**Two (Further) Possible Explanations of the Secured Debt Puzzle: A Note** *

Tomáš Richter[1]

*Since at least the early 1980's, students of financial economics and law & economics have puzzled over the question whether secured debt - and more importantly, its priority in bankruptcy, apparently ubiquitous in the real world - can or cannot be explained in terms of economic efficiency. The discussion, intellectually enticing as it may be, seems to lead nowhere. One would almost be tempted to discard the entire enterprise using Ronald Regan's alleged quote claiming that "an economist is someone who will convince you that something that works perfectly well in practice cannot work in theory." Before that is done, I thought that I would contribute to the debate with two further possible explanations of the puzzle. My ambition is not to be conclusive - as evidenced by the fact that one of the explanations I forward is benign whereas the other one is malign. What I hope to show, however, is that a look from outside of the world of mature legal and other institutions can bring about observations that may perhaps slip the eye of the beholder who takes such institutions for granted.*

The questions of why do jurisdictions (usually) grant secured debt priority over unsecured debt in bankruptcy, and whether such priority is or is not efficient, has fuelled one of the most exciting discussions in financial economics and in the economic analysis of law. The literature, dating back to the early 1980's is huge; fortunately, it has been surveyed at least twice in the late 1990's, so one does not have to start exploring the field from square one.[2] The discussion probably started in or around 1981, when Professor Alan Schwartz and possibly other founding fathers of the discussion questioned the intuition that violating the bargained-for priority of secured claims will inevitably lead to an increase in the cost of debt financing.[3] The problem with that intuition, however, is that given the usual assumptions made in microeconomics, any reduction in the cost of secured debt should be levelled out by a corresponding increase in the

* Published in Acta Oeconomica Pragensia, 2/2006, Vol. 14, pg. 117

1 Of Counsel, Clifford Chance LLP, Prague; Lecturer, Institute of Economic Studies, Faculty of Social Sciences, Charles University, Prague; Mgr. (Law) - Charles University, 1994; LL.M. (International Business Law) - Central European University, Budapest, 1996; Ph.D. (Business Law) - Masaryk University, Brno, 2002; JUDr. (Business Law) - Masaryk University, Brno, 2005

2 see Bowers, J.W., Security Interests, Creditors' Priorities and Bankruptcy, Chapters E and F, Encyclopedia of Law and Economics, 1999, available at: www.encyclo.findlaw.com. A more detailed survey, including detailed discussion of the various schools of thought, can be found in Siebrasse, N., A Review of Secured Lending Theory, 1997, available at: http://www.law.unb.ca/Siebrasse/Download

3 See Jackson, T.H., Kronman, A.T., Secured Financing and Priorities Among Creditors, 88 Yale Law Journal 1143 (1979)

cost of unsecured debt.[4] Therefore, secured financing is merely a zero sum game, and the intuitive explanation does not work.[5]

The following 25 years or so brought about a myriad attempts at explaining why secured debt is efficient and accordingly, the law should not meddle with its priority in bankruptcy or, conversely, why it is an inefficient tool of wealth transfer, and should accordingly be abolished or at least limited.

According to Siebrasse,[6] the authors advocating the efficiency view forward *inter alia* the following theories: (a) secured lending makes enforcement easier and cheaper, (b) it curbs problems with asymmetric information at the time of contracting, (c) it keeps the various agency costs of debt in check (including the risk that managers, on behalf of equity, will engage in inefficient *ex post* risk alteration or asset substitution), (d) it curbs the asymmetric information problem during the life of the loan (it keeps monitoring costs down and avoids duplicative monitoring) and (e) it prevents underinvestment problems.

The authors pointing to the costs of secured debt tend to argue that (a) priority granted to secured debt operates as wealth redistribution from (non-consensual, as well as some small consensual) creditors who, for various reasons, do not or can not adjust the price of their unsecured loans (this problem being exacerbated when security is granted *ex post*, i.e. after the loan has been made), (b) secured debt motivates the debtor to take on inefficiently low expected variance projects and (c) secured debt may lead to insufficient monitoring of the debtor.

I will not say more about these various theories here - the interested reader simply should refer to the writings of Bowers, Siebrasse, and of the authors surveyed by both of them. My purpose is to offer two further possible theories of the effects of secured debt, the first supplementing the efficiency-advocating theories, the latter taking a more sceptical view of secured debt.

## A. The Benign Explanation: Giving Teeth to Debt's Role in Corporate Governance

This entire discussion might not have come around at all had it not been for Modigliani and Miller.[7] And although a commentator whose name escaped my memory once noted disdainfully that the field of economics is polluted with irrelevance theorems, M&M's irrelevance theorem

[4] Schwartz, A., Security Interests and Bankruptcy Priorities: A Review of Current Theories, 10 Journal of Legal Studies 1 - 37 (1981)

[5] Bowers, *supra* note 2, page 99

[6] see Siebrasse *supra* note 2

[7] Modigliani, F., Miller. M.H., The Cost of Capital, Corporation Finance and the Theory of Investment, 48 Am. Econ. Rev. 261 (1958)

has proven particularly inspiring, or perhaps particularly difficult to shake off. Still, it may be a useful springboard to the argument that I want to forward.

