the rental company. The two companies would have to sort out ultimate liability amongst themselves. And if the construction company proved to have insufficient assets to cover the claim, the rental company would be left with the liability. In many ways, this arrangement is as it should be. The pedestrian is unable to vet the solvency or even safety performance of construction companies that he passes, but a rental company is capable of such vetting and monitoring, even if it strategically chooses not to vet or monitor its counterparties. Since the rental company can vet and monitor both its own equipment and the equipment operators, it does not seem inherently unfair for it to bear some of the liability when its equipment injures an innocent third party, who lacked such vetting and monitoring capabilities.

241 A key exception here are the so-called "hot goods" provisions of the Fair Labor Standards Act. *See* Citicorp Indus. Credit v. Brock, 483 U.S. 27, 39 (1987).

encumbered equipment while passing a construction site, his primary recourse is against the construction company unless he has a products liability claim against the crane manufacturer. Given the six figure–plus prices of heavy equipment, the construction company may only have a smattering of personal property—hammers, wrenches, scrap lumber, etc.—along with a small amount of cash to count among its unencumbered assets. The company may have sufficient insurance to make the pedestrian whole, but it may not. And if it does not, it is reasonably likely that the company will be unable to satisfy the pedestrian's claim in full. At this point, the pedestrian would have a choice among unattractive options. He could accept a settlement of less than he is owed and bear some of the cost of his own injury notwithstanding his blamelessness. Or, he could obtain a judgment and levy it against the construction company, liquidating its odds and ends into whatever cash he can get. Of course, the company would almost certainly file for bankruptcy protection before it let this happen. And in bankruptcy, the pedestrian would again have to accept a fraction of his claim along with the company's other unsecured creditors.

At no point could the pedestrian access the value of the company's encumbered equipment. The construction company may "own" that equipment, but, on account of the security interest, the lender also "owns" it. In bankruptcy, the lender could foreclose on it thereby defeating the company's ownership interest entirely or the company could keep it, subject to the security interest, and use it when it emerges as a reorganized company post-bankruptcy. Because the secured lender owns the collateral, it is not available to satisfy the pedestrian's claims, but somehow the secured lender's ownership does not include any responsibility for harm caused by its collateral.

Indeed, under our current regime, the scope of the secured lender's responsibility is that of the borrower company.[242] Although the property that caused the harm effectively has two owners—the lender and the borrower—legally, it is as if only one entity, the borrower, participated in that harm. While it may be true that the secured lender's contribution of capital technically enabled the corporate venture to cause the injury, limited liability shields them from such liability to incentivize future investments. The only thing at stake for a lender is its collateral.

But of course, the collateral is not really at stake because the secured lender's property right does not include any of the usual responsibility for property-related wrongs. The only risk faced by the collateral is the chance that it could be destroyed as a result of whatever the underlying wrong is (for example, if an encumbered vehicle is "totaled" in an accident in which that vehicle also causes other

242 Easterbrook & Fischel, *supra* note 6, at 89–90.

damage).[243] Herein lies the unfairness.[244] Secured creditors receive the privilege of priority that a third-party owner would receive, but, because they enjoy the company's limited liability, this ownership does not expose them to the kinds of direct liability that a typical asset owner would face.

## IV. SQUARING LIMITED LIABILITY WITH PRIORITY

The previous Part focused on the similarities between the two flavors of limited liability property—security interests and equity interests. There, I discussed the economic justifications for what appears to be a fundamentally unfair system in which the norm is not to pay claims in full as they are due. This Part will delve deeper into security interests as limited liability property. Section A will look closely at security interests' distributional priority over judgment creditors, a feature which magnifies the fundamental unfairness of not paying certain junior claims. Having identified how priority amplifies the effects of limited liability, Section B will then propose that if we take secured creditors' justification for their priority right seriously—that they have a property interest in the collateral—that alone tends to dial back the scope of their limited liability since ownership carries both burdens and benefits. This normative proposal is not without costs and complications, which are addressed in Section C.

