Rethinking Priority Rules in Insolvency

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RETHINKING PRIORITY RULES IN INSOLVENCY

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ABSTRACT

Priority rules shape the core dynamics of insolvency law: distributive outcomes, bargaining in reorganization, and the ex ante behavior of debtors and creditors alike—including their decisions about risk taking, capital structure, and the cost of credit. This Article maps significant cross-jurisdictional variations in priority rules, examining how various countries' insolvency laws treat different classes of claimants including secured creditors, employees, tax authorities, and equity holders, and special categories of claims such as those for rescue financing, tort damages, environmental obligations, and shareholder loans.

The Article then evaluates the desirability of the observed priority rules. This evaluation provides several normative lessons about the appropriate design of insolvency law, including guidance on when to deviate from the principles of full priority and equal treatment. In particular, the Article addresses whether and when to subordinate shareholder loans, the special protections that should be afforded to tort victims and employees, the right legal tools to address environmental threats, and the safeguards necessary when priority is given to administrative claims and rescue financing.

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INTRODUCTION

Insolvency proceedings in jurisdictions around the world face the challenge of addressing various economic and financial problems that, at their core, concern maximizing the value of an insolvent firm and allocating that value among the firm's stakeholders.[1] This Article focuses on the second question, exploring how countries around the world allocate value through their respective systems of priority, assessing whether the current rules governing priority in insolvency proceedings are appropriate, that is, whether they further the purposes of insolvency law.

Allocation decisions in insolvency often imply social and economic considerations and reflect deeper views about the purpose of insolvency law. They also embody normative judgments regarding the relative importance of stakeholders' rights and the extent to which special protection should be afforded in insolvency. In this context, priority rules are central: they determine who bears losses when firms fail and shape bargaining dynamics in corporate reorganizations.[2] At the same time, they influence ex ante incentives by affecting capital structure choices, risk-taking behavior, and relationships among different classes of creditors. By redistributing value from one group of claimants to another, priority rules carry important distributive consequences and raise fundamental questions about the role and limits of insolvency law, particularly when it is used to pursue broader social or economic objectives beyond the efficient allocation of the debtor's assets.

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1 For an analysis of the economic problems that insolvency law seeks to solve, see THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW (1986). For novel proposals seeking to maximize the value of the insolvent firm or facilitate the allocation of value in a cost-effective manner, see Mark J. Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganization*, 83 COLUM. L. REV. 527 (1993); Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J. LEGAL STUD. 127 (1986); Lucian A. Bebchuk, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775 (1988); Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 TEX. L. REV. 51 (1992); Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 STAN. L. REV. 311 (1993); Oliver Hart et al., *A New Bankruptcy Procedure That Uses Multiple Auctions*, 41 EUR. ECON. REV. 46 (1997); Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 YALE L.J. 1807 (1998). *See* INT'L MONETARY FUND, *General Objectives and Features of Insolvency Proceedings, in* ORDERLY & EFFECTIVE INSOLVENCY PROCEDURES: KEY ISSUES 5, 5–6 (1999) (highlighting that, despite the divergences of insolvency laws around the world, the two overall objectives that are generally shared by most systems are "the allocation of risk" and "to protect and maximize value").

2 *See generally* Douglas G. Baird, *Priority Matters: Absolute Priority, Relative Priority, and the Costs of Bankruptcy*, 165 U. PA. L. REV. 785 (2017) (arguing that priority rules are central to shaping distributive outcomes and bargaining dynamics in insolvency proceedings, and that their design has significant implications for the costs of bankruptcy).

Given the sensitive nature of decisions concerning the allocation of losses in insolvency, and the broader implications of policy choices in this area, it is unsurprising that countries around the world have adopted markedly different approaches to establishing the ranking of claims and interests in insolvency.[3] These differences are particularly pronounced with respect to secured creditors, employees, tax authorities, tort claimants, and shareholder loans.[4] Moreover, countries have also adopted different approaches regarding what shareholders may or may not obtain in reorganization procedures.[5]

Recent challenges and developments have further intensified debates over the priority of claims and interests in insolvency proceedings. High-profile mass tort bankruptcies, growing attention to the role of insolvency law in addressing climate change, and the rise of Environmental, Social, and Governance ("ESG")-oriented regulation have highlighted both the importance and the limitations of traditional priority rules. These new challenges call for a critical reassessment of long-standing assumptions about which claims should receive priority in insolvency and why. This Article responds to these concerns by evaluating whether the priority rules observed around the world are consistent with and further the normative purposes behind insolvency law. In doing so, the Article revisits the theoretical foundation of those purposes in light of contemporary challenges. This evaluation provides several normative lessons about the appropriate design of insolvency law, including guidance on when to deviate from the principles of full priority and equal treatment, whether and when to subordinate shareholder loans, the special protections that should be afforded to tort victims and employees, the right legal tools to address

[3] *See, e.g.*, AURELIO GURREA-MARTÍNEZ, REINVENTING INSOLVENCY LAW IN EMERGING ECONOMIES 66–67, 77, 90, 102 (2024). Such divergences in the ranking of claims even exist among countries from regions with high levels of economic and political integration such as the European Union. *See, e.g.*, GERARD MCCORMACK ET AL., *Ranking of Claims and Order of Priorities, in* STUDY ON A NEW APPROACH TO BUSINESS FAILURE AND INSOLVENCY: COMPARATIVE LEGAL ANALYSIS OF THE MEMBER STATES' RELEVANT PROVISIONS AND PRACTICES 112, 112–35 (2016), https://commission.europa.eu/system/files/2017-03/insolvency_study_2016_final_en.pdf; Horst Eidenmüller, *Comparative Corporate Insolvency Law* 33–39 (Eur. Corp. Governance Inst., Working Paper No. 319/2016, 2023), http://ssrn.com/abstract_id=2799863.

[4] *See, e.g.*, GURREA-MARTÍNEZ, *supra* note 3, at 66–67, 77, 90, 102.

[5] For the purposes of this Article, it is important to distinguish between shareholders in their capacity as equity holders—namely, when they acquire shares in the company—and shareholders in their capacity as debt holders, such as when they provide financing through other instruments, including bonds and shareholder loans. To our knowledge, jurisdictions worldwide adopt a broadly similar approach to the treatment of shareholders as equity holders in liquidation proceedings: they are entitled to recover from the company's residual assets only after all creditors have been paid in full. However, significant cross-jurisdictional differences exist with respect to the treatment of shareholder loans in insolvency, as well as the position of shareholders, in their capacity as equity holders, in reorganization procedures. An analysis of these divergences is provided in Sections VIII and IX.

environmental threats, and the safeguards necessary when priority is given to administrative claims and rescue financing.

I. THE IMPORTANCE OF PRIORITY OF CLAIMS IN BANKRUPTCY: INSOLVENCY AND NON-INSOLVENCY IMPLICATIONS

A priority rule in insolvency cannot be viewed solely as an ex post mechanism for allocating losses among creditors. Insolvency rules shape the expectations, decisions, and behavior of debtors and creditors long before a firm enters formal insolvency proceedings. In that context, priority rules play a key role by influencing how firms are financed, how creditors monitor and interact with borrowers, and how companies make investment decisions. Thus, from an ex ante perspective—before financial distress arises—priority rules affect incentives for investment and risk-taking,[6] and may have a significant impact on creditors' behavior and firms' access to finance.[7] Secured creditors, for example, require varying levels of collateral and exert varying levels of monitoring effort depending on the likelihood of being paid in full in the event of default,[8] whereas unsecured creditors price the risk of subordination into interest rates, covenants, and other contractual arrangements.[9] By shaping expectations about who will bear losses in distress, priority rules directly influence capital structure choices, entrepreneurial risk-taking, and the willingness of investors to provide financing. Where certain creditors cannot adjust, either because their claims are involuntary or because they lack information or bargaining power, priority rules may facilitate the externalization of risk onto those creditors, placing them in a

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6 *See generally* Lucian A. Bebchuk, *Ex Ante Costs of Violating Absolute Priority in Bankruptcy*, 57 J. FIN. 445 (2002) (demonstrating that deviations from absolute priority distort ex ante incentives for investment and risk-taking by shareholders, who may engage in value-destroying behavior when they expect to receive value in reorganization even when creditors are not paid in full).

7 *See, e.g.*, JOHN ARMOUR ET AL., *How Do Creditor Rights Matter for Debt Finance? A Review of Empirical Evidence*, *in* RESEARCH HANDBOOK ON SECURED FINANCING OF COMMERCIAL TRANSACTIONS 3 (Frederique Dahan ed., 2015) (reviewing the empirical literature analyzing how the treatment of creditors in insolvency proceedings affect firms' access to finance).

8 *See* Sergei A. Davydenko & Julian R. Franks, *Do Bankruptcy Codes Matter? A Study of Defaults in France, Germany and the UK*, 53 J. FIN. 565, 599 (2008); Lucian A. Bebchuk & Jesse M. Fried, *Uneasy Case for the Priority of Secured Claims in Bankruptcy: Further Thoughts and a Reply to Critics*, 82 CORNELL L. REV. 1279, 1315 (1997).

9 Alan Schwartz, *The Continuing Puzzle of Secured Debt*, 37 VAND. L. REV. 1051, 1054 (1984) ("Secured creditors will charge lower interest rates because security reduces their risks, but unsecured creditors will raise their interest rates in response because security reduces the assets on which they can levy, and so *increases* their risks.").

more vulnerable position. Moreover, such externalization of risk may have broader implications for economic efficiency.[10]

In addition to affecting solvent firms, priority rules influence the dynamics and incentives of financially distressed firms not yet subject to insolvency proceedings. They shape the decisions of directors and controlling shareholders regarding whether to initiate insolvency proceedings,[11] or to pursue an out-of-court restructuring, and they can affect the relative bargaining power of debtors and creditors in a potential workout. Once formal insolvency proceedings commence, priority rules play a central role in determining which stakeholders ultimately absorb the losses associated with the firm's failure. By doing so, priority rules affect the division of firm value within the procedure. At the same time, they influence bargaining dynamics in reorganization procedures, as well as the timing and efficiency of the proceedings.[12] Therefore, priority rules in insolvency proceedings should not be viewed in isolation or solely from an ex post perspective. Instead, they should be understood as guardrails governing the allocation of loss in the event of insolvency. As such, they shape the dynamics and bargaining power of parties in reorganization procedures, affect firms' ex ante and ex post investment decisions and capital structures, and ultimately impact financial markets and the broader economy.

II. THE PROTECTION OF PRE-BANKRUPTCY ENTITLEMENTS

A. Foundations

A foundational principle of insolvency law is the protection of pre-bankruptcy entitlements.[13] This principle holds that creditors and other

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[10] Lucian A. Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857, 896 (1996) (arguing that the adoption of secured credit gives the borrower and secured creditor "a larger slice of the pie at the expense of nonadjusting creditors" and simultaneously "reduces the size of the total pie"); Lynn M. LoPucki, *The Unsecured Creditors Bargain*, 80 VA. L. REV. 1887, 1898 (1994) (illustrating how value is diverted and risk is allocated to involuntary creditors through the grant of security); David Leebron, *Limited Liability, Tort Victims, and Creditors,* 91 COLUM. L. REV. 1565, 1646–49 (1991) (observing that grants of security are done for the benefit of creditors at the expense of tort claimants, the phenomenon of "externalization of tort risk").

[11] *See generally* Douglas G. Baird, *The Initiation Problem in Bankruptcy*, 11 INT'L REV. L. & ECON. 223 (1991) (examining the factors that go into the decision on whether and when to initiate bankruptcy proceedings).

[12] *See generally* Douglas G. Baird & Donald S. Bernstein, *Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain*, 115 YALE L.J. 1930 (2006) (examining the impact that priority rules have on bargaining dynamics).

[13] *See* JACKSON, *supra* note 1, at 28–29; *see also* THE WORLD BANK, PRINCIPLES FOR EFFECTIVE INSOLVENCY AND CREDITOR/DEBTOR REGIMES 26 (2021), https://documents1.worldbank.org/curated/en/391341619072648570/pdf/Principles-for-Effective-Insolvency-

stakeholders should generally receive in insolvency proceedings what they would be entitled to receive under non-insolvency law unless compelling insolvency goals suggest some alteration.[14] Such respect for pre-bankruptcy entitlements is essential to promote predictability and avoid an opportunistic use of insolvency proceedings.[15] Predictable enforcement of contractual and property rights enables creditors to price risk accurately, allocate capital efficiently, facilitate access to finance, and make informed lending and investment decisions.[16] Therefore, respecting pre-bankruptcy entitlements is an essential feature of effective and efficient insolvency regimes.[17]

At the same time, the protection of pre-bankruptcy entitlements cannot be absolute. Insolvency law is, by definition, a collective proceeding that modifies individual enforcement rights.[18] Moreover, pre-bankruptcy entitlements themselves may reflect market failures, information asymmetries, or unequal bargaining power. The protection of such entitlements should therefore be treated as a baseline rather than an immutable rule, allowing deviations from this rule in exceptional cases where it can be economically justified.[19] For instance, most insolvency laws permit deviations from pre-existing creditor rights by imposing an automatic stay that prevents creditors from exercising their

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and-Creditor-and-Debtor-Regimes.pdf ("The rights of creditors and the priorities of claims established prior to insolvency proceedings under commercial or other applicable laws should be upheld in an insolvency proceeding to preserve the legitimate expectations of creditors and encourage greater predictability in commercial relationships."); INT'L MONETARY FUND, *supra* note 1, at 5 ("The first overall objective [of insolvency law] is the allocation of risk among participants in a market economy in a predictable, equitable, and transparent manner.") (emphasis omitted).

14 *See* Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L.J. 857, 871 (1982) (advancing that the creditors' bargain model, which justifies the recognition of pre-insolvency entitlements "provides a satisfying theoretical explanation of why bankruptcy law should make a fundamental decision to honor negotiated non-bankruptcy entitlements"); Anthony J. Casey, *Chapter 11's Renegotiation Framework and the Purpose of Corporate Bankruptcy*, 120 COLUM. L. REV. 1709, 1727–28 (2020).

15 *See* Jackson, *supra* note 14, at 876; *see also* Douglas G. Baird & Thomas H. Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. CHI. L. REV. 97, 110 (1984) (remarking that bankruptcy concerns the recognition of non-bankruptcy entitlements).

16 THE WORLD BANK, *supra* note 13, at 11–12, 21 (emphasizing that the "inability to predict downside risk can cripple markets," the fact that "[i]n the absence of sufficient and predictable laws and procedures, creditors tend to extend funds only in return for unnecessarily high-risk premiums," and the need to "[r]ecognize existing creditor rights and respect the priority of claims with a predictable and established process").

