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THE BANKRUPTCY LADDER OF PRIORITIES AND THE INEQUALITIES OF LIFE

*Philip R. Wood QC (Hon)**

I. INTRODUCTION

The excellent work, *The Three and a Half Minute Transaction*,¹ raises some profound and intriguing questions about the documentation of some of the world's largest and most important transactions by far and about what lawyers actually do.

This Article raises a supplementary issue by way of an appendage. This issue is whether there ever was a principle of *pari passu*² distribution on bankruptcy, whatever that means. It concludes that equality on bankruptcy in the case of corporations at least is a mere metaphysical illusion and that the reality is rather different.

Bankruptcy law is the profound motivator of commercial and financial law because, if there is not enough brandy and biscuits on the raft, the law is at its most ruthless in having to choose who to pay. We have bankruptcy laws in order to prevent a race to dismember the assets and in order to achieve an equitable distribution amongst creditors.³ The

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1. MITU GULATI & ROBERT E. SCOTT, *THE THREE AND A HALF MINUTE TRANSACTION: BOILERPLATE AND THE LIMITS OF CONTRACT DESIGN* (forthcoming 2012) (on file with the Hofstra Law Review).

2. *Id.* (manuscript at 21).

3. SUBCOMM. ON CIVIL & CONSTITUTIONAL RIGHTS OF THE H. COMM. ON THE JUDICIARY, 95TH CONG., REP. ON HEARINGS ON THE COURT ADMINISTRATIVE STRUCTURE FOR BANKRUPTCY CASES 3-4 (Comm. Print 1978) (describing how over 500 separate lawsuits arose during the administration of a bankruptcy case in New York and the inherent need for speed in these types of cases as the assets deteriorate in value).

race to dismember the assets is controlled by stays or freezes—there are potentially at least half a dozen of these, depending on the jurisdiction.⁴

The heart and central core of bankruptcy regimes is the bankruptcy ladder of priorities which determines the hierarchy of claimants on final liquidation.⁵ “Even the most cursory examination of bankruptcy internationally shows that the *pari passu* rule is nowhere honoured. Nowhere is there a flat field.”⁶ On the contrary, creditors are paid according to a scale of priorities.⁷ There is an intricate series of steps as creditors scramble upwards, gasping for more air to escape the “swirling tides of rising debt [and] to breathe in the squeezed bubble of oxygen at the top.”⁸

II. WHY THE BANKRUPTCY LADDER IS FUNDAMENTAL

The bankruptcy ladder of priorities is fundamental because:

- It defines basic *contract and property rights*—rights which are considered crucial to economic development and which have been taken into account in insolvency regimes, including the resolution of banks.
- The ladder specifies the *risk* that the participants take and facilitates the pricing of the risk, for example, the pricing of equity capital, which is subordinated to everybody else or the pricing of a secured loan, which trumps everybody else.
- The ladder is the *backdrop* against which all negotiations between claimants have to take place because it specifies where claimants will be positioned in the event of liquidation if they do not agree. It is the backdrop to corporate reorganization plans and to bank resolution regimes.
- The ladder represents the profound *views of a society* about who should survive by being paid and who should be drowned.
- One of the main causes of international *legal disharmony* on bankruptcy matters results from different views about the ladder. Countries do not differ much on such questions as

4. See 1 PHILIP R. WOOD, *THE LAW AND PRACTICE OF INTERNATIONAL FINANCE SERIES: PRINCIPLES OF INTERNATIONAL INSOLVENCY* § 9-051, at 213-14 (2d ed. 2007) (discussing the stays within various jurisdictions); Franklin R. Edwards & Edward R. Morrison, *Derivatives and the Bankruptcy Code: Why the Special Treatment?*, 22 YALE J. ON REG. 91, 95 (2005) (discussing stays).

5. 1 WOOD, *supra* note 4, § 11-001, at 237.

6. *Id.* (emphasis added).

7. *Id.*

8. *Id.*

entry criteria, management, or even the avoidance of preferences (although they do differ on these matters but not nearly as much as they disagree about the ladder).