### A. *Locating the Problem*

As an initial matter, we should identify what exactly is "unfair" about secured credit. There has been considerable criticism that because of a proliferation of secured credit, the recoveries of unsecured creditors have declined in recent decades.[245] But it is not clear that limited

243 This destruction could be physical. For example, a piece of encumbered equipment could be so damaged as to retain value only as scrap. In the environmental context, encumbered land could become so polluted that no lender would ever foreclose on it since becoming the fee simple owner of the property would make the lender liable for the clean-up costs. In this case, the collateral literally has negative value to the lender. The more complicated form of destruction is reputational. Then a brand or the trappings of a brand serve as collateral, whatever wrong causes the financial distress that makes the collateral relevant may simultaneously drive down the value of that collateral.

244 *See infra* Part IV.

245 Such concerns have been around for quite some time. *See* Gilmore, *supra* note 142. But they continue to inspire calls for broad-scale bankruptcy reform. *See* COMMISSION TO STUDY THE REFORM OF CHAPTER 11, *supra* note 16. Some of the perception that secured creditors are driving down recoveries by unsecured creditors is wholly misplaced. Most notably, the safe harbors found in section 546(e) have given a myriad of transactions the super-priority status traditionally reserved for secured creditors by protecting them from recovery by the bankruptcy trustee. *See* Kandarp Srinivasan, *The Securitization Flash Flood* (Aug. 25, 2017) (unpublished

recoveries for unsecured creditors is inherently unfair or socially costly. For example, consider sophisticated unsecured lenders.[246] Many receive pennies on the dollar in bankruptcy, but—to put it bluntly—this is exactly what they signed up for.[247] That a secured creditor might prime their claim is part of, arguably even the main source of, the risk that entitles unsecured lenders to the higher interest rate than that paid to secured lenders.

Next, there are commercial creditors who are not traditional lenders. These are vendors who do not require companies to prepay for their goods and services.[248] During the period between when they provide their good or service and when they are paid, they have effectively lent the value of that good or service to the company. These parties traditionally do not typically conduct the kind of extensive due diligence that lenders do during their underwriting process. As a result, they arguably know less about the fiscal health and risks facing their clients.[249] Is it unfair when they are underpaid in bankruptcy? Yes and no. Larger companies could do more diligence or require payment on shorter schedules, i.e., within thirty days rather than ninety days. They could also build penalty features into their contract so that their claim grows over time, thereby increasing their pro rata claim on any unencumbered assets. Others could structure their transactions to fall into one of the special categories entitled to administrative expense priority so that they would be paid ahead of general unsecured creditors.[250] And others could structure their transactions to ensure that

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paper), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2814717. Again here, the argument is that we need to tolerate the apparent unfairness of paying wall street in full but not paying unsecured claimants in full—even when their property rights would otherwise entitle them to payment *pari passu*—to preserve the smooth functioning of wall street. Steven L. Schwarcz & Ori Sharon, *Derivatives and Collateral: Balancing Remedies and Systemic Risk*, 2015 U. ILL. L. REV. 699, 700; Steven L. Schwarcz & Ori Sharon, *The Bankruptcy-Law Safe Harbor for Derivatives: A Path-Dependence Analysis*, 71 WASH. & LEE L. REV. 1715 (2014). To the extent that we, as a society decide that one group deserves "more" and another "less" in the face of limited resources, it perhaps makes sense to look to the section 546(e) safe harbors and other provisions that redistribute wealth rather than attacking the foundational property rights on which our capitalist society was built.

246 Indeed, because of the risks inherent to being an unsecured creditor, only the largest companies can borrow on an unsecured basis. *See* Bebchuk & Fried, *supra* note 16, at 4–5. (rounding up studies that indicate only a small portion of loans are unsecured and that these go to large, stable companies).

247 *See* LoPucki, *The Unsecured Creditor's Bargain*, *supra* note 103.

248 Law firms are a classic example. While they may require a retainer to cover some of their costs, it is common for companies entering bankruptcy to list the firms that helped try to keep them out of bankruptcy among their unsecured creditors. *See In re* Adam Furniture Indus., 158 B.R. 291, 296 (Bankr. S.D. Ga. 1993).

249 Some, however, arguably know more about their clients than distant commercial lenders since they are on the ground with the borrower and may gain early insight into geographic or niche-specific risks.