17 THE WORLD BANK, *supra* note 13.

18 Casey, *supra* note 14, at 1713; *see also* Baird & Jackson, *supra* note 15, at 110.

19 THE WORLD BANK, *supra* note 13, at 11, 21 (stating that "deviations from this general rule [the need to preserve pre-existing creditors' rights] should occur only where necessary to promote other compelling policies, such as the policy supporting reorganization, or to maximize the insolvency estate's value."); *see also* Casey, *supra* note 14.

otherwise legitimate enforcement rights against a defaulting debtor, or by allowing the debtor to obtain new financing or cover the expenses of the insolvency procedure with priority over pre-existing unsecured claims. These departures are generally justified on efficiency grounds, provided that—if properly designed and enforced—they do not make the affected creditors worse off (or at least not significantly so) and can improve the welfare of the collective body of creditors. Accordingly, rather than being understood as a general reordering of rights, such departures should be viewed as economically justified policy interventions that, in principle, benefit all relevant stakeholders.[20]

In the United States, the centrality of pre-bankruptcy entitlements is reflected most clearly in the *Butner* principle, under which bankruptcy courts preserve substantive rights created by non-bankruptcy law unless a specific bankruptcy policy requires a different outcome.[21] This principle underscores that insolvency law is not intended to rewrite entitlements, but rather to administer them collectively and efficiently.[22] In sum, preserving pre-bankruptcy entitlements provides a critical foundation for predictability and efficiency in insolvency law. Clear rules and respect for contractual rights remain essential to the legitimacy and effectiveness of insolvency regimes, anchoring insolvency proceedings in the private law framework that governs commercial relationships outside bankruptcy.[23]

B. *The Role and Treatment of Secured Creditors in Bankruptcy*

Security interests constitute one of the most significant—and contested—entitlements in bankruptcy. While there is long academic debate about the role of secured credit in financing firms, traditional economic accounts justify secured credit on efficiency grounds, emphasizing its capacity to reduce borrowing costs, mitigate information asymmetries, and facilitate monitoring activities and efficient risk allocation.[24] By allowing creditors to claim the value

[20] Casey, *supra* note 14; *see also* Baird & Jackson, *supra* note 15, at 110.

[21] Butner v. United States, 40 U.S. 48, 55 (1979). *But see* Casey, *supra* note 14.

[22] *See* Jackson, *supra* note 14, at 871.

[23] *Id.*

[24] *See, e.g.*, Clifford W. Smith, Jr. & Jerold B. Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 1 J. FIN. ECON. 117, 127 (1979) (suggesting that the issuance of secured debts lower borrowing costs); Bebchuk & Fried, *supra* note 10, at 876 (providing several examples on how secured credit prevents inefficient behavior involving the securing interest, such as "reduce overinvestment …. inefficient asset dilution … costs associated with default… inefficient behavior by increasing the expected cost to a borrower of violating covenants… [and] the incentive of creditors to rush for assets when a borrower begins suffering financial difficulties"). For a review of the economic literature on secured lending, see John Armour, *The Law and Economics Debate about Secured Lending: Lessons for European Lawmaking?* 1 (Ctr. Bus. Rsch., Univ.

and control the disposition of specific assets upon default, security interests are said to encourage lending and investment, particularly for firms with limited reputational capital or constrained access to unsecured credit.[25] In this view, secured credit enhances ex ante value creation and should therefore be respected ex post in insolvency.

Consistent with this logic, most insolvency regimes accord priority to secured creditors, even if the precise level of priority differs across jurisdictions.[26] In some jurisdictions, such as the United States, the protection of secured claims even extends beyond formal priority in distribution to include mechanisms such as adequate protection,[27] which aim to preserve the value of collateral during the insolvency process.[28] These protections reflect the prevailing assumption that secured creditors are entitled to be insulated, as far as possible, from the collective nature of insolvency proceedings. At the same time, many jurisdictions suspend certain pre-bankruptcy remedial rights of secured creditors, such as the right to foreclosure and immediate payment.

Despite the ubiquity of secured credit, the case for granting full priority to secured creditors has been contested. In a very influential and thought-provoking article, Professors Lucian Bebchuk and Jesse Fried challenged the conventional efficiency-based defense of secured credit by arguing that full priority often operates primarily as a redistribution mechanism rather than a value-enhancing one.[29] According to Bebchuk and Fried, secured creditors can externalize risk onto unsecured and non-adjusting creditors—such as tort victims, employees, or small trade creditors—who are unable to price or contract around increased

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Cambridge, Working Paper No. 362, 2008); Anthony J. Casey & Andrew Verstein, *Deconstructing the Secured Creditor*, *in* 11 ENCYC. L. ECON. 207, 220–21 (Adam Badawi ed., 2024).

25 George G. Triantis, *Secured Debt Under Conditions of Imperfect Information*, 21 J. LEGAL STUD. 225, 248 (1992) (noting that secured credit enables investment in valuable opportunities which would otherwise be forgone); René M. Stulz & Herb Johnson, *An Analysis of Secured Debt*, 14 J. FIN. ECON. 501, 515–17 (arguing that secured debt resolves the problem of underinvestment); *see also* Casey & Verstein, *supra* note 24, at 220–21.

26 In some jurisdictions, secured creditors are paid first. In others, however, they are paid after other creditors (typically employees). *See* GURREA-MARTÍNEZ, *supra* note 3, at 66–67, 77, 90, 102.

27 11 U.S.C. §§ 361–363.

28 Baird & Jackson, *supra* note 15, at 110.

29 Bebchuk & Fried, *supra* note 10, at 896 (arguing that the adoption of secured credit gives the borrower and secured creditor “a larger slice of the pie at the expense of nonadjusting creditors” and simultaneously “reduces the size of the total pie”); *see also* LoPucki, *supra* note 10, at 1898 (illustrating how value is diverted and risk is allocated to involuntary creditors through the grant of security); Leebron, *supra* note 10, at 1646–49 (observing that grants of security are done for the benefit of creditors at the expense of tort claimants, the phenomenon of “externalization of tort risk”).

risk.[30] Full priority may therefore encourage excessive reliance on secured borrowing without corresponding social benefits, as firms can shift downside risk while retaining the upside of investment decisions.[31]

Central to Bebchuk and Fried's argument is the claim that secured credit does not necessarily increase the size of the pie, but rather reallocates value among creditor classes.[32] Where unsecured creditors are unable to adjust ex ante, the availability of secured credit may lead to inefficient overinvestment and heightened insolvency risk.[33] Moreover, Bebchuk and Fried question the governance justification for secured credit, observing that secured creditors tend to monitor collateral value rather than firm behavior.[34] As a result, their incentives may diverge from those of the firm as a whole, particularly in situations of financial distress, where collateral-focused enforcement can undermine the reorganization of viable firms.[35]

Bebchuk and Fried's critique has generated substantial debate. Defenders of secured creditor priority argue that their analysis underestimates the dynamic and indirect benefits of secured lending, including the fact that even non-adjusting creditors may benefit indirectly from secured credit, as lower borrowing costs and improved access to finance can enhance liquidity, promote firm growth, and reduce the risk of insolvency through increased monitoring by secured creditors.[36] Others contend that unsecured creditors are not as passive

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[30] Bebchuk & Fried, *supra* note 10, at 882–95; Bebchuk & Fried, *supra* note 8, at 1295–96; *see also* Steven L. Schwarcz, *The Easy Case for the Priority of Secured Claims in Bankruptcy*, 47 DUKE L.J. 425, 429 (1997) (finding that the savings debtors enjoy from secured credit "can result in an uncompensated increase in risk to nonadjusting creditors"); LoPucki, *supra* note 10, at 1898 (illustrating how the grant of security interests diverts value away from unsecured creditors and allocates insolvency risk to involuntary and non-adjusting creditors who are unable to protect themselves contractually).

[31] Bebchuk & Fried, *supra* note 10, at 899–900 (arguing that full priority alongside the concept of limited liability enables the company "to avoid internalizing the full costs imposed on tort victims by limiting the victims' claims to the amount of the borrower's assets in bankruptcy. This leads firms to underinvest in precautions and overinvest in risky activities that externalize harm to other parties").

[32] *Id.* at 896–97 (arguing that full priority subordinates the claims of other creditors).

[33] *See id.* at 873–75.

[34] *Id.* at 878.

[35] Yair Listokin, *Is Secured Debt Used to Redistribute Value from Tort Claimants in Bankruptcy? An Empirical Analysis*, 57 DUKE L.J. 1037, 1047–48 (2008) (arguing that secured and unsecured creditors have differing interests and preferences in the event of a company's declining financial viability); Wei Zhang, *The Paradoxes of Secured Lending: Is There a Less Uneasy Case for the Priority of Secured Claims in Bankruptcy?*, 16 U. PA. J. BUS. L. 789, 797 (2014) ("Because secured creditors have priority, they tend to prefer liquidation, which entails lower risk, even if reorganization may generate greater value to all parties involved as a whole.").

[36] *See, e.g.*, Schwarcz, *supra* note 30, at 430 (arguing that "the most important form of secured debt, where lenders offer new money in return for collateral . . . tends to create value for unsecured creditors as well as for the debtor" and "the availability of new money secured credit reduces the risk that the debtor will go bankrupt by increasing a debtor's liquidity"); Steven L. Harris & Charles W. Mooney, Jr., *A Property-Based Theory of*

as Bebchuk and Fried suggest.[37] From this perspective, the critique from Bebchuk and Fried may be overstating the redistributive effects of secured credit.

Additionally, critics of Bebchuk and Fried argue that limiting secured creditor priority could increase the cost of credit, particularly for financially constrained firms, and thereby reduce investment and innovation.[38] It has also been pointed out that concerns about opportunism and externalization are better addressed through targeted regulation such as tort law, insurance requirements or even unlimited liability of shareholders towards tort claimants, rather than through a generalized erosion of the priority of secured creditors.[39]

Nevertheless, even critics of Bebchuk and Fried acknowledge that their analysis exposes important distributional and incentive-based tensions within secured credit doctrine.[40] Many insolvency systems already reflect partial accommodations of these concerns through carve-outs, super-priority rescue

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Security Interests: Taking Debtors' Choices Seriously, 80 VA. L. REV. 2021, 2030–31 (1994) (arguing that secured credit reduces the likelihood of insolvency).

[37] Robert E. Scott, *The Truth About Secured Financing*, 82 CORNELL L. REV. 1436, 1462–63 (1997) (remarking that sophisticated creditors, namely banks and finance companies, are capable of protecting themselves against secured debt through contractual measures such as fixating fees based on proportion or charging a higher interest rate); *see* Thomas H. Jackson & Anthony T. Kronman, *Secured Financing and Priorities Among Creditors*, 88 YALE L.J. 1143, 1153 (1979) (arguing that unsecured creditors are able to find compensation for transferred risk by charging higher interest rates).

[38] *See* Efraim Benmelech, *The Benefits and Costs of Secured Debt*, 16 ANN. REV. FIN. ECON. 325, 329 (2024) (noting that the "security enables smaller, riskier, and financially constrained firms to access credit markets and raise debt capital to finance their operation"). In France, it has been shown that the lower priority that secured creditors receive in bankruptcy (compared to Germany and the United Kingdom) encourages banks to require more collateral at the time of extending credit. *See* Davydenko & Franks, *supra* note 8, at 590–99.

[39] Douglas G. Baird, *Importance of Priority*, 82 CORNELL L. REV. 1420, 1429–31 (1996) (arguing that the problem of diverting value from involuntary creditors may be resolved "without any change to the law governing secured credit"); *see also* Leebron, *supra* note 10, at 1646–49 (arguing that secured creditors should only be second to tort victims); Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879, 1916–23 (1991) (arguing that the concept of limited liability should not apply to tort claims); Vincent S.J. Buccola & Joshua C. Macey, *Claim Durability and Bankruptcy's Tort Problem*, 38 YALE J. ON REGUL. 766, 769–70 (2021) (arguing that concerns about the externalization of harm onto tort victims are best addressed through targeted non-bankruptcy mechanisms—such as mandatory insurance requirements and regulatory liability—rather than through adjustments to secured creditor priority in insolvency).

[40] *See* Scott, *supra* note 37, at 1463 (acknowledging that the security often regressively redistributes wealth from the relatively poor and uninformed unsecured creditors to sophisticated secured creditors); *see also* Baird, *supra* note 39, at 1429 (recognizing that "firms can shift the risk of insolvency onto . . . involuntary creditors by granting their creditors security interests," but rejecting that the solution to this is found in a change to the priority enjoyed by secured creditors); LoPucki, *supra* note 10, at 1912 (offering insurance and the subordination of security interests to tort victims in insolvency).

financing, and limits on enforcement during reorganization.[41] These mechanisms signal an implicit recognition that full priority is not always normatively or practically optimal. This evolution, together with the need to provide greater protection to non-adjusting and weakly adjusting creditors while facilitating access to financing in cases where firms' assets are fully encumbered, helps explain the more recent scholarly skepticism toward granting secured creditors full priority in insolvency.[42]

In our view, while secured creditor priority should remain the default rule in insolvency, it should not be treated as immutable. Therefore, insolvency laws should remain open to limited and carefully justified departures from full priority, particularly where necessary to protect vulnerable or non-adjusting creditors. To be clear, departing from full priority for secured creditors may lead to an undesirable increase in the cost of credit, in the form of higher interest rates or more collateral required by banks.[43] As a result, given the importance of bank finance in most countries around the world, and especially in emerging markets and developing economies, insolvency reforms in this direction may adversely affect access to finance, job creation, and economic growth.

That said, small deviations from full priority may achieve various desirable objectives, particularly in certain market and institutional environments. For example, in jurisdictions where employees are not protected by wage guarantee funds, granting employees priority over secured creditors can reduce their losses in insolvency proceedings, given that, to some extent, both mechanisms serve as substitutes for protecting workers.[44] This, in turn, mitigates the broader economic and social harm caused by financial distress, especially in jurisdictions where labor markets are insufficiently dynamic to facilitate rapid reemployment. Similarly, for companies in industries where firms may be liable to tort victims

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41 Bebchuk & Fried, *supra* note 10, at 883 (noting that carve-outs from secured creditor priority represent an implicit acknowledgment that absolute priority is not always optimal, particularly where vulnerable creditors lack the ability to protect themselves contractually); Casey & Verstein, *supra* note 24, at 220–21 (exploring the various limitations to secured creditor rights including limits on enforcement in insolvency proceedings).