- Claimants who are under water typically do not have a *vote*, at least in the proceedings themselves. This is because financial democracies are property democracies. If a claimant does not have any interest to protect, then the claimant is an outsider with no involvement and therefore should not be able to determine outcomes. For example, if the company is insolvent, this theory generally leads to the conclusion that shareholders have no vote at all on any reorganization plan. The same applies to underwater subordinated creditors in the tiers above shareholders.
- There is always a *direct cost* to somebody in changing the ladder. The insertion of any class of claimant higher up in the ladder potentially involves a greater loss to the claimants lower down. Thus, if retail depositors to a bank are ranked above ordinary creditors, this may impact upon the interest rate and maturities of capital-raising bond issues by banks. Most of the complications in working out priorities result from the near indecipherability of impact and of weighing up costs and benefits quantitatively.
- The essence of bankruptcy is that the law has to make *choices*. Typically, neither of the alternatives is perfect. In the case of the bankruptcy ladder, there are winners and losers, victors and victims, because there is not enough to go around. It is also the case that there is no escape—choices have to be made and it is these choices that reveal the credentials of a legal system. The priority ladder reflects the priorities of the legal culture.

The concept of a ladder of priorities is so potent that there is a consensus ladder in relation to state insolvency even though state insolvency is not governed by any mandatory bankruptcy laws.⁹ The result is that the bankruptcy ladder of priorities is directly implicated in the design of any legal regime for the rescue or liquidation of corporations and the resolution of banks.

9. See *id.* § 11-004, at 238; *State Insolvency—What Bondholders and Other Creditors Should Know*, ALLEN & OVERY GLOBAL LAW INTELLIGENCE UNIT, 5 (2010), available at <http://www.allenoverly.com/AOWeb/binaries/64484.pdf>.

III. SUMMARY OF THE LADDER

The bankruptcy ladder of priorities usually comprises at least six main ranks or rungs as follows:

- (1) Super-priority creditors;
- (2) Priority creditors;
- (3) *Pari passu* creditors;
- (4) Subordinated creditors;
- (5) Equity shareholders; and
- (6) Expropriated creditors.¹⁰

In addition, each of the grand divisions is often sub-divided into manifold little internal steps, sometimes as many as a dozen or more, especially in relation to priority post-commencement administrative costs.¹¹ So within the main rungs, there are tightly pitched mini-ladders. The actual amounts involved in each rung of the ladder varies between banks and corporations, between classes of debtor, and between debtors in the same generic class.

The typical principal members of each of the above six main classes of rungs are set out below.

A. Rung 1: Super-Priority Creditors

Super-priority creditors are of enormous economic importance. They are generally paid in full (or up to the amount of their asset) and are broadly outside the bankruptcy in the sense that they can take assets out of the debtor's estate for themselves. They are separatists.¹²

There are usually about eight sub-groups in this main group of which the most important are:

- (1) secured creditors with security interests over collateral, sometimes tiered into senior and junior tranches by voluntary agreement, include equivalent title finance substitutes such as sale and repurchase agreements;
- (2) creditors entitled to set-off and to net contracts on a close-out; and
- (3) beneficiaries under trusts, such as custodianship of securities.¹³

The institutions of security interest, set-off (and netting), and trusts are major risk mitigants. Notwithstanding this, the international

10. 1 WOOD, *supra* note 4, § 11-002, at 237 (emphasis added).

11. *Id.* § 11-006, at 239.

12. *Id.* § 11-008, at 240.

13. *Id.* §§ 11-008 to -010, -012, -016 to -017, at 240-44.

reception of these risk mitigants is very different around the world.¹⁴ One of the most fundamental decisions which policy-makers have to make is the degree of protection which they confer on these risk mitigants. In most cases, the amounts involved exceed world gross domestic product (“GDP”) and sometimes a multiple of world GDP, in terms of daily exposure.¹⁵

The rationale underlying the status of each super-priority claimant is detailed. The mainstream view is that the enormous amounts involved, the protection of the safety of capital-providers, and the capital needs of economic development support these risk mitigants.¹⁶ Yet there is much international discord.

B. Rung 2: Priority Creditors

The most important classes of priority creditors are typically:

- (1) retail depositors and life/pension insurance claimants;
- (2) employees for remuneration and benefits up to limits;
- (3) unpaid taxes; and
- (4) post-commencement administrative claims, including the important class of post-commencement new financing.¹⁷

Most of the controversy is about the size and scope of these priority claimants and also whether they should rank before or after *security interests*. If they rank ahead of unsecured claimants, the increased risk may have an adverse effect on the cost of *pari passu* capital. If they rank ahead of security interests, this will have an impact on the value of collateral. In practice, major listed corporations and banks do not grant security except in relation to emergency last resort new money¹⁸—which is when it really matters so that the ranking is critical in relation to corporate reorganizations and bank resolutions.

