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## A SEA CHANGE IN CREDITOR PRIORITIES

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Kristen van de Biezenbos\*

*This Article argues that the operation of maritime law undermines a primary justification for creditor priorities under U.S. law. Under current law, when a debtor becomes insolvent, its secured creditors will be paid the full amount of their debt to the extent of their security interest, even if that leaves nothing to pay unsecured creditors. This is controversial with respect to involuntary unsecured creditors, particularly those with tort claims against the debtor. Defenders of this scheme of priorities have argued that allowing greater priority to involuntary creditors would hinder the availability or increase the cost of credit. However, involuntary creditors have long enjoyed priority over secured creditors under maritime law, and it does not appear that firms subject to maritime law have experienced these effects. Experience with this priority scheme under maritime law may provide support for efforts to reform current U.S. law to give greater priority to involuntary creditors more generally.*

### INTRODUCTION

Secured credit is widely viewed as an essential part of commercial finance, yet it is also a source of controversy among scholars. The issue is so polarizing that, while some have referred to secured credit as a “blazing success,” others describe it as “evil, irrational[, and] . . . mysterious,” as well as a form of theft.<sup>1</sup> The core of the debate involves Article 9 of the Uniform Commercial Code (UCC), which provides that, in most circumstances, secured creditors have absolute priority over all other creditors; this means that they have first claim on a debtor’s assets serving as collateral up to the amount of their debt in the case of foreclosure and, generally, in bankruptcy as well.<sup>2</sup> As a result, secured creditors are paid first and

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1. Robert E. Scott, *The Politics of Article 9*, 80 VA. L. REV. 1783, 1785 (1994); David Gray Carlson, *On the Efficiency of Secured Lending*, 80 VA. L. REV. 2179, 2179 (1994).

2. See, e.g., Thomas H. Jackson & Anthony T. Kronman, *Secured Financing and Priorities Among Creditors*, 88 YALE L. J. 1143 (1979); Elizabeth Warren, *Making Policy with Imperfect Information: The Article 9 Full Priority Debates*, 82 CORNELL L. REV. 1373 (1997); Douglas G. Baird, *The Importance of Priority*, 82 CORNELL L. REV. 1420 (1997); Barty E. Adler, *An Equity-Agency Solution to the Bankruptcy-Priority Puzzle*, 22 J. LEGAL STUD. 73 (1993); Lucian Arye Bebchuk &

completely if a debtor becomes insolvent, while unsecured creditors must share whatever remains of the debtor's assets, subject to a security interest upon foreclosure. Many unsecured lenders, such as commercial banks, understand this *ex ante* when they lend to a debtor, but others do not. In particular, some unsecured creditors, such as tort victims, are involuntarily subjected to this priority scheme even though they never intended for the debtor to owe them in the first place.<sup>3</sup> Since the late 1970s, scholars have grappled with the distribution scheme of Article 9 and its apparent preference for sophisticated lenders over unwitting third parties.<sup>4</sup> When the dust settled in the late 1990s, the debate over secured credit seemed at an impasse. Meanwhile, priority treatment of secured creditors under Article 9 continues.

Initially, the debate over secured credit focused on economic arguments that sought to understand—and justify—this priority system based on the effects on the availability and costs of credit.<sup>5</sup> According to some scholars, secured credit is efficient because it shifts monitoring costs away from secured creditors, who take security instead of incurring the cost of monitoring the debtor's financial health, and, in return, charge the debtor a lower interest rate.<sup>6</sup> By contrast, voluntary unsecured creditors do not have security and so must monitor the debtor for any changes in capital structure that might impair the debtor's ability to repay, but they can charge higher interest rates to compensate for those monitoring costs.<sup>7</sup>

Other scholars have criticized this view, pointing out that frequently secured creditors are better able to monitor the debtor than unsecured creditors.<sup>8</sup> Further, the priority treatment of secured claims means that involuntary unsecured creditors such as tort victims bear the risk of loss when the debtor does not have sufficient assets to pay the secured creditors or only has enough assets to cover the secured claims.<sup>9</sup> These tort claimants include,

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Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857 (1996) [hereinafter *Uneasy Case 1*].