42 *See, e.g.*, R.J. de Weijs, *Secured Credit and Partial Priority: Corporate Finance as a Creation or an Externalisation Practice?*, 7 EUR. PROP. L.J. 63 (2018) (advocating for a system of partial priority for secured creditors in insolvency); Kevin E. Davis, Mariana Pargendler & Maria Eduarda Lessa, *Legal Heterodoxy in the Global South: Priority of Workers Versus Secured Creditors in Insolvency*, 74 AM. J. COMPAR. L. 1, 15–16 (2026) (justifying departures from full priority, particularly in jurisdictions with limited state capacity that lack wage guarantee funds or other mechanisms to secure the payment of workers' unpaid wages in insolvency).

43 *See* Davydenko & Franks, *supra* note 8 (showing that the worse treatment of secured creditors in France, compared to Germany and the United Kingdom, motivated French banks to require more collateral at the time of extending credit).

44 *See* Davis, Pargendler & Lessa, *supra* note 42, at 40 (arguing that "priority for workers' claims and wage guarantee funds are, to some extent, substitutes from the perspective of workers").

but are not required to have insurance, giving priority to tort claimants may reduce moral hazard and incentivize more diligent corporate behavior, as firms would be encouraged to internalize the potential costs resulting from their negligent actions.

Additionally, if partially reducing the rights or priority of secured creditors (especially banks) encourages greater monitoring of debtors and a stronger focus on the viability of companies and the investment projects they pursue, such reform may enhance the competitiveness and resilience of the financial system. Whether these benefits are ultimately realized, and whether they outweigh the potential costs of reducing secured creditors' priority, is an empirical question. In the absence of clear evidence, the most prudent rule that countries can adopt is reaffirming the rights and priority of secured creditors in bankruptcy. Nonetheless, some deviations from this rule may be justified, especially in markets and institutional environments where vulnerable creditors would otherwise remain unprotected.

C. The Principle of Equality Among Equally Situated Creditors

The principle of equality among creditors occupies a foundational yet conceptually indeterminate position in insolvency law.[45] In its canonical formulation, the principle of equality among creditors implies that equally situated creditors should receive a similar treatment in bankruptcy.[46] Professor Thomas Jackson famously defends this rule through a contractarian lens: because creditors are uncertain ex ante about whether they would be winners or losers in the future distribution of the debtor's assets if insolvency occurs and a race to collect ensues, they would rationally agree to a collective regime in which similarly situated creditors are treated equally in insolvency.[47] Such a rule would then reflect the hypothetical bargain that creditors would have reached had they had the opportunity to decide ex ante how to allocate the assets of their common debtor in the event of insolvency.[48]

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45 For a historical and critical analysis of the principle of equality of creditors, see David A. Skeel, Jr., *The Empty Idea of "Equality of Creditors"*, 166 U. PA. L. REV. 699 (2018).

46 *See id.* at 700.

47 *See* Jackson, *supra* note 14, at 865–67.

48 *See id.* at 866–67 (arguing from a contractarian perspective that because creditors cannot know ex ante the nature or priority of their future claims, they would rationally agree to a collective insolvency regime that treats similarly situated creditors equally, thus justifying the *pari passu* rule as a reflection of the hypothetical creditors' bargain). *But see* Casey, *supra* note 14, at 1716 (questioning the law's ability to reconstruct the hypothetical bargain that these creditors would reach).

On Jackson's account, the virtue of the principle of equality is not moral fairness but economic efficiency.[49] By replacing individual enforcement with collective distribution, the rule mitigates the "common pool" problem that would otherwise induce creditors to race for the debtor's assets.[50] Equal treatment among equals reduces monitoring costs, discourages inefficient liquidation, and preserves going-concern value.[51] In this sense, the principle of equality operates as a coordination mechanism that supports value maximization rather than as an intrinsic commitment to equality.[52]

However, creditors—even within the same class—may differ in aspects such as bargaining power, information, and ability to adjust terms ex ante. These differences, among others, often justify deviations from the principle of equality commonly observed in insolvency law.[53] Thus, it has been argued that the apparent clarity of, and the justifications for, the principle of equality among creditors dissolve upon closer examination.[54] Moreover, from an efficiency perspective, fights to preserve a strict commitment to equality can be costly and may ultimately reduce the value of the insolvent estate, leaving creditors worse off.[55] Deviations from the equality norm can often be justified if, for example,

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49 *See* Jackson, *supra* note 14, at 862–63, 867; *see also* Baird & Jackson, *supra* note 15, at 108 (arguing that "[h]ow a firm's assets are deployed should not turn on whether one, ten, or ten thousand people have rights in them. Bankruptcy law, accordingly, should aim to keep the asset-deployment question separate from the distributional question, and to have the deployment question answered as a single owner would answer it" such that the efficient outcome is pursued).

50 *See* Jackson, *supra* note 14, at 864–65 n.34 (explaining the "common pool" problem and how collective proceedings can mitigate it); *see also* Baird & Jackson, *supra* note 15, at 108–110 (explaining how the collective nature of bankruptcy resolves the common pool problem by preventing individual creditors from racing to seize the debtor's assets, thereby preserving the going-concern value of the firm for the benefit of all creditors).

51 *See generally* Jackson, *supra* note 14 (providing reasons as to why *pari passu* is beneficial in insolvency proceedings); Baird & Jackson, *supra* note 15, at 100–01 (showing how personal action taken by individual creditors leads to a decrease in value of the firm's assets and offering collective action as an alternative).

52 *See* Baird & Jackson, *supra* note 15, at 101–09.

53 *See* Skeel, *supra* note 45, at 742 (arguing that the concept of equality "becomes muddled" when applied to bankruptcy law, even for concepts which are widely considered to be undergirded by equality); *see also* Adrian Walters, *Preferences*, *in* VULNERABLE TRANSACTIONS IN CORPORATE INSOLVENCY 123, 133 (John Armour & Howard Bennett eds., 2003) (noting that the principle of equal treatment is not absolute, but rather is subject to exceptions such as statutory priorities, set-off rights, security interests, and other forms of priority derived from pre-existing entitlements).

54 *See* Skeel, *supra* note 45, at 744 (providing a critique of the principle of equality among creditors and arguing that "[b]ankruptcy judges, professionals, and scholars would do well to foreswear the language of equality, and direct their attention to the principles that still matter").

55 *See, e.g.*, Kenneth Ayotte & Alex Z. Huang, *Standardizing and Unbundling the Sub Rosa DIP Loan*, 39 EMORY BANKR. DEV. J. 523, 527 (2023) (describing some of the tensions often arising between maximizing value and preserving priorities); Casey, *supra* note 14, at 1728–30 (arguing that excessive adherence to formal equality among creditors can itself destroy value by generating costly disputes, and that insolvency law should focus on framework rules that facilitate efficient renegotiation rather than strict distributional equality); *see also* Skeel, *supra* note 45, at 744 (characterizing the equality norm as a "costly distraction" in bankruptcy).

they lead to more desirable outcomes for creditors and society as a whole. For instance, they may be warranted when they reduce the cost of credit, encourage monitoring, facilitate the reorganization of viable but financially distressed businesses, protect non-adjusting creditors from being expropriated by sophisticated lenders, or reduce the bargaining costs associated with reaching a value-enhancing restructuring agreement.[56] At the same time, the absence of a strong presumption in favor of equality may exacerbate some of the problems that insolvency law seeks to solve, such as opportunistic behavior, especially once a situation of insolvency threatens.[57]

In our view, the principle of equality should be understood as a default presumption of equality among creditors who are similarly situated for the relevant policy purpose. Departures from that presumption should be permitted, but only where they can be justified by clear efficiency gains or compelling distributional concerns, and where they are sufficiently transparent and predictable to allow ex ante pricing. In this sense, the principle of equality performs a disciplining function: it places the burden of justification on those who would fragment the common pool, while allowing insolvency law the flexibility necessary to maximize overall value. Viewed this way, the principle of equality neither mandates strict equality nor collapses into emptiness. Instead, it operates as an organizing norm within an efficiency-oriented insolvency framework—one that anchors collective distribution while permitting differentiated treatment where doing so enhances social welfare.

III. THE NEED TO PROTECT VULNERABLE CREDITORS IN INSOLVENCY

A. Conceptual Framework

Not all creditors are equally positioned to protect themselves against insolvency risk. Sophisticated lenders can adjust contract terms, demand security, or price risk through interest rates. By contrast, non-adjusting creditors—such as tort victims—and weakly adjusting creditors—such as employees and small suppliers—often lack meaningful opportunities to protect themselves ex ante. These creditors are particularly vulnerable to the redistributive effects of priority rules.

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56 *See generally* Casey, *supra* note 14 (identifying the circumstances under which departures from strict equality among creditors are economically justified, including where they lower borrowing costs, facilitate reorganization of viable firms, protect non-adjusting creditors from exploitation by sophisticated lenders, and reduce the transaction costs of reaching resolution in a reorganization).

57 *See* JACKSON, *supra* note 1, at 10.

Against this background, we believe that vulnerable creditors require special protection in insolvency proceedings—arguably to a greater extent than is currently provided in most jurisdictions. The challenge lies in identifying the most appropriate mechanisms to deliver that protection. Granting priority in bankruptcy is one possible approach, but it is neither the only one nor likely the first-best solution. Alternative mechanisms often observed across jurisdictions include exclusion from insolvency proceedings, exemption from the automatic stay, administrative expense status (a form of priority), or protection through non-insolvency law. Each mechanism involves trade-offs between creditor protection and the value-maximizing goals of insolvency law. Granting priority to vulnerable creditors often serves as a second-best solution, justified primarily where superior alternatives are unavailable (often because of local politics, culture, or institutions) or can lead to inferior outcomes. The following sections explore this proposition in greater depth, focusing specifically on the treatment and protection of two categories of vulnerable creditors: employees and tort victims.

B. Employees

Employees occupy a distinctive position in insolvency as creditors who are both economically vulnerable and structurally unable to adjust ex ante.[58] These features result from two primary factors. First, unlike other creditors, an employee's investment in a job is undiversified—that is, most (if not all) of an employee's income depends on the firm that employs them.[59] Second, employees are generally subject to information asymmetries and possess limited bargaining power at the time of contracting.[60] Together, these characteristics render employees paradigmatic examples of vulnerable creditors and explain why many insolvency regimes grant priority, or some other form of favorable treatment, to employees' claims in insolvency proceedings.[61]

From an economic perspective, the priority of employee claims raises a core problem of risk allocation. Insolvency reallocates losses among stakeholders

[58] *See* Arturo S. Bronstein, *The Protection of Workers' Claims in the Event of the Insolvency of Their Employer: From Civil Law to Social Security*, 126 INT'L LAB. REV. 715, 715–16 (1987); Bebchuk & Fried, *supra* note 10, at 908; Davis, Pargendler & Lessa, *supra* note 42, at 15–16.

[59] Federico M. Mucciarelli, *Employee Insolvency Priorities and Employment Protection in France, Germany, and the United Kingdom*, 44 J. L. & SOC'Y 255, 264 (2017) ("Employees are in a particularly vulnerable position since their investment is firm-specific and undiversified.").

[60] Bebchuk & Fried, *supra* note 10, at 885–87.

[61] *Id.*; *see also* Bronstein, *supra* note 58, at 716 (finding that the employee's "particularly disadvantageous and precarious position" provides compelling reason for "most national legislations [to establish] . . . special methods for protecting service-related claims in the event of the employer's insolvency").

when firm-specific risk materializes.[62] If employees bear these losses in full, their vulnerable position would lead to various economic and social costs.[63] At the same time, protecting employee claims through insolvency priority necessarily shifts risk onto other creditors, particularly sophisticated lenders, with potential consequences for credit pricing, capital structure, and investment decisions.[64] The challenge is to allocate insolvency risk to the parties best able to bear, manage, and price it.

Comparative insolvency law reflects divergent solutions to this problem. In many European countries, employee protection is largely externalized through wage guarantee schemes.[65] These systems provide employees with prompt payment of unpaid wages up to a statutory cap and subrogate the guarantor—typically a public or quasi-public fund—to the employee's insolvency claim.[66] As such, since workers' unpaid salaries—at least to a certain extent—are covered by a wage guarantee fund, the priority of employees' claims in insolvency proceedings would be less justified. For that reason, it is not surprising that in some countries with wage guarantee funds, such as Germany, employees' claims do not enjoy a priority in bankruptcy.[67] Because sophisticated lenders in that system are able to price credit without accounting for large, uncertain employee super-priority, it has been argued that this model tends to support predictable credit markets.[68] On the other hand, one might question that

[62] Barry E. Adler, *Bankruptcy and Risk Allocation*, 77 CORNELL L. REV. 439, 440 (1992) (stipulating that bankruptcy "in this way alters contractual priorities effectively reallocates among investors the risk of business insolvency").

[63] *See* Bronstein, *supra* note 58, at 716 (emphasizing the "disadvantageous and precarious" positions of employees if their employers become insolvent).

[64] *See* Li Guoqiang, *The Establishment of Limited Priority of Workers' Claims in the Enterprise Bankruptcy Law of China*, *in* ASIAN INSOLVENCY SYSTEMS: CLOSING THE IMPLEMENTATION GAP 169, 171 (2007) (arguing that super priority "might force financial institutions to increase their interest rates and to withhold lending" causing "hurt [to] struggling enterprises, and affect, directly or indirectly, the long-term interests of workers").

[65] *See* Davis, Pargendler & Lessa, *supra* note 42, at 40 (observing that wage guarantee funds are common amongst European jurisdictions and serve as "an alternative to elevated priority in insolvency as a means of compensating unpaid workers").

[66] *See* Bronstein, *supra* note 58, at 725 (explaining the origins and operation of wage guarantee funds).

[67] *See* Gordon W. Johnson, *Insolvency and Social Protection: Employee Entitlements in the Event of Employer Insolvency*, *in* ASIAN INSOLVENCY SYSTEMS: CLOSING THE IMPLEMENTATION GAP 228 (Org. Econ. Co-operation Dev., 2007); Eidenmüller, *supra* note 3, at 36–37.

[68] Johnson, *supra* note 67, at 227–28 (observing that the German approach provides one of the most predictable systems for creditors whereas models exclusively relying on bankruptcy priority, and particularly those where employees are paid ahead of secured creditors, undermine "the fundamental principle of secured creditors' rights and increases the insolvency risk in commercial relationships" without significantly enhancing "protection of workers' entitlements").

logic. After all, sophisticated lenders are in the business of pricing risks, and a clear rule of priority for employees should not be difficult to price.