Most jurisdictions do not give *bank depositors* a preference. Examples of countries which do are Republic of Argentina, Australia, Hong Kong, Japan, Russia, Singapore, Sweden, Switzerland, and the United States.¹⁹ Outside very simple retail banks, it is thought that

14. *Id.* § 11-007, at 239.

15. *Id.* §§ 4-001 to -002, at 75; Philip R. Wood, *How to Compare Regulatory Regimes*, 2 CAP. MARKETS L.J. 332, 336 (2007).

16. See 1 WOOD, *supra* note 4, §§ 4-001 to -002, 14-006, at 75, 356.

17. *Id.* §§ 11-030 to -035, at 249-51.

18. 2 PHILIP R. WOOD, THE LAW AND PRACTICE OF INTERNATIONAL FINANCE SERIES: COMPARATIVE LAW OF SECURITY INTERESTS AND TITLE FINANCE § 2-041, at 41 (2d ed. 2007).

19. 1 WOOD, *supra* note 4, § 11-035, at 251; Henri Pagès & João A.C. Santos, *Optimal Supervisory Policies and Depositor-Preference Laws* 1 n.2 (Bank for Int'l Settlements, Working Paper No. 131, 2003), available at <http://www.bis.org/publ/work131.pdf>.

depositor preference is not a protection against systemic runs: these tend to start in the wholesale market.²⁰ If a systemic collapse is on the way, the protection of retail depositors will not do much to stop it. The objects of depositor priority are generally to protect retail depositors (who have votes) and in turn any deposit protection fund on subrogation after payment to depositors.²¹

Most rescues require the injection of *new money*.²² The issue here is whether the new money should be prioritized over existing creditors. It is generally accepted that last resort emergency money should have a priority,²³ although, if a rescue fails, existing creditors will be subordinated.²⁴ Most leading bankruptcy regimes do not permit post-commencement new money to take priority over existing *secured* creditors, either not at all or at least without adequate protection of the secured creditors.²⁵

There are pros and cons about the *tax priority*. A number of countries have abolished the tax priority, at least in relation to ordinary corporate insolvencies, for example, Switzerland (1996), Britain (2002), Spain (2003), Portugal (2004), Sweden (2004), and Belgium (2009), but not Italy, Japan, or the United States.²⁶

C. Rung 3: *Pari Passu* Creditors

This group contains the true *pari passu* creditors upon liquidation. Upon insolvency, they often receive nothing or a small percentage.²⁷ The largest of these creditors are often other banks and bondholders.²⁸ Trade creditors and real property lessors are proportionately small in the normal case.²⁹

A critical issue is the frequent need to be able to convert debt—especially for bank lenders and bondholders—into shares quickly so as to restore the solvency of the debtor. This can be achieved by an agreed debt-equity conversion or by a judicial plan or by the terms of the debt

20. 1 WOOD, *supra* note 4, § 24-015, at 735-36.

21. *Id.* §§ 24-015, -017, at 735-36.

22. *Id.* § 23-109, at 718.

23. *Id.*

24. *See id.* § 23-111, at 719.

25. *Id.* § 14-032, at 371.

26. *See id.* § 11-032, at 250; *Tax Authorities and the Continuity of Enterprises Act: Still No Clarity*, EUBELIUS (June 2011), http://www.eubelius.com/en/spotlight/tax_authorities_and_the_continuity_of_enterprises_act_still_no_clarity.

27. *Id.* § 11-059, at 266.

28. *Id.*

29. *See id.*

instruments themselves.³⁰ A strong-arm bank resolution regime may force a conversion: these forcible bail-ins were being widely discussed in relation to banks in late 2010.³¹ Contentious issues in forcible conversions are whether shareholders should be disenfranchised in regards to their control over new issues, pre-emption rights, and any required approval of material disposals.³² The argument would be that claimants who do not have a property right should not have a vote, but in practice there are acute problems about valuation. For example, in the financial crisis starting in 2007, bank valuations hinged upon the values of homes which were very unpredictable.³³

D. Rung 4: Subordinated Creditors

All of the subordinated creditors and those below them generally receive nothing upon liquidation because of the insolvency.³⁴ The main classes include:

- (1) creditors who have voluntarily agreed to be subordinated, such as junior bondholders providing hybrid capital. These creditors may be divided into tiers, for example, senior subordinated, junior subordinated, and preferred shares;
- (2) creditors who are compulsorily subordinated in some jurisdictions, for example, for misconduct; and
- (3) post-insolvency interest.³⁵

E. Rung 5: Equity Shareholders

The subordination of equity shareholders is critical to corporate theory and the capital adequacy regimes for banks. Common shareholders bear the first loss.³⁶ They know they bear the first loss and they are compensated by increased returns, by the fact that profits go to the bottom line, and by the possibility of capital appreciation.³⁷ A key

30. *Id.* § 2-001, at 31.