250 Although not guaranteed, they could structure their relationship with the borrower so that they receive payments, even on the eve of bankruptcy "in the ordinary course" of business or as a critical vendor such that they would receive special treatment in the first-day orders and

they would become secured creditors having taken a purchase money security interest in their goods.[251] And finally, these vendors could raise their prices to cover the risk that they will not collect their contracts in full. In sum, many of the traditional unsecured lenders have paths to protect their status, and if they do not it may be because they took the strategic risk of proceeding unsecured, perhaps hoping to make up any losses on volume or market share. For these companies, it is hard to argue that declining unsecured creditor recoveries represent any significant unfairness.

Small companies, however, present a more sympathetic case.[252] They may lack any realistic ability to improve their priority, or even to demand payment on a tighter schedule, but their transactions are still fundamentally voluntary. Perhaps the best that can be said is that the owners of these companies could pursue other vocations if they cannot stomach the risks of entrepreneurship.[253]

But even this argument is not available for truly involuntary creditors. Involuntary creditors cannot satisfy their claims when a bankrupt company has no unencumbered assets. They may bear the costs of an injury that is no fault of their own. In many cases, this sense of unfairness may be magnified since, for all intents and purposes, it may appear to the casual observer that there is a party that both can and should shoulder the costs instead.

This unfairness, however, is not a unique feature of security interests but rather of capital property and its limited liability more generally. Specifically, it is the ability of limited liability to create judgment-proof entities that nonetheless have the capital to operate that creates the potential for this unfairness. Consider the taxi cab company above. From the view of the injured rider, the outcome is the same if the cars and medallions are divvyed up into several judgment-proof companies or if all the assets sit in a single company but are covered by a blanket lien. If companies owned in fee simple the capital they needed to operate, there would be more assets available to satisfy the claims of involuntary claimants. But, security interests or not, that is not how business organization law works in this country.

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have defenses against preference actions. *See* 11 U.S.C. 363(c)(1) (2012). *But see In re* Kmart Corp., 359 F.3d 866 (7th Cir. 2004) (holding that a bankruptcy court lacked authority to bypass usual priority rules with a critical vendor order).

251 Purchase money security interests are priority liens given to lenders who finance the purchase of an asset against that asset. U.C.C. § 9-103 (AM. LAW INST. 2012).

252 Indeed, many of these small companies may hardly be companies at all but rather individuals' sole proprietorships.

253 This is, of course, easier said than done. Still, I hesitate before any suggestion that we create special recovery rules for small business creditors since our system of easy incorporation makes remaining a nominally small business easy. Just consider the taxi cab companies discussed in Section III.C, *supra*. Each taxi could be its own company, which is about as small a business as they come, yet the ultimate owner of a web of such companies might be a large, sophisticated taxi conglomerate.

Of course, it is an open empirical question whether tort claimants and other unsecured creditors would be better off if the law discouraged judgment-proofing and security interests since there might be less investment, less innovation, and less entrepreneurship as a result.[254] The arguments in favor of tolerating judgment-proofing in the corporate structure context have always been that it encourages economic activity and therefore promotes overall flourishing.[255] These are the same arguments used to defend security interests.[256]

### B. *Bringing Coherence to Limited Liability Property*

One way to mitigate some of this unfairness while at the same time making the priority rights held by secured lenders more coherent is to treat security interests more like the property rights that they claim to be.[257] Our current system allows secured lenders to peel certain privileges of property ownership off of the responsibilities that normally accompany those property interests.

Moreover, property rights are claims against the world, not claims against the rights of other individuals. It is odd, then, that security interests functionally convert certain *in rem* aspects of the property right—notably ownership-based liability—into *in personam* obligations belonging to the borrower.[258] This conversion happens because secured lenders do not incur any ownership-based liability as long as their interest is technically a security interest—that is, before a foreclosure sale has occurred—even when it would be nearly impossible for the borrower to relieve the asset of the encumbrance.[259] The borrowers

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254 The closest that we can get to conducting such a study is to compare the United States to other jurisdictions that permit fewer security interests, that do not adhere to our absolute priority rule in bankruptcy, or that do not offer companies the same limited liability protections found in the United States. Such a project is beyond the scope and aspirations of this Article. However, it is worth noting that as countries modernize their lending, insolvency, and corporate laws to encourage growth, the trend is to make laws more like those in the United States, not less.

255 *See supra* Section III.B.1.