In other jurisdictions, such as the United States, employee wage claims receive a small priority boost through capped priority (where the cap is very low) above general unsecured creditors but below secured claims.[69] Moreover, broader income protection is provided through unemployment insurance and labor law rather than bankruptcy.[70] This model reflects an implicit judgment that insolvency law *should* provide limited, targeted protection to employees without substantially undermining secured credit.

Other jurisdictions rely on more intensive insolvency solutions for the protection of employees, or even a combination of insolvency-based protections and a wage guarantee fund. For example, in France, employees are paid ahead of secured creditors.[71] Additionally, there is a wage guarantee fund covering (up to certain limits) the employees' unpaid salaries.[72] Therefore, for salaries not exceeding the amount covered by the wage guarantee fund, in practice, the super priority ultimately benefits the state rather than the employees themselves. Spain adopts a similar regime, combining a system of priority in the ranking of claims and a wage guarantee fund.[73] However, while employees' claims rank ahead of unsecured creditors,[74] and part of their unpaid wages (up to certain limits) for the 30 days preceding the commencement of insolvency proceedings is treated as an administrative expense,[75] employees are not paid ahead of secured creditors.[76]

In various emerging markets from Asia and Latin America, employees' unpaid salaries are not covered by any type of wage guarantee fund. Instead, the protection of employees has been entirely left to insolvency law.[77] For that

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[69] *See* 11 U.S.C. § 507(a)(4) (establishing the position of employees in the order of repayment). It is worth noting that the low cap on these claims makes it somewhat inconsequential in many large bankruptcies.

[70] *See* Bronstein, *supra* note 58, at 725–26 (noting that in U.S.-style systems, social security and labor law provide the primary safety net for employees, with insolvency law playing only a supplementary role).

[71] *See* Eidenmüller, *supra* note 3, at 36–37; Davis, Pargendler & Lessa, *supra* note 42, at 18–21.

[72] CODE DU TRAVAIL [C. TRAV.] [Labor Code] art. L.3253-1 & 3253-2 (Fr.).

[73] Spanish Workers' Statute (Estatuto de los Trabajadores) art. 33 (R.D.L. 2015, 255) (Spain) (providing the details of the wage guarantee fund in the event of the employers' insolvency); Spanish Insolvency Act 2020, art. 242-1.2.º & 280-1.º (B.O.E. 2020, 127) (Spain) (providing different types of priority for workers' claims).

[74] *See* Spanish Insolvency Act 2020, art. 280-1.º (B.O.E. 2020, 127) (Spain).

[75] *See* Spanish Insolvency Act 2020, art. 242-1.2.º (B.O.E. 2020, 127) (Spain).

[76] *See* Spanish Insolvency Act 2020, arts. 242-1.2.º, 280-1.º & 429–440 (B.O.E. 2020, 127) (Spain).

[77] Davis, Pargendler & Lessa, *supra* note 42, at 41 (noting that the implementation of the effective wage guarantee funds requires state capacity and entails the burden of securing financing and ensuring that the fund is administered competently, and also arguing that the lack of wage guarantee funds in the Global South could

reason, the insolvency responses have generally been more aggressive. For example, in India and Brazil, employee wage claims are paid ahead of secured creditors.[78] In other countries, such as Ecuador and Mexico, employees are not even subject to the automatic stay.[79] Some authors have shown that such strong insolvency protections are more prevalent in the Global South, justifying them on the limited state capacity of some of these countries, which makes it difficult for them to provide alternate solutions such as a wage guarantee fund.[80]

In our view, the most effective solution for protecting employees' claims is the coverage of unpaid wages through a wage guarantee fund. Nonetheless, the optimal adoption of that solution would require subjecting the coverage to appropriate limits. Imposing a cap on coverage is justified on the grounds that higher salaries are typically earned by more highly qualified employees, who can reasonably be expected to possess greater information, bargaining power, and ability to assess firm risk at the time of contracting. Such employees often have the ability to partially diversify their risk by investing their accumulated wealth in other places. For such employees, the contracting failure that underpins special protection in insolvency is therefore less likely to exist. Moreover, higher-paid employees are often more skilled and thus better positioned to secure alternative employment, reducing the need for paternalistic intervention. Thus, extending full protection to high salaries may generate moral hazard and impose disproportionate fiscal costs that are difficult to justify. For these reasons, wage guarantee schemes should be capped, and senior executives should be excluded altogether, as they are best characterized as adjusting creditors rather than vulnerable employees.

Where such targeted wage guarantee funds exist, vulnerable employees are more effectively protected than under any insolvency-based priority mechanism, as their claims are satisfied irrespective of the debtor's financial condition. At the same time, this approach avoids distorting the core function of insolvency law, which is (or should be) to minimize the destruction of value while facilitating the efficient allocation of the debtor's assets. By externalizing redistribution away from insolvency proceedings, wage guarantee schemes allow insolvency law to focus exclusively on its primary function—a function

be attributed to the "states' relatively limited capacity to implement wage guarantee funds" and their "large informal sectors").

78 *Id.* at 29–32.

79 Ley de Concurso Preventivo [Law on Preventive Restructuring], art. 23 (2006) (Ecuador); Ley de Concursos Mercantiles [LCM], art. 65,

80 *See* Davis, Pargendler & Lessa, *supra* note 42, at 40.

that, if effectively performed, can enable insolvency law to serve as a catalyst for economic growth.[81]

That said, wage guarantee funds are not costless. They require financing, typically through contributions from employers, the state, or both. Therefore, whether such schemes are overall more efficient than purely insolvency-based solutions is ultimately an empirical question. In terms of effectiveness, however, wage guarantee funds represent superior options to insolvency solutions for the protection of employees.

Not all jurisdictions, however, possess the institutional capacity or fiscal space necessary to adopt such schemes.[82] Accordingly, some countries may need to rely on alternative approaches, including protections embedded in insolvency law, to safeguard employees. If such approach is adopted, however, countries need to be aware of their potential costs. For example, granting employees priority over secured creditors may induce lenders to respond by increasing the cost of credit, demanding additional collateral, tightening lending conditions in order to protect their security interests, or in extreme cases, leaving the market altogether. Thus, it may end up harming firms' access to finance, thereby adversely affecting employees by reducing the financing of projects and companies on which they might be employed.

Alternative insolvency-based mechanisms may generate other costs. For instance, excluding employee claims from the automatic stay, which is another solution observed in various jurisdictions, may allow workers to pursue enforcement actions that disrupt the restructuring of otherwise viable firms. This, in turn, may undermine the value-maximizing goals of insolvency law and lead to the liquidation of firms that could have been preserved as a going concern. As a result, this mechanism for protecting employees may prove counterproductive, paradoxically harming employees—by leading to the inefficient liquidation of viable firms and, consequently, to the loss of their jobs—while also making society and the general body of creditors worse off.

In sum, comparative experience suggests that there is no single "best" approach to employee protection in insolvency. In economies with deep credit markets, strong fiscal capacity, and good institutional environments, external wage guarantee schemes appear preferable to insolvency-based solutions. While their relative efficiency remains an empirical question, such schemes are clearly more effective in protecting employees and less disruptive to the proper

81 *See* GURREA-MARTÍNEZ, *supra* note 3, at 4–10.
82 *See* Davis, Pargendler & Lessa, *supra* note 42, at 40.

functioning of insolvency law. By contrast, in jurisdictions characterized by limited state capacity and high labor precarity, enhanced insolvency priority for employees may serve as a pragmatic, albeit imperfect, mechanism for the protection of employees. From a policy perspective, the primary takeaway from this section is that employees deserve special protection of some sort. Whether such protection is best achieved through insolvency-based solutions (including priority) or through alternative mechanisms is a separate question. The appropriate answer to that question is generally context-specific and therefore may vary across jurisdictions.

C. Tort Victims

Tort victims are among the clearest examples of non-adjusting creditors in insolvency. Their claims arise involuntarily, often as a result of injury or product defects, and they generally cannot price, negotiate, or otherwise manage the associated risk ex ante.[83] Unlike other creditors, tort victims are unable to diversify exposure or influence firm behavior prior to harm.[84] Despite their non-adjusting status, most insolvency systems treat tort claims as ordinary unsecured claims.[85] One of the countries that has deviated from this general solution is Spain, where tort victims are granted priority in the ranking of claims.[86]

The question of how best to protect tort victims depends in part on the availability and effectiveness of alternative mechanisms for risk internalization. Where firms are required to maintain mandatory liability insurance covering potential harm to tort victims, insolvency-based priority may be redundant or economically inefficient. Insurance spreads losses across firms over time, mitigating the social costs of insolvency without altering priority rules in insolvency.[87] While insurance can provide effective protection to tort victims, coverage is often insufficient in certain cases. In other cases, firms—particularly

83 *See* Bebchuk & Fried, *supra* note 8, at 1297 (categorizing tort creditors as non-adjusting creditors who cannot adjust their claims to account for security interests); Bebchuk & Fried, *supra* note 10, at 882–83; Eidenmüller, *supra* note 3, at 36 (observing that tort creditors are unable to adapt in response to the debtor's existing credit transactions). In some cases, they can adjust by choosing not to buy product from certain firms, but such adjustment is not likely common because torts are often unpredictable and often the harm affects even those who do not have a relationship with the firm.

84 *See* Bebchuk & Fried, *supra* note 10, at 882–83 (noting that tort claims "arise when private parties are injured by the firm, and their claims exceed the firm's insurance coverage limits at the time the firm goes bankrupt").

85 *See* Anthony J. Casey, Aurelio Gurrea-Martínez & Robert K. Rasmussen, *A Commitment Rule for Insolvency Forum*, 4 U. CHI. BUS. L. REV. 51, 62 n.22 (2025).

86 *See* Spanish Insolvency Act 2020, arts. 242.1-1.º & 280-5.º (B.O.E. 2020, 127) (Spain).

87 *See* S. Shavell, *The Judgment Proof Problem*, 6 INT'L REV. L. & ECON. 45, 55 (1986) (proposing mandatory insurance for the protection of tort victims).

small businesses—may lack insurance altogether. Moreover, insurance is not costless. Thus, mandating or relying heavily on insurance can increase the cost of doing business and may, in turn, exacerbate the problem of informality observed in many countries, particularly in emerging markets and developing economies.

In contexts where tort risks are incompletely internalized, insolvency law can provide an alternative mechanism to protect tort victims.[88] Moreover, granting priority to tort claims can reduce the ability of firms to externalize harm onto victims, thereby improving ex ante incentives for risk management.[89] From an economic perspective, the trade-offs are clear. Elevating tort victims' claims may correct externalities and partially remedy failures in ex ante contracting.[90] Yet such priority can also increase the cost of capital for firms, as sophisticated lenders may respond by demanding higher interest rates.[91] Conversely, failing to provide adequate compensation may produce negative social consequences, including moral hazard for firms, opportunistic behavior by creditors who might enrich themselves at the expense of non-adjusting creditors, and the persistence of uncorrected contracting failures that can lead to an undesirable outcome for tort victims.[92]

These considerations indicate that the efficient treatment of tort victims depends on the interplay between insolvency law, regulatory institutions, and broader social safety nets. Priority should not be automatic but calibrated to the presence of ex ante risk management mechanisms, the nature of the claims, and the institutional context in which the firm operates. Therefore, while granting priority can serve as an ex post corrective to a contracting failure, alternative mechanisms—such as mandatory adequate insurance coverage—may achieve

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88 For example, some scholars have advocated for tort claimants to receive priority treatment in bankruptcy, allowing them to be paid ahead of secured creditors. *See, e.g.*, Kathryn R. Heidt, *Cleaning Up Your Act: Efficiency Considerations in the Battle for the Debtor's Assets in Toxic Waste Bankruptcies*, 40 RUTGERS L. REV. 819, 851–62 (1988) (discussing the use of superliens and other mechanisms for granting priority to states with toxic tort claims against debtors); Leebron, *supra* note 10, at 1643–49; Christopher M.E. Painter, Note, *Tort Creditor Priority in the Secured Credit System: Asbestos Times, the Worst of Times*, 36 STAN. L. REV. 1045, 1080–82 (1984).

89 *See* Leebron, *supra* note 10, at 1650 (arguing that giving tort claimants priority over secured and unsecured creditors reduces negative externalities and inefficiencies).

90 *See id.* at 1643–44.

91 *See* Paul M. Shupack, *Solving the Puzzle of Secured Transactions*, 41 RUTGERS L. REV. 1067, 1100–01 (1989) (arguing that other creditors can adjust their loans upwards to account for super-priority given to tort claims); LoPucki, *supra* note 10, at 1909–10.

92 *See* Leebron, *supra* note 10, at 1650.

the same social objectives, sometimes more effectively.[93] The most appropriate solution depends on the particular features of a country. For instance, in jurisdictions where tort victims are adequately protected through insurance or alternative mechanisms, treating tort claims as ordinary unsecured claims may be sufficient. By contrast, in institutional environments where such protection is absent or inadequate, granting tort victims priority in insolvency proceedings may operate as a pragmatic second-best solution.[94]

IV. THE UNEASY CASE FOR PREFERRING TAX AUTHORITIES (AND MORE GENERALLY THE PUBLIC SECTOR) IN INSOLVENCY PROCEEDINGS

The preferential treatment of tax authorities and other public creditors represents one of the most controversial aspects of insolvency law.[95] Tax claims are often treated as having priority over other unsecured claims, reflecting a perceived need to protect public revenues and ensure the continued functioning of the state.[96] This treatment is frequently justified on the grounds that tax authorities are "non-adjusting" creditors: unlike private creditors, they are unable to negotiate the terms of their claims.[97] Yet this characterization is

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[93] *See* LoPucki, *supra* note 10, at 1906–07 (proposing that mandatory insurance schemes could serve as alternatives to affording priority to tort claims, but noting that the effectiveness of insurance schemes is limited to the extent of the insurance's coverage).

[94] Complicating matters further, the amount of a tort victims claims will vary dramatically across jurisdictions. While the U.S. generally provides little by way of priority protection, the awards to tort victims are larger than those awarded in other jurisdictions by a huge margin. *See* Stephen D. Sugarman, *A Comparative Law Look at Pain and Suffering Awards*, 55 DEPAUL L. REV. 399, 399 (2006) (noting that the U.S. is "enormously more generous" in its awards to injured victims and that the sums awarded are "unheard of elsewhere"). This has a similar effect to boosting the priority of tort victims.