3. See generally Jackson & Kronman, *supra* note 2; Warren, *supra* note 2; Baird, *supra* note 2; Adler, *supra* note 2; *Uneasy Case 1*, *supra* note 2; Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy: Further Thoughts and a Reply to Critics*, 82 CORNELL L. REV. 1279 (1997) [hereinafter *Uneasy Case 2*].

4. See, e.g., Jackson & Kronman, *supra* note 2; Warren, *supra* note 2; Baird, *supra* note 2; Adler, *supra* note 2; *Uneasy Case 1*, *supra* note 2.

5. See generally Jackson & Kronman, *supra* note 4.

6. *Id.* at 1149–58.

7. *Id.*

8. See Part I, *infra*.

9. Lynn M. LoPucki, *The Unsecured Creditor's Bargain*, 80 VA. L. REV., 1887, 1893 (1994). As LoPucki puts it, "Law and Economics relies heavily on consent to prove the inherent justice of the way things are. When the analysis requires the consent of a party to some aspect

but are not limited to, victims of negligence, toxic torts, and business torts.<sup>10</sup> Some argue that from a welfare economics perspective, secured credit may actually be inefficient because it allows a company to externalize its tort liability, which may distort the true cost of doing business.<sup>11</sup>

In response to the fact that the Article 9 priority system can sometimes leave tort victims uncompensated and allow debtors to externalize their tort liability, some scholars have called for revising Article 9 to give “super-priority” to tort victims over secured creditors.<sup>12</sup> Supporters of secured credit have attacked these proposals as undermining Article 9 and potentially having an adverse effect on commercial lending.<sup>13</sup> Because relatively little empirical evidence shows either that the Article 9 priority system is efficient or inefficient, or that its positive effect on lending outweighs its negative effects on tort victims, there has been no significant movement in the debate.<sup>14</sup>

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of social organization, but that party clearly did not give it, the standard economic move is to argue that the party would have agreed to that aspect *ex ante*, by which they mean before the party knew what role it would have in society.” *Id.* at 1899.

10. This category includes “(1) product liability claimants; (2) victims of business torts, ranging from negligence to intentional interference with contractual relations; (3) victims of antitrust violations, unfair competition, and patent, trademark and copyright infringement; (4) environmental agencies that perform clean-ups; (5) taxing authorities; (6) creditors who became such through the debtor’s fraud, including securities fraud; (7) government agencies . . . and (8) utility companies.” *Id.* at 1896. Conceptually, the recommendations made in this Article also apply to other involuntary creditors.

11. When a company’s assets are insufficient to cover all secured claims, or are just sufficient enough to cover only those claims, tort claimants could potentially receive nothing, meaning that the company has not internalized the costs of its wrongdoing but instead has shifted those costs to the public. *See, e.g.*, Christopher M.E. Painter, *Tort Creditor Priority in the Secured Credit System: Asbestos Times, the Worst of Times*, 36 STAN. L. REV. 1045, 1058–61 (1984). Lucian Bebchuck and Jesse Fried argue that secured credit is actually inefficient and propose that secured creditors be given partial, as opposed to absolute, priority. *Uneasy Case 1, supra* note 2, at 867–72. One source of the inefficiencies, according to Bebchuck and Fried, is that allowing secured creditors and debtors the ability to force third parties to assume the risk of the debtor’s failure encourages those two parties to enter into this arrangement, even when it is not efficient to do so. *Id.* at 870.

12. Warren, *supra* note 2; *Uneasy Case 1, supra* note 2; *see also* F.H. Buckley, *The Bankruptcy Priority Puzzle*, 72 VA. L. REV. 1393, 1411–12 (1986) (arguing that secured credit is efficient but suggesting that involuntary creditors could be granted “superpriority rights . . . ranking them ahead of consensual secured creditors”). *See generally* LoPucki, *supra* note 9.

13. *See* Warren, *supra* note 2, at 1385–86 (1997). LoPucki gives an overview of the strategies that debtors might employ, wishing to make themselves “judgment proof,” which in turn would give involuntary creditors no recovery because there would be no assets from which to recover. Lynn M. LoPucki, *The Death of Liability*, 106 YALE L.J. 1, 62–64 (1996). Part III.C, *infra*, addresses these concerns.