256 *See generally* Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L.J. 857 (1982) (advocating for the efficiency of preserving of non-bankruptcy rights in bankruptcy).

257 We can treat security interests *like* property interests for liability purposes even if they are not ultimately *true* property under prevailing theories of property. *See* Thomas W. Merrill & Henry E. Smith, *Optimal Standardization in the Law of Property: The* Numerus Clausus *Principle*, 110 YALE L.J. 1 (2000) (excluding security interests from true property interests). *But see* Yun-chien Chang & Henry E. Smith, *Structure and Style in Comparative Property Law*, *in* COMPARATIVE LAW AND ECONOMICS 24–28 (Giovanni Battista Romello & Theodore Eisenberg eds., 2014) (arguing that because they entail a right to exclude, act *in rem*, and run with the collateral, "a mortgage is a property right" even if it lacks certain characteristics of other property rights).

258 *See generally* Merrill & Smith, *supra* note 76 (describing how to be a hybrid of *in rem* and *in personam* rights).

259 To be sure, an *ex machina* infusion of cash could allow the borrower to buy off the

retain all of the responsibility for the property, even when they no longer have the right to use the property for their own benefit since, facing insolvency, their fiduciary obligations have shifted from equity holders to debt holders.[260]

Since secured lenders' priority right depends on security interests being at least property-like interests, a better system would be to condition secured lenders' priority right on assuming ownership-based liability. That is, where owners of property face liability by virtue of their ownership alone, so too should holders of security interests. The scope of this liability is narrow—primarily consisting of real property–based liability[261] and negligent entrustment. Critically, other metrics of creditor behavior—notably, control—would be irrelevant to determining whether the creditor should bear liability. Despite the limited scope, this change would go a long way towards making the *in rem* rights of security interest holders make sense as *in rem* rights. Secured lenders would hold both the privileges and liabilities of their *in rem* claims.

Such a system would also be more coherent with the system of capital property described in Part I above. There, I described how equity holders receive limited liability in exchange for forfeiting direct control over their capital.[262] Since they no longer control their capital, they do not personally assume any responsibility for the proceeds of their capital. One of the ways in which equity holders have given up control over their capital is by delegating to the company the ability to give other claimants a priority claim over the assets of the company in the hope that such claims will ultimately increase their residuary. When the company issues unsecured debt, it accepts another class of capital whose value is supported by the residuary of the company. Companies have a contractual obligation to repay unsecured debt, but their ability to do so depends on the health of the company as a whole. Unsecured claimants can only look to the unencumbered assets of a company for assurance that they will be able to satisfy their claims should the company fail to

security interest, but there are many cases in which the odds of a company regaining the financial health needed to do so are virtually zero. Consider a manufacturing outfit that has incurred significant environmental liability on its land. No solvent company will want to acquire the manufacturer if the environmental liability exceeds the expected value of the going concern. And due to concerns that the manufacturer will worsen the pollution problem, state and federal regulators may prevent it from conducting business as usual in an effort to operate its way into solvency. Lacking the cash to do the clean-up itself and to re-tool its operations to be cleaner, it has no path, even through bankruptcy, to de-leverage its assets.

260 Laura Lin, *Shift of Fiduciary Duty Upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors*, 46 VAND. L. REV. 1485, 1499–1500 (1993).

261 I am conceiving of real property liability as liability that belongs to the owner of real property by virtue of his ownership. The largest category of such liability is undoubtedly environmental liability for which owners face strict liability under various regulatory regimes.

262 Instead of owning any company assets, equity holders own the residuary of a company, which is merely a pro rata share of the proceeds remaining once any assets are sold to satisfy prior claims.

make its contractual payments.

But when a company issues secured debt, it accepts another class of capital whose value is supported by the assets to which the security interest attaches. The security interest then removes that asset from the pool of assets supporting all junior claims. Whereas the ownership interests held by equity and the claims held by unsecured creditors are rights to the proceeds of a pool of assets, secured creditors have a direct claim on particular assets. But while they take ownership of the asset from the company such that the asset no longer supports general claims against the company, they leave the claims generated by that asset with the company.