[95] *See* Irving Aw, Brendan Crowley & José M. Garrido, *Should Tax Be King? The Debate over Tax Priority in Insolvency* 5, 7 (Int'l Monetary Fund, Working Paper No. 118, 2025); *see also* F.H. Buckley, *The Bankruptcy Priority Puzzle*, 72 VA. L. REV. 1393, 1412–15 (1986) (examining the theoretical justifications for tax priority in bankruptcy and finding them largely unpersuasive, arguing that the case for granting government claims preferential treatment rests on weak empirical and normative foundations); Barbara K. Morgan, *Should the Sovereign Be Paid First? A Comparative International Analysis of the Priority for Tax Claims in Bankruptcy*, 74 AM. BANKR. L.J. 461, 463–69 (2000) (surveying the treatment of tax priority across multiple jurisdictions and assessing the justifications offered for preferential treatment of government tax claims in insolvency). *See generally* Shu-Yi Oei, *Taxing Bankrupts*, 55 B.C. L. REV. 375, 375–76 (2014) (analyzing the interaction between tax law and bankruptcy and arguing that the priority afforded to tax claims can generate significant distortions in creditor behavior and distributional outcomes in insolvency proceedings).

[96] *See* Aw, Crowley & Garrido, *supra* note 95, at 4, 13–14, 19–20.

[97] *See* Bebchuk & Fried, *supra* note 10, at 896 (explaining why tax authorities are non-adjusting creditors); Aw, Crowley & Garrido, *supra* note 95, at 20–25 (explaining why taxpayers, and by that extension, tax authorities, are involuntary creditors lacking the high level of economic and bargaining power that unsecured creditors have, but highlighting the ineffectiveness of existing tax priority regimes in preventing the shifting of costs from private secured and priority creditors onto lower-income taxpayers).

misleading.[98] Governments possess extensive enforcement powers, access to superior information, and the capacity to diversify risk across large tax bases.[99] They also have the power to adjust tax rates on risky firms through legislation. Moreover, unlike private creditors, they can draw on alternative sources of finance, such as sovereign borrowing, or adjust future tax obligations, which raises questions about whether additional protections in insolvency are truly necessary.[100]

Comparative evidence shows that the treatment of tax claims varies significantly across jurisdictions, with advanced economies exhibiting a clear trend toward curtailing or abolishing statutory tax priorities.[101] Empirical studies suggest that such priorities contribute little to overall public revenue while imposing disproportionate costs on other creditors, particularly small businesses that rely on prompt repayment to maintain liquidity.[102] In emerging economies, where institutional weaknesses can hamper the efficient allocation of resources from the public sector, tax priorities are even less justified.[103] Thus, by protecting the state's claims at the expense of private creditors, tax priorities may inadvertently undermine broader social and economic objectives.[104]

Beyond these structural considerations, advocates of tax priority argue that granting preferential treatment signals the importance of tax compliance, encourages debtors to meet their obligations, and safeguards public revenue.[105] Yet, there is limited empirical evidence demonstrating that tax priorities meaningfully increase the amount recovered by the state or deter defaults and

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98 *See* Aw, Crowley & Garrido, *supra* note 95, at 20 (noting that "tax authorities can often use the same instruments as private creditors and obtain the treatment of secured creditors by recording liens over the debtor's assets").

99 *See* Jacob S. Ziegel, *Preferences and Priorities in Insolvency Law: Is There a Solution?*, 39 ST. LOUIS U. L.J. 793, 801–02 (1995); Aw, Crowley & Garrido, *supra* note 95, at 24; Buckley, *supra* note 95, at 1412; Roy Babitt & Susan Freiman, Comment, *The Priority of Federal Claims: Selected Problems and Theoretical Considerations*, 24 CASE W. RSRV. L. REV. 521, 553 (1973). *But see* Oei, *supra* note 95, at 411–33 (describing limitations on governments' ability to diversify risk).

100 *See* Aw, Crowley & Garrido, *supra* note 95, at 20–25; *see also* William T. Plumb, Jr., *Federal Liens and Priorities—Agenda for the Next Decade*, 77 YALE L.J. 228, 244 (1967) (arguing that states, as opposed to private creditors, are better equipped to self-insure against the cost of debtor insolvency as states "draw[] [their] revenue from the entire population").

101 *See* Aw, Crowley & Garrido, *supra* note 95, at 7, 37–44, 46 (observing that in recent times, various jurisdictions have curtailed or abolished statutory preferential status for tax debt).

102 *See* Buckley, *supra* note 95, at 1415 (arguing that subordinating creditor claims below state claims unduly shifts the burden of monitoring tax payment onto creditors, resulting in deadweight efficiency losses arising from information costs); *see also* Aw, Crowley & Garrido, *supra* note 95, at 25–28.

103 *See* GURREA-MARTÍNEZ, *supra* note 3, 233–34.

104 *See* Aw, Crowley & Garrido, *supra* note 95, at 25–28.

105 *See* Babitt & Freiman, *supra* note 99, at 554; Aw, Crowley & Garrido, *supra* note 95, at 22.

evasion.[106] In many cases, the existence of a statutory priority does not guarantee recovery if the debtor is deeply insolvent.[107] The potential harm to private creditors, by contrast, is more readily observable.[108] Indeed, tax priorities distort the traditional ranking of claims in insolvency, often reducing recoveries for other unsecured creditors and creating inefficiencies in monitoring and collection.[109] This effect is particularly pronounced for small businesses, which typically have limited access to external financing and are more sensitive to cash flow disruptions.[110] By contrast, the government can raise funds through taxes or sovereign borrowing, mechanisms that are unavailable to private creditors.[111] The unequal consequences of tax priorities thus raise fundamental questions about equity and efficiency in insolvency law, especially in contexts where private actors are economically vulnerable.[112]

Emerging economies illustrate these tensions most clearly. In jurisdictions where public institutions are less effective, maximizing recoveries for tax authorities does not necessarily translate into improved social welfare.[113] The additional resources recovered by the state may be inefficiently used or fail to reach the broader population.[114] In such environments, allowing private creditors—particularly small firms—to recover more from insolvent estates may

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106 *See* Aw, Crowley & Garrido, *supra* note 95, at 26.

107 *See id.*

108 *See id.* at 27–28; Thomas C. McNally III, *Federal Tax Lien Priority: An Injustice to Creditors*, 14 HASTINGS L.J. 52 (1962); Plumb, *supra* note 100, at 244 (arguing that the government is better placed to self-insure its risks compared to private parties "for some of whom the failure of even a single major debtor may be ruinous").

109 Aw, Crowley & Garrido, *supra* note 95, at 25; *see also* Jack F. Williams, *National Bankruptcy Review Commission Tax Recommendations: Individual Debtors, Priorities, and Discharge*, 14 [EMORY] BANKR. DEV. J. 1, 51 (1997) (highlighting that "favored treatment accorded tax claims also increases general creditor disenchantment with the entire bankruptcy process").

110 *See* Morgan, *supra* note 95, at 466 n.14 (providing the argument that private creditors would face far greater hardship than the government); Frances R. Hill, *Toward a Theory of Bankruptcy Tax: A Statutory Coordination Approach*, 50 TAX LAW. 103, 150–51 n.216 (1996); *see also* Australian Law Reform Commission, *General Insolvency Inquiry* (Report No 45, 1988) 301 ("Taxation debts of insolvents are insignificant in terms of total government receipts but the amount forgone by a private creditor may be the difference between the creditor surviving or failing . . . . The net loss to the Commissioner from the abolition of the priority would be insignificant.").

111 *See* Plumb, *supra* note 100, at 244.

112 Law Commission *Priority Debts in Distribution of Insolvency Estates: An Advisory Report to the Ministry of Commerce* (NZLC SP2, 1999), at 31 (N.Z.), https://www.nzlii.org/nz/other/nzlc/sp/SP2/SP2.pdf (acknowledging the argument that it is "unfair for the Commissioner to have a priority over other unsecured creditors because […] the provisions of the Tax Administration Act 1994 and other revenue statutes provide the Crown with remedies that facilitate the collection of debts, whereas similar procedures are not available to ordinary unsecured creditors").

113 *See* GURREA-MARTÍNEZ, *supra* note 3, at 234.

114 *See id.*

generate greater social and economic benefits, including preserving jobs, sustaining local economies, and ultimately supporting broader tax collection through increased economic activity.[115] From this perspective, the preferential treatment of tax authorities may serve the narrow and short-term interests of the state at the expense of overall economic welfare and the long-term interests of all stakeholders including the state.

The limited empirical data on the effects of tax priorities compounds the difficulty of resolving this debate.[116] It has been argued that measuring the actual gains obtained by tax authorities through priority claims, and comparing these to potential recoveries for other creditors if tax priorities were abolished, would provide critical insight.[117] Similarly, understanding the behavioral responses of debtors and other creditors to tax priorities would allow policymakers to assess whether such rules achieve their intended objectives or merely redistribute losses.[118] In practice, however, such data are rarely collected systematically, leaving policy decisions grounded largely in theoretical arguments and anecdotal evidence.[119]

Despite the intensity of these debates, evidence from jurisdictions that have abolished tax priorities suggests that the fiscal impact is often minimal.[120] Public finance systems have not generally suffered as a result of eliminating statutory tax priority, indicating that the amounts at stake are relatively small in the context of total government revenue.[121] At the same time, these amounts can be significant for private creditors, particularly small firms, whose recoveries may mean the difference between survival and insolvency. This asymmetry highlights a fundamental tension in insolvency policy: the interests of the state are not always aligned with those of private creditors or broader social welfare.

Thus, while tax authorities often enjoy preferential treatment in insolvency proceedings, the traditional rationales for such priority are difficult to justify. Governments have resources, enforcement tools, and alternative mechanisms to secure revenues that private creditors lack. The state is rarely a vulnerable party in need of protection, whereas small private creditors often are. Moreover, in

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115 *See id.*

116 *See* Aw, Crowley & Garrido, *supra* note 95, at 18 (noting that "it is difficult to find statistics on the average recovery rates in insolvency for different classes of creditors, and most tax authorities do not publish information on the recoveries made through insolvency").

117 *See id.* at 6.

118 *See id.* at 19.

119 *See id.*

120 *See* Morgan, *supra* note 95, at 466.

121 *See id.*

countries with weak institutional environments and problems of corruption, maximizing recovery for the state may generate fewer social benefits than improving recoveries for private actors. For these reasons, the preferential treatment of tax authorities should be reconsidered, and likely abolished. In our view, providing equal treatment to public and private creditors and increasing recoveries for the latter—given the absence of priority for the former—may offer a more desirable outcome, especially in the context of countries with weak institutional environments and inefficient public sectors.

Finally, it should be noted that public-sector creditors can sometimes be favored through mechanisms other than priority, such as being exempted from the moratorium or not being bound by a restructuring plan. Some of these mechanisms that exempt public creditors from the general rules governing insolvency proceedings have been discussed in the context of employees. However, with employees, it has been argued that several factors—including their weaker bargaining power and limited information, which create the need for ex post correction of an ex ante contracting failure—place them in a vulnerable position that requires regulatory intervention to protect them, whether through insolvency-based mechanisms or, ideally, through alternative measures such as wage guarantee funds. Such vulnerability, however, does not exist with public creditors.

As noted above, tax authorities might sometimes be considered "non-adjusting creditors" from a narrow perspective—that is, if non-adjusting creditors are understood simply as those who do not negotiate and adjust the terms of their claims. From a broader perspective, however, they are not: they generally have access to information, resources, legislative changes to tax rates, legal actions, and administrative tools that put them in a very privileged position. Accordingly, we see no convincing reason to exempt tax authorities or other public creditors from the general rules governing insolvency proceedings, such as the need to be subject to a moratorium, or the ability to accept (if it is voluntary) or being bound by (if it is involuntary) a restructuring plan. In fact, such exceptions may create greater costs than simply granting public creditors a priority in the ranking of claims. If public creditors enjoy a priority, the primary cost is the corresponding reduction in recoveries for other creditors. However, if they are exempted from the moratorium or are not bound by a restructuring plan, the consequences can be even more severe. For example, if public creditors use these powers to seek full repayment, other creditors would be worse off, as happens when public creditors enjoy a priority. Additionally, if the debtor is unable to pay the public creditors due to liquidity constraints or any other reasons, the possibility of being subject to legal actions initiated by public creditors can destroy a potentially viable firm. Therefore, if a priority in the ranking of claims is not generally justified for public creditors, there is a strong case for subjecting public creditors to the same moratorium and other general rules applicable to private creditors.

V. THE PRIORITY OF NEW FINANCING: FOUNDATIONS, LIMITS AND POLICY DESIGN

A firm's insolvency significantly constrains its ability to access external finance, placing viable but financially distressed firms at risk of ceasing operations and foregoing value-creating investment opportunities.[122] This situation can lead to a loss of value not only for the firm's creditors but also for a variety of stakeholders and society at large.[123] To address this problem, many jurisdictions have adopted regimes of debtor-in-possession ("DIP") financing that, in essence, encourage lenders to extend financing to insolvent firms by providing them with various forms of priority that, while varying across jurisdictions, may include administrative expense priority, new or junior liens, senior liens, and an administrative expense priority over other administrative expenses.[124] By doing so, it has been convincingly argued that insolvency law can function as a "liquidity provider" for insolvent firms, enabling them to continue operations and pursue value-creating projects.[125]

The rationale for DIP financing rests on several economic and practical considerations. First, when a firm becomes insolvent, its counterparties—employees, suppliers, and creditors—may have incentives to terminate relationships even if the firm remains economically viable.[126] Without mechanisms to maintain these relationships by ensuring that new debts and expenses will be paid, firms risk losing value or becoming non-viable. Second, the inability to secure new financing can prevent firms from undertaking investment projects with positive net present value, creating an underinvestment

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[122] *See generally* Kenneth Ayotte & Aurelio Gurrea-Martínez, *The Promise and Perils of Debtor-in-Possession Financing: Lessons from the United States,* 21 INT'L CORP. RESCUE 309 (2024) (highlighting the risks and challenges associated with DIP financing systems).

[123] *See* Aurelio Gurrea-Martínez, *Debtor-in-Possession Financing in Reorganisation Procedures: Regulatory Models and Proposals for Reform*, 24 EUR. BUS. ORG. L. REV. 555, 556 (2023).

[124] *See generally id,* (providing a comparative overview of the various regulations adopted for DIP financing).