Pondering why is it that companies apparently spend a lot of time and money designing their capital structures even though, according to M&M, this design should be irrelevant to their value, economists and lawyers started to think that one reason why there may be debt in corporate balance sheets is in order to police management's slack.[8] By introducing hard budgetary restraints, debt may help keep management on its toes because, if the company does not earn enough to service its debt, bankruptcy will result in reallocation of its assets to a better use - and in managers losing their jobs. The stick that debt carries with it therefore becomes an important tool of corporate governance - or does it?

Any stick will pack only as much punch as much the one over whose head it is being waived believes that it will actually strike. In legal terms, this translates into the question of how probable it is that the creditor will push the debtor into bankruptcy, which is the judgment day for management.[9] The problem is that a general creditor can wave the stick of its claim as much as it pleases, and management will probably not be concerned much - it will know that the stick really is more of a silver bullet in the hands of an unsecured creditor. For once bankruptcy kicks in, the unsecured creditor will inevitably be hit by the effect of the *pari passu* rule - the rule that dictates *pro rata* sharing among all general creditors and that commonly results in general creditors' claims not being satisfied in full in bankruptcy. This rule, fair and/or efficient as it may be, therefore takes away much of the bite that debt would otherwise have.

And this is where the crux of the argument comes. The fuller priority bankruptcy law gives to the secured creditor's claims, the more credible the threat of the secured creditor actually starting bankruptcy proceedings will be. And the more credible that threat, the more likely is debt to influence management to run the business efficiently.[10] The point should be quite an obvious one and the fact that it has not been made or, so far as I know, not made expressly, may be a function of the place from which one looks. It could be that the point becomes much more lucid when viewed from a jurisdiction that severely limits the bankruptcy priority of secured debt, such as the Czech Republic.[11] As the result, even secured creditors may do all they can to

[8] Jensen, M.C., Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers, 76 Am. Econ. Review 323 (1986)

[9] This assumes that management does not enjoy the unchecked use of a safe-harbour of bankruptcy proceedings such as the U.S. Chapter 11 that allows the debtor's management to enter the proceedings at will and stay in office for quite a while before anyone can do anything about it.

[10] This of course only works up to the point where all hope is lost and management has an incentive to gamble its way out of bankruptcy. Bankruptcy law should contain rules designed to curb these perverse incentives.

[11] Under current Czech bankruptcy law, a secured creditor will have no control over the time or manner of realization of its security, it will not be compensated for the time value of money while it waits for the bankruptcy trustee (whose choice it will be unable to influence) to realise the security, and at the end of the process, it will not receive

avoid bankruptcy, with the result that badly managed companies do not change management, or hands, until it is too late.

Under this view, giving full priority to secured credit is probably efficient, although such a rule should be augmented by bankruptcy rules that allow the debtor or other creditors to invoke a stay on secured creditors' individual collection action - in cases where that is likely to be efficient from the point of view of the body of creditors as a whole.

B. The Malign Explanation: Competition is Not Perfect, and Worse …

My malign theory again benefits (if that word can be used in this context) from a view from an economy whose markets and institutions are underdeveloped compared to the West.

Probably no one takes very seriously the standard economic assumption of perfect competition (which does not prevent almost everybody from relying on it as and when need be). What may not be apparent at the first blush when looking at a developed economy, however, is that not only is competition not perfect. It gets worse: in some markets, competition is much more imperfect than in others. For example, the competition in the capital market may be much weaker than in the markets for low added value supplies and services. This may not be obvious when looking at a market with hundreds of years' worth of accumulated capital, hundreds of banks, hoards of non-banking finance companies, all of that topped with a deep and liquid bond market. It should, however, be perfectly clear when looking at an emerging economy with perhaps only a handful of banks, virtually no non-banking lending industry, and a bond market that is almost not worth mentioning.

In both the goods and services markets and the capital market, credit is being extended. However, the debtor is faced with radically different competitive situations in each of these markets. Whilst in the goods and services markets, it will always have an abundance of suppliers he can hold against each other for payment (i.e. credit) terms, in the capital market, it will be facing a mere handful of banks, who will be able to insist on their terms of extending credit. Would it be surprising if this kind of competition mismatch resulted in systematic wealth transfers from the suppliers of trade credit to the suppliers of financial credit? I think not. Would it be surprising if security interests, demanded by the oligopolistic suppliers of financial credit, served as a conduit of these transfers? Not really.

---

more than 70 percent of the proceeds of the realization, less costs and expenses. See Section 28(4) of Czech Act 328/1991 Coll., on bankruptcy and composition. The proposed new Czech Insolvency Act, approved by the Lower House of the Czech Parliament in February 2006, would abolish this rule.

Neither of the two explanations I offer is entirely new. Rather, I think that they offer a non-standard look at propositions that had been made before.[12] What the explanations perhaps show, however, is that taking a step outside the advanced institutional setting in which most of the state-of-the-art economic and legal research takes place may help identify patterns that could have been obscured by the unnoticed workings of the very institutions that had allowed that research to advance as far as it did.

This version: 24th February, 2006

[12] Explanation A of course builds on the agency theories of secured debt. Explanation B is a systematic application of the theory of wealth transfers from non-adjusting creditors.