14. Some literature suggests that very large companies do not use secured credit often so that the problem of tort victims’ subordination in priority under Article 9 is not severe. *See, e.g.*, Yair Listoken, *Is Secured Debt Used to Redistribute Value from Tort Claimants in Bankruptcy? An Empirical Analysis*, 57 DUKE L.J. 1037, 1044 (2008) (arguing that empirical evidence suggests

This Article argues that the experience of private actors subject to maritime law can shift the debate. Maritime law is the oldest form of commercial law still in practice and reflects a long-standing collaboration of financial institutions, commercial borrowers, and individual actors in the shipping and maritime transportation industries.<sup>15</sup> It gives super-priority to certain classes of involuntary unsecured creditors, including tort victims, via an *in rem* action against a vessel or vessels, but yields to the Article 9 priority system in bankruptcy. Maritime law thus offers a concrete picture of how to reform secured credit to protect tort victims without freezing the availability of credit or unfairly punishing secured lenders.

Although some writers in the secured credit debate have noted the priority scheme under maritime law, this Article is the first to compare it systemically to Article 9 and to explore its potential implications. This Article proposes that the experience of parties subject to maritime law challenges the view that giving super-priority to tort claimants would impair the ability of debtors to obtain financing. Although tort victims have long had priority over secured creditors in maritime *in rem* actions, no evidence suggests that this priority scheme has negatively impacted credit availability or cost to maritime borrowers.<sup>16</sup> Further, this Article proposes that some additional assumptions and conclusions employed by both sides of the debate may not be correct. In particular, this Article challenges the presumptions that secured credit necessarily encourages poor monitoring and the inefficient use of debt covenants, and that tort victim super-priority would be inefficient because of increased transaction costs. Using maritime law as a case study, this Article illustrates how and why these assumptions may not be correct.

Part I of this Article gives a brief overview of the debate over secured credit. Part II gives an overview of the priority scheme of the maritime *in rem* action, the justifications for that scheme, and the

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that large, “high tort” debtors use secured credit less frequently than smaller companies). While it is possibly true that large companies with sufficient asset pools will not use secured credit because of the additional transaction costs, most small and mid-sized businesses do use secured credit, and anyone who suffers based on such business’s tortious activity may be subordinated under Article 9.

15. As more fully discussed in Part II.A, *infra*, customary admiralty law predates the written record, with the Rhodian Sea Law (*Nomos Rhodion Nautikos*, dating in written form from around 600–800 C.E.) standing as probably the earliest recorded example. See GEORGE MOUSOURAKIS, THE HISTORICAL AND INSTITUTIONAL CONTEXT OF ROMAN LAW 404 (2003). Maritime law scholars who have written on the history of present-day admiralty law trace the origin of many current principles to the Rhodian Sea Law. See, e.g., PETER N. EHLERS, ELISABETH MANN BORGESSE, ET AL., EDs., MARINE ISSUES: FROM A SCIENTIFIC, POLITICAL AND LEGAL PERSPECTIVE 2–5 (2002).

16. See Part II, *infra*.

response of secured lenders to being behind tort claimants in that context. This includes a review of the mechanics of the *in rem* action and the ranking of priorities according to last in time, first in right. Part III examines whether the design of priorities under maritime law calls into question some of the assumptions that reforms to the Article 9 priority scheme cannot address the unfair prejudice that prevents tort victims from obtaining compensation for their injuries.