[125] *See generally* Kenneth Ayotte & David A. Skeel Jr., *Bankruptcy Law as a Liquidity Provider*, 80 U. CHI. L. REV. 1557 (2013) (arguing that bankruptcy law serves a liquidity-providing function by enabling financially distressed firms to obtain financing and avoid value-destroying liquidation).

[126] Gurrea-Martínez, *supra* note 123, at 556.

problem.[127] In particular, shareholders may be disincentivized to finance new investments if the benefits are likely to accrue to pre-petition creditors while they bear the associated risks.[128] Third, insufficient access to financing may reduce creditor recoveries if a viable firm ends up in a piecemeal liquidation, potentially increasing the cost of credit ex ante.[129] Fourth, the provision of new financing can serve as a market signal, demonstrating lender confidence in the firm's viability and encouraging other stakeholders to continue engagement.[130] Finally, DIP financing can improve corporate governance, as lenders may impose conditions that, in certain circumstances, may enhance managerial efficiency and support successful reorganization.[131]

Despite these benefits, DIP financing regimes carry inherent risks. One particularly significant risk is that granting priority to DIP lenders may reduce recoveries for pre-existing unsecured creditors if the new financing fails to create, or at least preserve, value.[132] Additionally, priming existing liens, as they are allowed in certain jurisdictions such as the United States, Singapore, and Malaysia, can dilute secured creditors' rights and may lead to an undesirable increase in the cost of credit.[133] Finally, when new financing is obtained by non-viable firms, a system of DIP financing may contribute to delaying the shutdown of such businesses, destroying value during the interim and hampering the efficient reallocation of resources.[134] Moreover, distinguishing between value-enhancing and value-destroying DIP loans is inherently challenging.[135] Therefore, even independent and sophisticated courts and insolvency practitioners can make decisions that may ultimately reduce creditor recoveries. This is particularly true because approval of DIP financing must, in most cases, occur early in the proceedings and on the basis of very limited information.

Given these considerations, while adopting rules that grant priority to new lenders should generally be regarded as a desirable policy, the design of DIP financing provisions should be tailored to the particular features of a country.

[127] *Id.* at 557.
[128] *Id.*
[129] *Id.*
[130] Fayez A. Elayan & Thomas O. Meyer, *The Impact of Receiving Debtor-in-Possession Financing on the Probability of Successful Emergence and Time Spent Under Chapter 11 Bankruptcy*, 28 J. BUS. FIN. & ACCT. 905, 909 (2001).
[131] David A. Skeel, Jr., *Creditors' Ball: The "New" New Corporate Governance in Chapter 11*, 152 U. PA. L. REV. 917, 919 (2003).
[132] Gurrea-Martínez, *supra* note 123, at 572.
[133] *Id.*
[134] *Id.*
[135] *See* George G. Triantis, *Theory of the Regulation of Debtor-in-Possession Financing,* 46 VAND. L. REV. 901, 902–03 (1993).

For example, in countries with competent and efficient courts and insolvency practitioners, the approval of DIP financing may rely primarily on the discretion and expertise of these actors.[136] This is consistent with the approach currently adopted in jurisdictions with sophisticated courts, such as the United States and Singapore, where DIP loans require judicial approval, or the approach followed in administration procedures in the United Kingdom, where any new loans obtained by the debtor must be authorized by the administrator.[137]

Even if the decision to approve new financing relies on competent and reliable third parties, it is important to bear in mind that the company's pre-existing creditors ultimately bear the costs if the new loan fails to create or preserve value. Therefore, creditors should play a more significant role in the approval of DIP financing.[138] The extent of that involvement may differ across jurisdictions. Policy options may range from simply providing creditors with notice and an opportunity to be heard to requiring courts to reject the authorization of new financing if a specified percentage of creditors—or those most directly affected—do not support the approval of the DIP loan.

By contrast, in jurisdictions with weaker institutional environments and less efficient courts and insolvency practitioners, the decision to approve new financing should be primarily driven by creditors.[139] This approach is reflected in practice in several countries, particularly in the Global South.[140] For example, in India, any new financing must be approved by the committee of creditors.[141] In Chile, DIP loans exceeding 20% of a company's assets require creditor approval.[142] In the Dominican Republic, creditors may veto the approval of new financing.[143] The extent of creditor involvement and the appropriate group of creditors must be carefully calibrated and tailored to the specific institutional and economic context of each country. This calibration is especially important because any veto right can be turned into a tool for opportunistic behavior. Nonetheless, empowering creditors in the approval of DIP financing—and more broadly in insolvency proceedings—can generally be regarded as sound policy

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[136] *See* Gurrea-Martínez, *supra* note 123, at 575–77.

[137] *See id.* at 558–71 (providing an overview of DIP financing regimes in several jurisdictions, including the United States, the United Kingdom and Singapore).

[138] Ayotte & Gurrea-Martínez, *supra* note 122, at 311–12.

[139] Gurrea-Martínez, *supra* note 123, at 574–75.

[140] *See* Aurelio Gurrea-Martínez, *Insolvency Law in the Global South: Lessons for the Global North,* AM. J. COMP. L. (2026) at 29, https://academic.oup.com/ajcl/advance-article/doi/10.1093/ajcl/avaf036/8676545.

[141] *Id.*

[142] *Id.*

[143] *Id.*

in certain jurisdictions, particularly in emerging markets and developing economies.[144]

In conclusion, DIP financing represents a critical tool to preserve value in financially distressed but viable firms, supporting operational continuity, investment activity, and broader economic growth. The central policy question is not whether to adopt DIP financing, but how to structure it optimally. This includes setting the rules for DIP financing priority and for approval of that priority. Effective design requires calibrating approval mechanisms to the sophistication of courts and insolvency practitioners, providing creditors with veto power where appropriate, and aligning decision-making authority with the specific creditors most affected by the financing.

VI. ADMINISTRATIVE EXPENSES

Granting priority to administrative expenses is fundamental to the effective functioning of insolvency proceedings.[145] These expenses typically include costs incurred after, or as a result of, the commencement of proceedings that are necessary to preserve the value of the estate, such as remuneration for insolvency professionals or operational costs incurred during the procedure.[146] Without priority treatment, professionals, suppliers, and employees may be reluctant to engage with financially distressed firms, potentially undermining both the preservation of value and the orderly administration of the estate.[147]

At the same time, granting administrative expense priority requires careful calibration. Unrestricted or overly broad priority can create perverse incentives, allowing inefficient continuation of non-viable firms or unfair distribution of assets. To mitigate these risks, oversight mechanisms are often necessary, involving a gatekeeper—such as a judge, insolvency practitioner, or creditors' committee—to ensure that expenses are reasonable, necessary, and in the best interests of the estate. While this oversight can improve accountability, it may also slow decision-making, which can interfere with a debtor's immediate operational needs, such as purchasing, selling, or other routine business activities. Thus, as a general principle, debts, costs, and expenses incurred in the

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144 *Id.*

145 *See* Eidenmüller, *supra* note 3, at 37–38 (providing that administrative expenses are justified on the basis that they are necessary for insolvency proceedings commenced for the benefit of unsecured creditors).

146 *See* Arturo Bris, Alan Schwartz & Ivo Welch, *Who Should Pay for Bankruptcy Costs?*, 34 J.L. STUD. 295, 316 (2005) (observing that professionals "enhance firm value [and] try to convince the court to take a more favorable view towards their clients").

147 *See* Gurrea-Martínez, *supra* note 123, at 556.

ordinary course of business should receive immediate priority, ensuring that the debtor can continue essential operations without delay. By contrast, extraordinary expenses outside the ordinary course of business should be subject to gatekeeper approval, as is commonly required in the context of DIP financing. If there is concern that continuing operations may keep a non-viable firm alive, facilitating the termination of proceedings—for example, by allowing a percentage of creditors to terminate the process or, in jurisdictions with efficient judicial systems, by allowing courts to determine that outcome upon request by relevant parties—may be a more effective response than restricting administrative expense priority.

A further complexity arises when the estate's assets are insufficient to cover administrative expenses, particularly in cases where most or all assets are encumbered by secured interests. In some jurisdictions, such as India and Brazil, the costs of the insolvency procedure are granted priority over secured claims.[148] In many insolvency regimes, however, secured creditors are entitled to be paid first from the proceeds generated by the sale of their collateral. In such cases, the debtor may lack any effective means to fund the insolvency proceedings if all the assets are encumbered. To address this problem while mitigating some of the inefficiencies potentially generated by a system of full priority for secured creditors, some authors have suggested a system of partial priority, consistently with the idea advocated by Bebchuk and Fried.[149] Under this proposal, a portion of the proceeds generated by the sale of the collateral would be reserved to cover the costs of the procedure.[150]

Such a proposal is controversial. A firm whose assets are fully encumbered has little to gain from the bankruptcy process. If secured creditor priority is to be respected, such a firm has no estate to administer, no funds to pay for the proceedings, and the case can be resolved through the non-bankruptcy remedies available to the secured creditors. To the extent that secured creditors themselves desire a bankruptcy proceeding to facilitate coordination among themselves and the debtor, they can, of course, voluntarily carve out funds to cover administrative expenses.

A final complicating factor is that the value of collateral may not be known at the outset. This creates a paradox where the availability of unencumbered funds to finance the proceeding can only be discovered through the proceeding

148 *See* Insolvency and Bankruptcy Code, 2016, § 53 (India); Lei No. 11.101, de 9 de Fevereiro de 2005, DIÁRIO OFICIAL DA UNÃIO [D.O.U.] de 02-09-2005, art. 84 (Braz.)

149 *See, e.g.*, de Weijs, *supra* note 42, at 77–80.

150 *See id.* at 96–97.

itself. Again, a voluntary carve out can solve this problem or some mandatory partial administrative priority for expenses related to valuation may be in order.

VII. INSOLVENCY LAW AND ENVIRONMENTAL PROTECTION

Environmental regulation exists to protect public health and natural resources by holding parties accountable for pollution, requiring remediation, and facilitating emergency responses to hazardous releases. Those responsible for environmental harm are generally expected to bear the costs of cleanup.[151] However, these costs can be substantial and may exceed the financial capacity of the responsible party. In such cases, companies may seek relief through bankruptcy, potentially limiting or delaying their environmental obligations.[152]

This situation raises important questions about the role of insolvency law in addressing environmental claims and, more broadly, in supporting ESG objectives.[153] While the primary role of insolvency law is not (and should not be) to protect the environment, insolvency regimes should not create incentives for pollution or generate other negative externalities. In other words, while performing its proper function, insolvency law should be designed in a cost-effective manner. This includes ensuring that it does not generate or exacerbate moral hazard, negative externalities, or other forms of market failure. And yet

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151 *See* Jonatan Schytzer, *What if Polluters Cannot Pay? The Swedish Mining Bankruptcies – Problems and Proposals*, *in* NETH. ASS'N FOR COMPAR. & INT'L INSOLVENCY L., THE 'INSOLVENT POLLUTER STILL PAYS' PRINCIPLE? 9, 9, 12–14 (2024), https://nvrii.nl/wp-content/uploads/2025/01/9789462129801_WEB.pdf (explaining the polluter pays principle); Andrew Keay & Paula de Prez, *Insolvency and Environmental Principles: A Case Study in a Conflict of Public Interests*, 3 ENV'T L. REV. 90, 95 (2001) ("The 'polluter pays principle' can be regarded as a fundamental principle of environmental law . . . .").

152 *See, e.g.,* Douglas G. Baird & Thomas H. Jackson, *Kovacs and Toxic Wastes in Bankruptcy*, 36 STAN. L. REV. 1199, 1199 (1984). *See, e.g.*, Ohio v. Kovacs, 469 U.S. 274, 284 (1985) (holding that a state cleanup order constituted a 'claim' under the Bankruptcy Code, thereby permitting its discharge); Midlantic Nat'l Bank v. N.J. Dep't of Env't. Prot., 474 U.S. 494, 506–07 (1986) (explaining that the trustee attempted to abandon contaminated property in contravention of state environmental laws).

153 *See* Schytzer, *supra* note 151, at 9, 12–14; Shuai Guo, *When Environment Meets Bankruptcy: Global Lessons for and from China*, 34 REV. EUR. CMTY. & INT'L ENV'T L. 124, 127–28 (2025) (observing that environmental claims have been regarded as normal claims under bankruptcy and thus subject to discharge); G. Ray Warner, *Sustainable Bankruptcy*, 33 AM. BANKR. INST. L. REV. 123, 155–61 (2025); *see also* ANTONIA MENEZES & AKVILE GROPPER, WORLD BANK GROUP, CLIMATE CHANGE AND SINKING CORPORATES: MITIGATING THE RISKS 12 (2023) https://documents1.worldbank.org/curated/en/099060724171014551/pdf/P17566419ac2150e61abc9147e659fb7616.pdf (observing that the intersection of insolvency law and ESG objectives raises important questions about how bankruptcy frameworks should address environmental liabilities when firms become financially distressed, and recommending policy reforms to prevent insolvency proceedings from functioning as a mechanism to escape environmental accountability).

insolvency law, when coupled with entity partitioning and limited liability, often does exactly that.[154]

To prevent such outcomes, insolvency law may need to include special provisions for environmental claims.[155] If environmental obligations do not receive any special treatment in bankruptcy, and they are treated as general unsecured claims, they could be discharged, encouraging irresponsible behavior and undercapitalization of companies involved in environmentally harmful activities. This outcome imposes broader economic and societal costs. Therefore, while relying solely on insolvency proceedings to enforce environmental compliance would be both insufficient and inefficient,[156] we believe that insolvency law may need a role to play when dealing with environmental claims. Again, we stress that these are second-best solutions. The first-best solution, in our view, is non-bankruptcy regulation mandating insurance and adequate capitalization for firms that pose an externalization risk.

And so again, there are different approaches that insolvency law can consider.[157] For example, environmental agencies acting as regulators could be exempted from the automatic stay, as can occur, under certain circumstances, in the United States. Thus, as discussed in the context of countries that adopt a similar approach for the protection of employees, these solutions would imply that companies that do not want to be sued would need to comply with their regulatory obligations in full. This approach can certainly be effective for minimizing environmental harm. But it can also hamper the reorganization of

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[154] *See generally* Joshua Macey & Jackson Salovarra, *Bankruptcy as Bailout: Coal Company Insolvency and the Erosion of Federal Law*, 71 STAN. L. REV. 879 (2019) (documenting how coal companies have used bankruptcy proceedings to escape environmental cleanup obligations and limit liability to tort claimants, illustrating how the combination of entity partitioning, limited liability, and insolvency law can systematically externalize environmental costs onto the public).