Such a split between ownership and ultimate liability fits with our permissive system of contracting. Borrowers could easily indemnify secured lenders for any liability arising out of their security interest. But such indemnification claims would necessarily be unsecured claims supported by the residuary.[263] This split makes little sense in a system of property rights where one of the core distinctions between property rights and contract rights is their enforceability against third parties. For this reason, certain structures such as priority and subordination, that are desirable options in contracts, are not necessarily desirable options when enforced through property rules.

Making secured lenders liable for certain ownership-based claims would force secured lenders to look to their own limited liability to manage risk rather than enjoying the limited liability of equity holders while claiming to have a property interest in the company assets that is distinct from equity's interest in the residuary. To be sure, secured lenders could use corporate law to achieve a nearly identical degree of judgment-proofing as they can under the present system, but the mechanism by which claims went unpaid would be more coherent. Moreover, the same reputational and political forces that already motivate conglomerates to satisfy their subsidiaries' liabilities[264] might come to bear on secured lenders if they formally owned that liability.[265]

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263 Loan documents could also use a mechanism like cross-collateralization to support any indemnity claims with the original collateral. Such a system would be inferior in the eyes of secured creditors since it would only be effective if they were over-secured by at least the amount of the indemnity claim and if a bankruptcy court would recognize the addition to the secured claim. If the addition occurred post-petition, the automatic stay found in 11 U.S.C. § 362 (2012) would likely prevent the secured creditor from tucking its indemnity claim under the existing security interest.

264 For example, after the Deepwater Horizon oil spill killed eleven workers and pumped millions of barrels of oil into the Gulf of Mexico, the relevant subsidiaries parent companies, BP Corporation North America Inc. and BP P.L.C. guaranteed the global settlement reached by the Department of Justice, five states, and BP. *U.S. and Five Gulf States Reach Historic Settlement with BP to Resolve Civil Lawsuit Over Deepwater Horizon Oil Spill*, U.S. DEP'T JUST. (Oct. 5, 2015), https://www.justice.gov/opa/pr/us-and-five-gulf-states-reach-historic-settlement-bp-resolve-civil-lawsuit-over-deepwater.

265 For example, if the Dakota Access Pipeline is built with secured financing from subsidiaries of Bank of America and Wells Fargo, and it then causes an environmental disaster,

### C. *Additional Implications*

Of course, any revisions to our system to take more seriously secured lenders' direct ownership claims would cause significant headaches—perhaps even chaos—in the loan industry. The most immediate effect of which would almost certainly be reduced overall secured lending. The main change for secured lenders would be an increase in their risk when taking security interests. Where previously they could hold security interests with virtually no added liability, they now would face ownership-related liability.[266] This risk would cause their expected returns to dip, even on loans to otherwise very credit-worthy companies. Underwriting costs would rise as diligence into potential ownership liability claims become essential. In turn, there may be convergence in the pricing of secured and unsecured debt. And in high-risk industries—such as those prone to environmental liability—secured debt could become costlier than unsecured debt making it an unattractive option for borrowers and lenders alike.

It is also possible that full recognition of the property claims inherent to secured lending would make true blanket liens less appealing.[267] For example, if a creditor asserts a lien on all of the firm's value instead of against particular assets, perhaps there is a point at which the lender becomes liable for all of the firm's actions. That is, perhaps the secured lender's liability would match the scope of equity's liability but lack the protection of limited liability.

There would also be added administrative costs, particularly with widely held leveraged loans. Under the proposed system, a plaintiff could sue the holders of debt,[268] who may be numerous and constantly in flux. Lenders would have to have a system in place for participating in ownership liability suits in a coordinated way. One could imagine this becoming the responsibility of the collateral agent or indenture trustee.

For widely traded debt, plaintiffs might have little choice but to sue

even though the cost of the clean-up may exceed the value of the lending subsidiaries, one can imagine that the reputational harm that Bank of America and Wells Fargo would suffer if they let those subsidiaries become insolvent while posting large profits elsewhere, might inspire them to pay claims beyond their technical liability.

266 Current law does impose additional liability on secured lenders who use their status to exercise too much control over a company. *See* Daniel R. Fischel, *The Economics of Lender Liability*, 99 YALE L.J. 131, 131–40 (1989) (explaining lender misbehavior). This risk is not something that must necessarily be priced into a loan since the lender can choose to avoid it completely by not exercising an impermissible level of control over the borrower.