### I. THE DEBATE OVER SECURED CREDIT

Although the principles of secured credit and secured creditor priority are possibly “fundamental” commercial finance law, it is unclear whether those principles benefit anyone other than secured creditors. Indeed, the debate over secured credit has been smoldering “like a coal mine fire” for over three decades;<sup>17</sup> partly because, of all the provisions of the UCC, Article 9 and the resulting secured credit system have the most direct impact on commercial transactions, even though the effects are not fully felt until the debtor is in financial distress.<sup>18</sup> Under the current regime, secured creditors are entitled to the highest priority in bankruptcy proceedings, which means that the entire amount of the creditor’s debt up to the value of its collateral will be satisfied before making any payment to any unsecured creditors.<sup>19</sup> Secured claims are prioritized on a first in time, first in right basis, so the first claims filed in accordance with Article 9 will take precedence.<sup>20</sup>

Article 9 is not only a relatively recent development, but it is also a departure from the state of the law prior to when it was drafted.<sup>21</sup> Under the traditional common law, one individual could only obtain a security interest in personal property by taking actual possession of the property.<sup>22</sup> Grant Gilmore, who was instrumental in drafting the first iteration of Article 9, characterizes the time before its promulgation as “a period of disintegration.”<sup>23</sup> During that time, expanding exceptions that varied from state to state began to “whittle[ ] away” the long-standing principle that non-possessory interests in personal property were permissible only in

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17. LoPucki, *supra* note 9, at 1890.

18. See Peter F. Coogan, *The New UCC Article 9*, 86 HARV. L. REV. 477, 480 (1973).

19. *Uneasy Case 1*, *supra* note 2, at 867.

20. Robert E. Scott, *The Politics of Article 9*, 80 VA. L. REV. 1783, 1795–96 (1994).

21. See GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY 288 (1965).

22. *Id.*

23. *Id.*

connections with certain types of negotiable interests.<sup>24</sup> Article 9 represented an attempt to harmonize this inconsistent system, which arose as a patchwork of state laws as lawmakers responded to the increasing demands of lenders to receive non-possessory security interests in all types of personal property.<sup>25</sup> Even during the drafting stage, tension existed over whether Article 9 unfairly favored institutional lenders. Concerns arose that harmonization might favor lenders too much at the expense of third parties. The counter-arguments contended that attempts to protect third parties were inappropriate “social legislation” that unfairly discriminated against banks and consumer lending institutions.<sup>26</sup> In Gilmore’s view, Article 9’s focus on lenders was all for the best due to the “impossibility of arriving at a satisfactory solution.”<sup>27</sup>

#### A. *The Justifications for Secured Credit*

The traditional justification for secured credit is that it increases the amount of credit available to borrowers by incentivizing lenders, whom the risk of default might otherwise have deterred.<sup>28</sup> The entrance of Law and Economics scholars into the conversation particularly jump-started scholarly interest in secured credit and the absolute priority rule.<sup>29</sup> In particular, Thomas H. Jackson, Anthony T. Kronman, and Douglas G. Baird were early proponents of the idea that an efficiency analysis can explain (and justify) secured credit.<sup>30</sup> They advanced the “creditor’s bargain” model, which postulates that secured credit is efficient because the secured creditor

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24. *See id.*

25. *Id.* (describing the drafting of Article 9 as an attempt at synthesizing state laws of security, which Gilmore described as laws “of extraordinary complexity in which a transaction relatively simple in itself had become fragmented into bits and pieces.”).

26. *Id.* at 293.

27. *Id.*

28. *See, e.g.*, JAMES C. VAN HORNE, FINANCIAL MANAGEMENT AND POLICY 536 (3rd ed. 1974) (Firms that pose a significant risk of default often “cannot obtain credit on an unsecured basis. . . In order to make a loan, lenders require security so as to reduce their risk of loss.”).

29. *See* Jackson & Kronman, *supra* note 2.

30. *See id.*; Thomas H. Jackson & Douglas G. Baird, *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 (1984). In the latter article, Jackson and Baird point out that many non-Law and Economics scholars who object to absolute priority often focus only on bankruptcy proceedings. Jackson & Baird, *supra*, at 101–02. According to Jackson and Baird, even if an argument can be made that absolute priority should not be the rule in non-bankruptcy debt collection, the rule should be preserved in bankruptcy. *Id.* at 101. This exception for bankruptcy results from trying to address all of the myriad harms that a corporate failure might cause beyond the scope of the bankruptcy court. *Id.* at 102–03. This Article addresses this argument in Part II, *infra*.