[155] There is an increasing consensus in academic literature about this point. *See* Schytzer, *supra* note 151, at 9, 12–14 (explaining the polluter pays principle); *see also* Guo, *supra* note 153, at 127–28; Warner, *supra* note 153, at 146; Michael Ohlrogge, *Environmental Claims in Bankruptcy: Dischargeability, Priority, and Other Policy Responses*, in NETH. ASS'N FOR COMPAR. & INT'L INSOLVENCY L. THE 'INSOLVENT POLLUTER STILL PAYS' PRINCIPLE? 47, 50 (2024), https://nvrii.nl/wp-content/uploads/2025/01/9789462129801_WEB.pdf.

[156] Ohlrogge, *supra* note 155, at 50.

[157] *See* Schytzer, *supra* note 151, at 14–37 (recommending that environmental claims should be given priority in bankruptcy and explaining how post-bankruptcy environmental claims may be regarded as administrative expenses which receive higher priority in repayment); Ohlrogge, *supra* note 155, at 56–57 (evaluating the use of non-dischargeability and priority rules for environmental claims); Stephanie Ben-Ishai & Stephen Lubben, *Involuntary Creditors and Corporate Bankruptcy*, 45 U. B.C. L. REV. 253, 259, 269 (2012) (explaining the U.S. approach under which environmental orders are non-dischargeable in insolvency and may be enforced during and after the debtor's reorganization); Guo, *supra* note 153, at 127–30 (arguing that environmental claims should enjoy a priority and proposing exemption of environmental claims from the automatic stay).

viable but financially distressed firms. Therefore, if the objective is to ensure that firms bear the costs of environmental harm while simultaneously providing incentives to minimize such harm ex ante, granting priority to environmental claims—either as an administrative expense priority or, at minimum, a basic priority over unsecured creditors—would likely be preferable. This approach, particularly when combined with non-bankruptcy rules, including criminal sanctions where environmental violations constitute a crime and adequate capitalization and insurance requirements, can reduce moral hazard by ensuring that companies internalize environmental costs. Moreover, it can encourage ex ante compliance while allowing environmental obligations to be addressed without undermining the successful reorganization of viable but financially distressed firms.[158]

VIII. SUBORDINATION OF SHAREHOLDER LOANS

In several jurisdictions, particularly in Continental Europe and Latin America, shareholder loans are subordinated in insolvency proceedings.[159] In countries outside those regions, however, such a subordination rule remains rare. The United States falls between these extremes, as it permits the equitable subordination of shareholder loans, albeit only in exceptional circumstances.[160]

When shareholder loans are subordinated, any credit extended by parent companies, founders, or other shareholders to finance the company's operations can only be repaid once all secured and unsecured creditors have been paid in full. Thus, from a legal perspective, such a subordination rule effectively grants priority to all other creditors.

The rationale for the subordination of shareholder loans often cited in the literature is that it may protect the general body of creditors by discouraging the

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[158] *See* Schytzer, *supra* note 151, at 9, 31–32(arguing that granting priority to environmental claims internalizes environmental costs and positively changes firm and creditor environmental behavior); *see also* Michael Ohlrogge, *Bankruptcy Claim Dischargeability and Public Externalities: Evidence from a Natural Experiment*, AM. L. & ECON. REV. (Forthcoming) (manuscript at 1–4, 11, 19, 33), https://papers.ssrn.com/sol3/Papers.cfm?abstract_id=3273486.

[159] *See* Martin Gelter & Jürg Roth, *Subordination of Shareholder Loans from a Legal and Economic Perspective,* 5 J. FOR INST. COMPARISONS 40, 40–43 (2007); Dirk A. Verse, *Shareholder Loans in Corporate Insolvency — A New Approach to an Old Problem,* 9 GER. L.J. 1109, 1111–12 (2008); Juan Luis Goldenberg & Aurelio Gurrea-Martínez, *El Reconocimiento y Clasificación de Créditos en los Procedimientos Concursales*, INSTITUTO IBEROAMERICANO DE DERECHOY FINANZAS (Sept. 14, 2017), https://www.derechoyfinanzas.org/el-reconocimiento-y-clasificacion-de-creditos-en-los-procedimientos-concursales/. All these studies document that, under certain circumstances, shareholder loans can be subordinated in countries like Italy, Germany, Austria, Spain, Colombia, Chile, Uruguay, Brazil, Portugal, Mexico, Switzerland and the United States.

[160] *See* 11 U.S.C § 510(c).

financing of investment projects that should not be pursued, including the continuation of non-viable firms.[161] Put differently, the subordination of shareholder loans can mitigate an overinvestment problem.[162] If shareholder loans are repaid only after all other creditors have been paid in full, shareholders may have stronger incentives to reconsider whether the company is truly viable or whether a particular investment project is worth pursuing. If they conclude that it is, they should have incentives to provide financing through equity rather than loans, as this would allow them to share in the profits generated by the future success of the firm or investment project. Conversely, if they opt for a loan, whose claim in the event of insolvency (and in the absence of any subordination rule) would rank *pari passu* along with the rest of the company's unsecured creditors, it may indicate uncertainty regarding the viability of the company or the investment project. Thus, to some extent, the subordination of shareholder loans is designed to make those with the greatest incentives, resources, and information—typically the controlling shareholders—act as "gatekeepers" of the firm's investments, viability, and financial position.

When a company is solvent, such overinvestment problems are not expected to be particularly significant. Because shareholders remain the residual claimants of the firm and therefore bear the losses associated with the firm's investment decisions, directors—who are appointed, removed and remunerated by shareholders, when they are not the shareholders themselves—have incentives to pursue investment projects with a positive net present value.[163] By contrast, when a firm is factually insolvent but has not yet entered formal insolvency proceedings, several circumstances may exacerbate the risk of opportunistic behavior that benefits shareholders at the expense of creditors.[164] In particular, because shareholders may have already lost their economic stake in the firm and benefit from limited liability, they may have incentives to gamble for resurrection or to keep the firm alive in the hope that the firm's financial

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161 *See, e.g.*, Gelter & Roth, *supra* note 159, at 45 (mentioning that "shareholders will often gamble for resurrection, resulting in a high risk of dissipation of the remaining corporate funds"); *see also* Andreas Cahn, *Equitable Subordination of Shareholder Loans?*, 7 EUR. BUS. ORG. L. REV. 287, 291–95 (2006) (analyzing the rationale for subordinating shareholder loans in insolvency, arguing that such subordination is designed to prevent shareholders from using loan structures to benefit at the expense of outside creditors by preserving a creditor-like claim while retaining the governance rights of equity).

162 *See* John Armour, Gerard Hertig & Hideki Kanda, *Transactions with Creditors, in* THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 109, 132 (3d ed. 2017) (discussing the subordination of shareholder loans as one of the mechanisms to protect creditors against the opportunism of shareholders and mentioning that the rationale of this solution is "to deter overinvestment in distressed firms").

163 *See id.* at 109–14

164 *See id.*

situation will improve in the future.[165] In both cases, these decisions are made at the expense of creditors. Moreover, such inefficient decision-making in the zone of insolvency may be further amplified by cognitive and emotional factors, including attachment to the business and behavioral biases such as over-optimism and the tendency to adhere to initial decisions even when doing so is no longer rational.[166] Therefore, by prompting insiders—especially controlling shareholders—to reassess both the viability of the business and the value of a potential rescue, the subordination of shareholder loans can help mitigate the risk of inefficient continuation or the financing of undesirable investment projects.

Notwithstanding its well-intentioned rationale, the automatic subordination of shareholder loans raises significant concerns. First, it may prevent solvent firms from accessing a form of financing that is often quick, flexible, and widely used in practice.[167] Because equity injections are typically more costly and subject to greater legal and regulatory formalities,[168] shareholder loans represent a practical source of funding for many companies. Thus, automatically subordinating such loans can hinder firms' access to financing. Second, when a firm is experiencing financial difficulties, the subordination of shareholder loans may discourage shareholders from providing financing to viable but financially distressed firms.[169] Penalizing such financing by subordinating it can therefore reduce the availability of critical liquidity at times when it is most needed. This, in turn, can reduce the likelihood of saving viable firms to the detriment not only

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[165] *See id.*

[166] *See* Amir N. Licht, *My Creditor's Keeper: Escalation of Commitment and Custodial Fiduciary Duties in the Vicinity of Insolvency*, 98 WASH. U. L. REV. 1731, 1739–40 (2021) (emphasizing the behavioral biases associated with remaining committed to original choices even when it is not rational to do so); Aurelio Gurrea-Martínez, *Implementing an Insolvency Framework for Micro and Small Firms*, 30 INT'L INSOLVENCY REV. 46, 48 (2021) (emphasizing that "emotional and behavioral factors" can facilitate the inefficient continuation of non-viable firms).

[167] *See* Avraham Tabbach & Barak Yarkoni, *Shareholder Loans and the Agency Costs of Debt* 1 (Dec. 22, 2023) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4968299 (documenting how "[s]hareholder loans . . . are a prevalent feature in both privately and publicly held companies").

[168] Apart from the potential effects that, as has been explored in the finance literature, the use of debt or equity may have on the governance and overall value of the firm, the issuance of shares generally requires approvals and formalities imposed by corporate and securities law that do not apply when a company obtains a loan. In addition, most jurisdictions favor the use of debt by providing tax incentives that generally do not apply when companies raise capital through equity. *See* Aurelio Gurrea-Martínez & Nydia Remolina, *The Dark Side of Implementing Basel Capital Requirements: Theory, Evidence, and Policy*, 22 J. INT'L ECON. L. 125, 140, 143–46 (2019).

[169] *See* Martin Gelter, *The Subordination of Shareholder Loans in Bankruptcy*, 26 INT'L REV. L. & ECON. 478, 480, 489–90 (2006); Armour, Hertig & Kanda, *supra* note 162, at 131–32.

of creditors but also of employees and society at large.[170] Therefore, the automatic subordination of all types of shareholder loans does not appear to be the most desirable policy.

A more sensible solution would be to determine, on a case-by-case basis, whether a particular shareholder loan should be subordinated. This is, in fact, how the doctrine of equitable subordination operates in the United States and how some European countries have traditionally approached the issue of shareholder loans.[171] This approach would allow courts to intervene when there is evidence of abuse, overreaching, or other inequitable conduct, while preserving incentives for informed and motivated shareholders to contribute to the firm's survival.[172] Yet, this solution is far from perfect, and certain circumstances make it particularly unsuitable for some jurisdictions. First, embracing this solution requires a sophisticated judiciary capable of evaluating complex financial arrangements, balancing competing interests, and carefully assessing the ex ante and ex post effects and desirability of departing from non-bankruptcy law to subordinate shareholder loans in a particular case.[173] Unfortunately, many jurisdictions do not have predictable and sophisticated insolvency courts.[174] As a result, in those jurisdictions, reliance on such case-by-case interventions may undesirably generate uncertainty and inefficient outcomes.[175] Second, even in jurisdictions with sophisticated courts, doctrines such as equitable subordination can generate uncertainty and, when invoked, litigation costs. Third, if countries are truly concerned about the opportunistic behavior of corporate insiders in the zone of insolvency, there are more efficient and effective ways to address this problem, for example through the imposition

[170] *See, e.g.*, Gelter & Roth, *supra* note 159, at 45 (observing that "most economic analysis has emphasized that subordination creates a disincentive against legitimate rescue attempts, as shareholders will not obtain an insolvency quota if the rescue attempt financed by the shareholder loan fails"); *see also* Cahn, *supra* note 161, at 297 (observing that "creditors would be even worse off if the shareholders failed to supply additional money to the company and simply continued to operate the business until the funds supplied by the creditors are exhausted").

[171] For a comparative analysis of shareholder loans in several jurisdictions, including the United States and various European countries, see Gelter & Roth, *supra* note 159, at 41–42; David A. Skeel, Jr. & Georg Krause-Vilmar, *Recharacterization and the Nonhindrance of Creditors*, 7 EUR. BUS. ORG. L. REV. 259 (2006).

[172] *See* Skeel & Krause-Vilmar, *supra* note 171, at 262–68.

[173] *See id.* at 271 ("[C]ourts . . . are not well positioned to make these calculations. In addition to the complexities of the basic analysis, the scrutiny would be prone to the kinds of hindsight bias that make courts reluctant to inquire into business judgements in other contexts.").

[174] *See* GURREA-MARTÍNEZ, *supra* note 3, at 14–15, 103–07, 295–96.

[175] *See id.* at 18–22; Anthony J. Casey & Joshua C. Macey, *Insolvency Courts: General Principles for Systems Design*, 33 INT'L INSOLVENCY REV. 23, 25–26 (2024) (providing general principles for designing the proper role and limits of insolvency courts in countries with different market and institutional environments).

of special directors' duties in the zone of insolvency,[176] or by strengthening the system of avoidance actions.[177]

In our view, shareholders' loans should not be treated less favorably than other creditor claims.[178] If the concern is that the absence of subordination rules may allow insiders to benefit at the expense of creditors, there are more targeted and effective mechanisms to address such risks. For instance, where shareholder loans facilitate the inefficient continuation of non-viable firms, the appropriate response lies in the enforcement of directors' duties in the zone of insolvency. Likewise, if a shareholder loan is extended when the company is solvent and is secured or repaid shortly before the commencement of insolvency proceedings, this should constitute an avoidable preference, in addition to any potential liability arising from the directors' decision to grant such security or authorize such repayment.

Mandating the subordination of all shareholder loans can unnecessarily restrict firms' access to financing. And if the subordination is limited to cases in which financing is provided to a company facing or foreseeing a situation of insolvency, such a rule may impede value-enhancing restructuring efforts. For these reasons, rules mandating the automatic subordination of shareholder loans are difficult to justify. While doctrines permitting the case-by-case subordination of shareholder loans may be feasible in jurisdictions with sophisticated courts, they may be unnecessary if alternative mechanisms exist to prevent shareholder opportunism in the zone of insolvency, and they are particularly ill-suited in jurisdictions lacking predictable courts with competent and experienced judges possessing a high level of expertise in financial matters.

Thus, it is not surprising that when financing became urgently needed during the COVID-19 pandemic, some countries that mandate the subordination of shareholder loans chose to temporarily suspend this rule.[179] Unfortunately, many firms—particularly micro and small enterprises—face significant challenges in accessing financing, especially in emerging markets and developing economies.

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[176] *See* Aurelio Gurrea-Martínez, *Towards an Optimal Model of Directors' Duties in the Zone of Insolvency: An Economic and Comparative Approach*, 21 J. CORP. L. STUD. 365, 374–87 (2021) (providing an overview of different policy options for the regulation of directors' duties in the zone of insolvency).