267 It is unlikely that secured creditors can actually take a security interest in all of a company's going concern value since security depends on having identifiable assets as collateral. *See* Jacoby & Janger, *Tracing Equity*, *supra* note 96.

268 There are various ways such liability could work, each yielding subtly different results. For example, lenders could be joint and severally liable or subject only to pro rata liability.

defendants as a class.[269] Since the liability would be ownership-based, some of it would not depend on when the holder purchased the security interest.[270] Purchasers of debt on secondary markets might find deeper diligence needed before they can comfortably purchase debt. Debt in high-risk industries might become less tradeable on secondary markets. Large issuances could become more difficult as participating banks worry about holding significant and indeterminate risks on their balance sheets.[271]

Diligence over the life of the loan would also become more essential for the protection of lenders. In addition to their usual servicing costs,[272] secured lenders would have potentially significant monitoring costs as they would need to inspect not only the value of their collateral but also whether that collateral may cause them additional trouble. These costs could make secured lending more expensive or even unavailable in difficult-to-monitor industries.[273] For example, it could become difficult to impossible to get secured financing to build gas stations, auto body shops, and dry cleaners because of the risk that some deep corner of soil would become an environmental liability.[274] At the same time, the cost of complying with covenants could increase for borrowers as lenders may require additional audited reporting or inspections.

These added costs, though significant, might nonetheless prove to be net positives for society. Lenders' diligence might sufficiently reduce liability-producing incidents, especially those that optimally should never occur. Consider how the incentives to maintain an oil pipeline might change if the secured lender whose collateral includes the pipeline could instantly become liable in the event of a leak versus a

269 Such defendant classes are rare now, but unwieldly and burdensome on courts when they do arise. For example, the fraudulent transfer litigation arising from Lyondell Chemical's 2009 bankruptcy was still pending nearly a decade later having been through various appeals and other costly hurdles. Voluntary Petition (Chapter 11), *In re* Lyondell Chem. Co., 543 B.R. 127 (Bankr. S.D.N.Y. 2016) (No. 09-BK-10023).

270 Claims about the condition of property may not depend on the time of purchase since they function almost like strict liability claims. However, claims such as negligent entrustment may depend on who held the debt when the wrong occurred.

271 The norm in large-scale leverage finance is for a small coalition of banks to fund a leveraged loan then for those banks to quickly diversify their holdings by selling portions of their loan on secondary markets or through securitization. In January 2017 alone, there was nearly $57 billion dollars of debt traded over the secondary markets. *IQ17 Secondary Trading Volume: Trade Activity Spikes to a Record $178.7 Billion*, LOAN SYNDICATIONS & TRADING ASS'N (April 24, 2017), https://www.lsta.org/news-and-resources/news/1q17-secondary-trading-volume-trade-activity-spikes-to-a-record-1787-billion.

272 Namely, payment processing, covenant monitoring, and collateral monitoring.

273 Monitoring only makes sense if the cost of monitoring is less than the higher interest the debtor would have to pay in its absence. Otherwise, both parties benefit from agreeing not to monitor. *See* Jackson & Kronman, *supra* note 19, at 1150 (in which case the lender may prefer to lend on an unsecured basis, if at all).

274 Such businesses may find themselves shut out of capital markets if they are not creditworthy enough for even very expensive unsecured debt.

conglomerate that holds the pipeline in a judgment-proof subsidiary. While lenders themselves could use some judgment-proofing strategies to minimize their exposure, the mere threat of litigation should make them somewhat more sensitive to risks,[275] especially those risks that are easily avoided.[276] This might be particularly true since the borrower, not the lender, could be made responsible for the cost of mitigating the risk under the terms of the loan agreement.[277]

Moreover, there are reasons to believe that lenders may be better at monitoring risks than borrowers.[278] While they may lack the insider's view of the borrower itself, large-scale lenders may have a whole-industry view that affords it considerable expertise both about risks and about best practices. A lender with a reputation to protect may also be a more diligent monitor than an anonymous company that can easily rebrand and move on if the unthinkable happens.[279]

While these consequences are certainly negatives for the lending industry, they could better align actual, collectible liability with the idealized liability rules of our private law and regulatory system. That is, shifting some ownership liability to secured lenders may help undo our system for not paying claims. In any event, however, we can only evaluate this proposal by first understanding the awkward fit between secured lenders' direct ownership claim—and therefore their priority right—and limited liability.