is willing to offer credit at lower rates to debtors with liquidity problems in return for security.<sup>31</sup> Access to credit would increase efficiency by encouraging parties to lend because they can protect their investment via security in lieu of monitoring the creditor's entire business.<sup>32</sup> Conversely, the voluntary unsecured creditor does not have any guarantee that it will receive payment in full in the event of the debtor's insolvency, but it can charge higher interest rates in compensation for its monitoring burden and the higher risk of non-payment.<sup>33</sup>

This explanation initially held great appeal, as it explained why secured credit was popular with lenders despite higher transactions costs. However, the creditor's bargain model swiftly came under fire because it did not comport with commercial realities. Alan Schwartz and Saul Levmore argued that Jackson and Kronman's hypothesis leads to the counterintuitive conclusion that those creditors who are typically unsecured, such as trade creditors and employees, are better at monitoring against debtor misbehavior than those typical secured parties, such as banks and financial institutions.<sup>34</sup> Instead, Schwartz asserted that there was no real supportable argument in favor of secured credit.<sup>35</sup> However, he also believed that no reform of Article 9 should occur until either research had revealed whether a more plausible justification for the current system exists or, conversely, what effects any proposed changes would have on the availability of credit.<sup>36</sup>

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31. See Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditor's Bargain*, 91 YALE L. J. 857, 869 (1982); Buckley, *supra* note 12, at 1393; see also Jackson & Kronman, *supra* note 2, at 1147-61 (defense based on monitoring considerations). The starting point for the efficiency analysis of secured credit is the Modigliani-Miller theorem of corporate capital structure, which states that, in a perfect market, that how that firm is financed does not affect the value of a firm. See Baird, *supra* note 2, at 1422.

32. Jackson & Kronman, *supra* note 2, at 1147-61.

33. *Id.* Jackson and Baird subsequently elaborated on the Jackson and Kronman argument; they posited that there are two categories of monitors: specialized monitors, who take security interests in assets that they are particular suited to monitor, and general monitors, who may remain unsecured in order to exploit their comparative monitoring advantage or take security in specific assets in order to reduce their higher monitoring costs. DOUGLAS G. BAIRD, THOMAS H. JACKSON, & RANDAL C. PICKER, *CASES, PROBLEMS, AND MATERIALS ON SECURITY INTERESTS IN PERSONAL PROPERTY* 361-67 (1984).

34. See Alan Schwartz, *Security Interests and Bankruptcy Priorities: A Review of Current Theories*, 10 J. LEGAL STUD. 1, 8-9 (1981); Saul Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 YALE L.J. 49, 69 (1982); Robert Scott, *A Relational Theory of Secured Financing*, 86 COLUM. L. REV. 901, 909-10 (1986).

35. *Id.*

36. Alan Schwartz, *The Continuing Puzzle of Secured Debt*, 37 VAND. L. REV. 1051, 1051 (1984) ("My article did not advocate repealing the privileges attached to secured debt, however, because then-current knowledge also did not permit very precise predictions about repeal's effects.").



A rush of scholarship responded to this criticism by proposing different rationales for Article 9, most of which were variations on the theme of monitoring costs.<sup>37</sup> Like Schwartz, Saul Levmore recognized that *secured* debtors are typically most able to monitor debtors.<sup>38</sup> In Levmore's view, secured debtors could use their monitoring abilities to help shareholders of debtor companies keep abreast of the debtor's financial health and possible misbehavior by the debtor's managers.<sup>39</sup> Expounding on this view, Robert Scott suggested that the relationship between debtors and secured creditors actually encourages business development.<sup>40</sup> Because Article 9 gives secured creditors a "floating lien" on a debtor's present and future assets, it provides the creditor with the power to "turn off the spigot" of financing if the debtor fails act in the business' best interests.<sup>41</sup> Thus, secured creditors can take an active role in ensuring that debtors behave in a financially responsible way, and secured creditors perform functions they would otherwise not undertake without security, which allows them to share in the debtor's returns.<sup>42</sup>

Others defended secured credit on property law principles. Steven Harris and Charles Mooney, for example, suggested that the fact that secured lending might work against the interests of third parties does not necessitate a change.<sup>43</sup> "[T]he assumption that the creation of security interests—or any other voluntary activity, for that matter—imposes costs on third parties, produces inefficient results, or otherwise is not socially optimal (or even useful) does not compel the conclusion that the law should *prohibit* that activity."<sup>44</sup> Harris and Mooney also suggested that the real choice most commercial debtors face is not whether to finance their venture with