[177] In certain countries, such as the United States, it has been argued that the avoidance action needs to be revitalized to serve as a more effective mechanism to protect creditors. *See* AM. BANKR. INST., COMMISSION TO STUDY THE REFORM OF CHAPTER 11, at 148–56 (2014), https://commission.abi.org/full-report.

[178] *See* Cahn, *supra* note 161, at 299–300 (proposing for shareholder-creditors to enjoy equal treatment to other creditors).

[179] *See* Aurelio Gurrea-Martínez, *The Future of Insolvency Law in a Post-Pandemic World*, 31 INT'L INSOLVENCY REV. 385, 392 (2022) (documenting how during the COVID-19 pandemic various countries in Europe and Latin America temporarily suspended their rules mandating the subordination of shareholder loans).

These financial constraints become more pronounced when a company is insolvent, even if its business remains economically viable. Consequently, the reasons that prompted many jurisdictions to temporarily suspend the subordination of shareholder loans during the COVID-19 pandemic often exist in normal circumstances and are particularly acute for smaller firms. We therefore believe that the rules mandating the subordination of shareholder loans found in many jurisdictions (especially in Europe and Latin America) should be abolished, as they unnecessarily restrict access to finance, hinder the survival of economically viable firms, and undermine the fundamental objectives of insolvency law. Moreover, the concerns these rules are designed to address can be more effectively managed through alternative mechanisms, such as directors' duties and avoidance actions.

IX. Absolute Priority, Relative Priority and the Treatment of Shareholders in Reorganization Procedures

Finally, we turn to the treatment of shareholders in reorganization procedures. In jurisdictions that follow an absolute priority rule ("APR") and respect pre-bankruptcy entitlements, such as the United States, it is widely acknowledged that shareholders cannot recover anything until all creditors have been paid full value. While it is true that negotiated outcomes often include payment to shareholders that reflect less than absolute priority,[180] such outcomes frequently arise from valuation uncertainty or settlements aimed at reducing litigation costs.[181]

While such an APR is generally followed in liquidation proceedings across jurisdictions, countries vary significantly when it comes to reorganization procedures. For example, in Singapore, a scheme of arrangement may result in the approval of a plan requiring creditors to take a haircut while leaving shareholders' equity interests fully intact. In the United Kingdom, dissenting secured creditors may be crammed down even if they are not paid in full and junior claimants, including shareholders, retain value. In many reorganization procedures in Europe, Asia, and Latin America, creditors can be required to absorb losses while shareholders retain their equity interests.

These differences can present particularly thorny problems in cross-border cases where the rules of one country may directly conflict with the rules of

[180] *See* Mark J. Roe & Frederick Tung, *Breaking Bankruptcy Priority: How Rent-Seeking Upends the Creditors' Bargain*, 99 VA. L. REV. 1235, 1280–85 (2013).

[181] *See, e.g.*, Baird & Berstein, *supra* note 12, at 1951.

another. For example, it is not entirely clear that a reorganization procedure cramming down a class of creditors while leaving equity intact would be enforceable in the United States if the creditors objected. To date, cross-border cases of this sort have been decided without any objection. Thus, while the courts have recognized and enforced these plans, they have not had to answer the question of what to do if the creditors object to the shareholder retention of value.

Any differential treatment of shareholders between liquidation and reorganization creates potential distortions. Creditors who do better in liquidation will expend resources to push companies into those proceedings even when it is inefficient. Similarly, shareholders will push to avoid liquidation even when it is the best outcome. Such distortions should be avoided in all jurisdictions. This can be done by allowing identical priority rules or by imposing a robust best-interests-of-creditors test ensuring that creditors are never worse off in reorganization than they would be in liquidation.

That being said, there is value in a regime based on "relative priority" where junior creditors and equity holders receive the option value of their interests even when creditors are not paid in full.[182] But it is important to note that relative priority is not merely the allowance of junior creditors to retain any value. Properly understood, the value they retain should be tied to the option value—that is, the value that exists because the continuing corporation might regain value in the future. Looking at pre-bankruptcy rights, it is clear that if a firm continues to operate there is some possibility that future value will accrue in an amount large enough to return the firm to solvency. In the absence of liquidation, such value belongs to the equity holders. A relative priority regime would estimate the probability of such an outcome and compensate the equity holders for that value. Crucially, though, the option value awarded to creditors must be capped such that it never results in creditors receiving less than they would in liquidation.

To our knowledge, no jurisdiction has implemented a true relative priority regime in the proper sense of the term. As Douglas Baird explained:

> "Relative priority" is not a vague idea that allows any plan as long as senior stakeholders fare better than junior ones. Relative priority fully respects the right of senior creditors to be paid before junior creditors.

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[182] *See* Anthony J. Casey, *The Creditors' Bargain and Option-Preservation Priority in Chapter 11*, 78 U. CHI. L. REV. 759, 772–75 (2011).

> It differs from absolute priority only in the way it identifies the time at which the rights of the players are assessed.[183]

Many insolvency regimes in Europe, Asia, and Latin America simply allow value to remain with equity holders without tying the amount to option value or timing of the assessment of rights. In our view, unmoored rules that permit the cramdown of creditors while leaving shareholders fully intact are generally ill-advised. Such violations of the APR may generate a range of undesirable effects, including higher borrowing costs, moral hazard, and inefficient investment decisions by shareholders while the firm remains solvent.[184] In certain circumstances—particularly once a firm approaches or enters insolvency—limited deviations from the APR may, however, produce offsetting benefits, such as encouraging firms to file for bankruptcy in a timely manner, discouraging managers from pursuing excessively risky projects in the zone of insolvency, and incentivizing shareholders to adopt a more cooperative attitude during a restructuring procedure, potentially reducing the duration and cost of insolvency proceedings.[185] Viewed in this light, deviations from the APR in favor of shareholders function as a form of "reward" designed to elicit behavior that ultimately benefits creditors.

Nonetheless, as noted above, such rewards are costly ex ante. Moreover, many of the benefits they seek to achieve can be obtained through alternative mechanisms. These include imposing special directors' duties and liability in the zone of insolvency,[186] improving the efficiency of insolvency proceedings to make them more appealing,[187] or, in more radical approaches, adopting a form of bail-in regime under which shareholders would be automatically wiped out upon the occurrence of specified default or distress triggers.[188] Such mechanisms

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[183] Letter from Douglas G. Baird, Harry A. Bigelow Distinguished Serv. Professor of L., Univ. of Chi. L. School, to Prof. dr. R.J. de Weijs (Mar. 7, 2019) (on file with *Emory Bankruptcy Developments Journal*); *see also* Baird, *supra* note 2, at 792 n.22 ("Relative priority is not merely a 'deviation' from absolute priority.")

[184] *See* Bebchuk, *supra* note 6, at 452–54. For a review of some of the costs associated with the deviation of the APR, see R.J. de Weijs, A.L. Jonkers & M. Malakotipour, *The Imminent Distortion of European Insolvency Law: How the European Union Erodes the Basic Fabric of Private Law by Allowing 'Relative Priority' (RPR)* (Ctr. for the Study of Eur. Cont. L., Working Paper No. 05, 2019).

[185] *See* Bebchuk, *supra* note 6, at 446 (citing various arguments traditionally provided to support deviations from the APR).

[186] Gurrea-Martínez, *supra* note 176, at 374–87 (analyzing how different countries around the world provide specific duties in the zone of insolvency with the purpose of protecting creditors).

[187] The adoption of more attractive insolvency proceedings for debtors, for example by providing an exclusivity period to propose a reorganization plan, keeping the manager in control of the company during the insolvency process, and providing an automatic stay to protect the debtor's assets, as occurs in the United States, can also encourage the timely filing of insolvency proceedings.

[188] *See* Adler, *supra* note 1, at 319–24.

would allow jurisdictions to preserve the benefits of the APR while mitigating some of its perceived shortcomings.

In practice, however, many jurisdictions do not adopt these solutions, or such solutions may not work effectively—as often happens with countries that impose special directors' duties and liability in the zone of insolvency. In those settings, a second-best approach may consist of allowing a form of relative priority, particularly in firms where the decision-making is largely driven by controlling shareholders. It is therefore not surprising that deviations from the APR (as understood in the United States), for example by allowing shareholders to retain their equity interests, are more frequently observed in jurisdictions characterized by concentrated ownership structures, as is common in Europe, Asia, and Latin America.[189]

Other deviations from the APR can be observed in the context of micro and small enterprises. For example, under subchapter V of chapter 11 in the United States, small business owners may retain equity provided they propose a viable multi-year payment plan.[190] The justification for this approach is not grounded in option value, but rather in the recognition that, apart from incentivizing cooperation and early filings, the costs of litigating and negotiating strict compliance with the APR may far exceed its benefits in such cases. Once again, this reflects a second-best solution driven by institutional constraints that render first-best rules prohibitively expensive to implement.

Based on the apparent success of Subchapter V,[191] and the theoretical justifications for avoiding litigation over priority in small firms, we are supportive of allowing deviations from the APR for such firms and therefore allowing the shareholders to retain the ownership of the company. For large companies with controlling shareholders, however, the adoption of alternative mechanisms, such as special directors' duties and liabilities in the zone of insolvency and more attractive restructuring procedures that incentivize voluntary initiation of insolvency proceedings, can provide a more desirable means of achieving the benefits that deviations from the APR seek without generating the costs such deviations generate.

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189 *See, e.g.*, ALEJANDRA MEDINA, ADRIANA DE LA CRUZ & YUNG TANG, OWNERS OF THE WORLD'S LISTED COMPANIES 5–6 (Org. Econ. Co-operation Dev. 2019) (documenting that most countries around the world, especially in Asia, Latin America and Europe, generally have companies with concentrated ownership structures) www.oecd.org/corporate/ca/Owners-of-the-Worlds-Listed-Companies.pdf.

190 *See* 11 U.S.C. §§ 1181–1195.

191 *See* Edith Hotchkiss, Benjamin Iverson & Xiang Zheng, *Can Small Businesses Survive Chapter 11?*, J. FIN. (forthcoming) (manuscript at 21–22), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4726391.

CONCLUSION

This Article has sought to identify the most common forms of priority found across insolvency systems worldwide and to assess whether there is a need to revisit existing priority rules. Unsurprisingly—at least to us—there are no one-size-fits-all answers. Local customs, political choices, institutional capacity, market development, and the sophistication of claimants all play an important role in the design of insolvency priority rules and must be taken into account. That said, we have identified several general lessons that can guide the choice of priority rules and serve as starting points and guardrails in system design.

For instance, in the absence of compelling empirical evidence showing that the benefits of deviating from a system of full priority—particularly in terms of enhanced monitoring, improved viability screening, or greater financial stability—outweigh the likely increase in the cost of credit that such deviations may produce, we have argued in favor of respecting full priority for secured creditors. In our view, departures from this principle should be limited and justified only where non-adjusting or weakly adjusting creditors, such as employees and tort victims, lack access to alternative forms of protection, including wage guarantee schemes or insurance mechanisms.

A similar logic applies to the principle of equal treatment of creditors. Although frequently criticized and subject to numerous exceptions, *pari passu* treatment should remain the default rule. By contrast, we identify certain priority rules that appear to lack a strong empirical or theoretical foundation. Most notably, this is the case for the priority often afforded to tax authorities. We have advocated for the abolition of tax priorities, particularly in jurisdictions with inefficient public sectors, typically found in emerging markets and developing economies—ironically, the countries that most frequently retain such priorities.

We reach a similar conclusion with respect to the treatment of shareholder loans, an area that merits reconsideration. While some jurisdictions—particularly in Europe and Latin America—subordinate such claims, it has been argued that this approach is difficult to justify as a matter of policy. Where adopted, subordination should occur only on a case-by-case basis and only in jurisdictions with highly sophisticated courts. Even then, subordination rules may generate uncertainty and other costs, including discouraging insiders from attempting to rescue financially distressed firms, even when those firms remain economically viable.

With respect to vulnerable creditors, such as employees and tort victims, our conclusion is clear: they warrant special protection in insolvency. Whether that protection should take the form of priority is a separate question. As a general matter, we have argued that priority should be treated as a second-best solution, appropriate only where alternative, and often more effective, mechanisms—such as wage guarantee schemes for employees or mandatory insurance for tort claims—are unavailable or insufficient.

Other areas present more nuanced trade-offs. Environmental protection, for example, should ideally be addressed through non-bankruptcy regulation. Where such regulation is incomplete or ineffective, however, insolvency law may need to play a residual role. In this context, and in contrast to exemptions from the automatic stay adopted in some jurisdictions, we have argued in favor of using priority—potentially even administrative-expense priority—to address environmental claims.

When it comes to administrative expenses and new financing, we have clearly advocated for granting priority. Nonetheless, the appropriate design of such rules should vary across jurisdictions. In countries lacking competent and reliable courts, for example, creditors may need to play a greater role in the approval of new financing. While we support priority for suppliers of new goods, services, labor or financing provided during insolvency proceedings, such rules should be subject to safeguards as well as tailored to the market and institutional environment of each country.

Finally, we have argued that the APR should generally be respected as the starting point. Deviations may be justified, but only where they are clear, predictable, and economically grounded. One such deviation may arise in the context of small businesses, where the costs of litigating priority disputes may exceed the benefits of strict adherence to priority rules. Similarly, allowing owners to retain equity may constitute a permissible departure from absolute priority where the rule is clearly defined and capable of being accurately priced ex ante.

One of the takeaways of this Article is that "priority matters,"[192] not only in the event of insolvency but also ex ante, as it shapes the incentives and decisions of debtors, creditors and shareholders long before a firm faces financial distress. Yet, the optimal way to deal with priority differs across jurisdictions. This raises concerns for the international recognition of insolvency proceedings. As we have argued elsewhere,[193] jurisdictions seeking to recognize foreign procedures

192 *See* Baird, *supra* note 2, at 785.

193 *See* Casey, Gurrea-Martínez & Rasmussen, *supra* note 85, at 60–62. Very few jurisdictions today would recognize a foreign insolvency proceeding that nullified their citizens existing contract rights or security

should generally require such procedures to respect local priority rules. This "International *Butner* Principle" provides a practical framework for managing the tensions created by the diversity of priority regimes worldwide, while still allowing flexibility for domestic legal, economic, and institutional contexts.

interests. Such proceedings would fall under the public policy exception to recognition. There is—or should be—a sort of international principle providing that substantive rights come from the applicable non-insolvency law.

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