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275 Modern banking regulations may make it more difficult for lenders to use the most aggressive judgment-proofing strategies. *See, e.g.*, Regulatory Capital Rules, 78 Fed. Reg. 55,340, 55,343–344 (2013) (imposing capital requirements on FDIC-insured banks).

276 For example, secured lenders could condition the loan on receiving regular independent inspection reports.

277 To control their liability, lenders may have to shoulder the cost of some repairs should borrowers refuse to make them, but they could structure their loan agreements so that such refusal is a material default or even capitalize the costs of repairs into their security interest. Unless the borrower were truly insolvent and had no hope or intention of reorganizing, its desire to maintain a positive relationship with lenders would further incentivize it not to force the lender to make repairs itself. After all, the borrower's long-term fiscal viability likely depends on it having regular access to lenders.

278 But duplicative monitoring obligations can also lead to under monitoring or inefficient over monitoring. *See* Levmore, *supra* note 31, at 50 (exploring the problem of freeriding monitors and arguing that that "the freeriding problem is solved if unique monitoring tasks can be assigned to secured creditors"); *see also* Schwartz, *Security Interests and Bankruptcy Priorities*, *supra* note 19, at 12 (explaining that the sanction of lost good will reduces the need for monitoring).

279 Even very large companies that are not consumer-facing rebrand as a strategy for burying stains on their reputation—to cease to be household names when they never wanted to be household names. Consider for example how Blackwater, a defense contractor known for abuses in Iraq, became Academi, a defense contractor that no one has ever heard of and whose creative use of vowels suggests a benign Silicon Valley–based education venture. *See* Ben Makuch, *The Company Formerly Known as Blackwater Is Training Canadian Soldiers*, VICE (Apr. 9, 2015, 4:31 PM), https://www.vice.com/en_us/article/3bj85y/the-company-formerly-known-as-blackwater-is-training-canadian-soldiers-296.

## CONCLUSION

Security interests have many features of a one-sided property right that gives holders many of the privileges of ownership without any of the liability that ownership normally entails. They are a kind of limited liability property—a direct ownership interest in company assets that cannot be liable for more than the existing value of that ownership interest. This disconnect between direct ownership and liability helps fuel the perception that secured lending imposes undue costs and risks on downstream claims. These costs and risks are not unique to security interests, but instead are the products of our systems of property and limited liability. We are mostly comfortable with the costs of private property and limited liability because we believe that they are net positives for society. While secured lending merges the externalities of both systems into a particularly potent force, it is quite possible that secured lending as it currently exists is also a net positive for society. After all, it has proven to be an incredibly effective tool for financing small businesses, homeownership, and countless other trappings of the American dream, downstream concerns notwithstanding. It could well be that the benefits of secured credit vastly outweigh its costs.[280] But we cannot begin to answer that question—or even begin to see why it needs to be asked—until we understand security interests for what they are: limited liability property.

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280 Ultimately, these concerns reduce to an empirical question: would taking secured lenders' property rights seriously by affording them liability along with privileges of ownership produce a more optimal level of liability? Knowing the answer to this question would dramatically improve our ability to design an efficient system of property and property-like rights. But of course, we would first have to know what a more optimal level of liability is. If the limited liability literature teaches us anything, it is that knowing the optimal level of liability is a fabulously difficult question. *See* A. Mitchell Polinsky & Steven Shavell, *Punitive Damages: An Economic Analysis*, 111 HARV. L. REV. 869, 877–97 (1998) (describing the problem of setting optimal liability). At some point, the answer may boil down to one's view of the relationship between fairness, welfare, and even redistribution. *See* Louis Kaplow & Steven Shavell, *Fairness Versus Welfare*, 114 HARV. L. REV. 961, 966 (2001) (arguing that fairness should not be an independent criterion for evaluating policies); Jeremy Waldron, *Locating Distribution*, 32 J. LEGAL STUD. 277, 298–99 (2003) (championing distributive convictions as valid notwithstanding the lack of a complete theory in which to situate them).