31. See, e.g., LISA CURRAN & JAAP WILLEUMIER, INT'L BAR ASS'N, EXECUTIVE SUMMARY: G20 SURVEY ON BANK BAIL-INS AND NVCC 1 (2011), available at http://www2.lse.ac.uk/fmg/events/conferences/2011/DBWorkshop_14Mar2011/6-IBASummary.pdf; Tamara Burnell, *Bail-in Proposals Are Not Necessarily Bad for Investors—M&G*, RISK.NET (Mar. 4, 2011), <http://www.risk.net/credit/opinion/2031415/bail-ins-necessarily-bad-investors>.

32. See CURRAN & WILLEUMIER, *supra* note 31, at 4, 6.

33. Michael Legg & Jason Harris, *How the American Dream Became a Global Nightmare: An Analysis of the Causes of the Global Financial Crisis*, 32 UNSW L.J. 350, 363-64 (2009).

34. 1 WOOD, *supra* note 4, § 11-062, at 267.

35. *Id.* §§ 11-062 to -070, -072, at 267-71.

36. *Id.* § 11-073, at 271-72.

37. *Id.* § 2-046, at 47.

issue is whether a shareholder induced by misrepresentation to subscribe for shares can leapfrog up the rungs claiming damages, as in Australia.³⁸

F. Rung 6: Expropriated Creditors

Typical expropriated creditors are claimants for foreign tax and penalties who are typically excluded from claiming locally (although not always).³⁹ Often one of the largest classes of expropriated creditors is composed of foreign currency creditors.⁴⁰ Under the law of most jurisdictions, foreign currency claims against the debtor are converted into local currency at the commencement of the insolvency proceeding in order to achieve parity.⁴¹ The result is that, if the local currency depreciates rapidly during a long-drawn-out insolvency, a foreign currency creditor is similarly depreciated.⁴² The conversion rule can inflict considerable damage on foreign currency creditors.

The risk is particularly high if the sovereign state concerned is bankrupt because the bankruptcy generally precipitates a sudden decline in value of the currency of the sovereign state.⁴³ Thus, in the case of the insolvency of Argentina around 2002, foreign creditors claiming foreign currency loans from Argentine corporate debtors were anxious to prevent the formal bankruptcy of the corporate debtors since the conversion would have inflicted massive losses in addition to the normal bankruptcy losses.⁴⁴

IV. CONCLUSION

A precise description of the ladder in all of the jurisdictions of the world would require a large and impenetrable treatise. As a very broad generalization however, a key feature of the common law group of jurisdictions, compared to the Napoleonic and Roman-Germanic groups, is the super-priority accorded by the common law jurisdictions to the three key risk mitigants: security interests, set-off, and trusts. They therefore tend to be more protective of a certain class of claimants on insolvency to the detriment of the rest.

38. *Id.* § 11-073, at 271-72.

39. *Id.* §§ 11-074, -077, at 272-73.

40. *Id.* § 11-078, at 274.

41. *Id.*

42. *Id.*

43. *Id.*

44. See generally U.S. CONG. JOINT ECON. COMM., 108TH CONG., ARGENTINA'S ECONOMIC CRISIS: CAUSES AND CURES (2003) (Rep. Jim Saxton), available at http://jec.senate.gov/republicans/public/?a=Files.Serve&File_id=5fbf2f91-6cdf-4e70-8ff2-620ba901fc4c.

The question of who ranks where on the bankruptcy ladder of priorities is undoubtedly the issue which inflames the most passionate debate. Whatever one may think of the various rationales advanced for preferring one claimant over another, it would seem that the human desire to arrange people in a hierarchy is deeply rooted. Even if the law did not impose a hierarchy, one suspects that markets would devise means of creating a ladder spontaneously. To queue is human. The real questions are—is the ladder efficient? And is the ladder fair?

There are some more basic and primitive issues. Are we rational? Or do we create legal systems which are mainly romantic? These same questions also arise in relation to the famous *pari passu* clause.