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37. See Homer Kripke, *Law and Economics: Measuring the Economic Efficiency of Commercial Law in a Vacuum of Fact*, 133 U. PA. L. REV. 929, 933–55 (1985) (defense "based on realistic observation of the commercial world"); Levmore, *supra* note 34, at 51 (noting how secured lending can promote monitoring while minimizing free-rider problems); Scott, *supra* note 34, at 916–33 (arguing that secured lending as a relational contract serves monitoring goals); James J. White, *Efficiency Justifications for Personal Property Security*, 37 VAND. L. REV. 473, 491–502 (1984) (maintaining that a firm can lower its cost of credit by granting security to the most risk-averse creditors).

38. Levmore, *supra* note 34, at 69.

39. See *id.*

40. See Scott, *supra* note 34, at 948.

41. *Id.* at 913.

42. *Id.*

43. Steven L. Harris & Charles W. Mooney, Jr., *A Property-Based Theory of Security Interests: Taking Debtors' Choices Seriously*, 80 VA. L. REV. 2021, 2037 (1994).

44. *Id.* at 2026–27.

secured or unsecured debt but rather whether to finance with secured debt or not be able to obtain funding at all.<sup>45</sup>

However, others criticized Article 9 directly. In addition to the problem of potential unfairness to unsecured third parties, as discussed below, they claimed that secured debt causes inefficient bargaining between secured creditors and debtors.<sup>46</sup> Whenever two parties are able to shift the risk of loss from one another to a third party, the parties are incentivized to do so, even when the relationship—in this case, one of secured creditor and debtor—results in a loss.<sup>47</sup> This arrangement is also arguably at cross-purposes with the goals of bankruptcy, which do not allow a debtor to increase the pool of assets available to one creditor at the expense of another.<sup>48</sup> Further, debtors could theoretically use secured debt to externalize the costs of a debtor's wrongdoing, since fully encumbering assets with secured debt might make it nearly impossible for tort victims and other involuntary creditors to recover.<sup>49</sup> This cost externalization would conceal the true cost of doing business from consumers, as the debtor is not forced to raise prices to account for internalized tort costs. In addition, as Warren has pointed out, proof does not exist that the current system is actually efficient.<sup>50</sup>

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45. See *id.* at 2030.

46. See *Uneasy Case 1*, *supra* note 2, at 867–71.

47. *Id.* at 867.

48. *Id.* at 870–71.

49. See LoPucki, *supra* note 9, at 1897–99; see also David W. Leebbron, *Limited Liability, Tort Victims, and Creditors*, 91 COLUM. L. REV. 1565, 1646–49 (1991). As LoPucki explains,

[t]o take the simplest example, assume that Debtor has assets of \$100 and debt of \$100 owed to a creditor (“C”). Debtor then inflicts a tortious injury of \$100 on a victim (“T”). Debtor becomes liable for the tort, but does not gain from it, so that Debtor has assets of \$100 and debt of \$200. Debtor is then liquidated. If the debt to C is unsecured, C and T each receive distributions of \$50. If the debt to C is secured, C receives \$100, and T receives nothing. Because C collects \$100 with security and only \$50 without it, Debtor’s cost of borrowing from C likely will be lower if the loan is secured. The cost saving thus achieved is not offset by higher costs of borrowing from T, because T had no opportunity to bargain.

LoPucki, *supra* note 9, at 1898.

50. As Elizabeth Warren has stated,

without empirical evidence, it is hard to estimate the actual effects of a full priority system show who benefits and who loses. No studies show the consequences of highly leveraging businesses. No studies show larger economic effects of Article 9. Although a number of Article 9 missionaries carry the message of Article 9 to foreign countries, as Americans have actively pushed the adoption of a UCC-style full priority system throughout Europe, Asia, and South America, the benefits of the system are asserted rather than proved.

Warren, *supra* note 2, at 1379.

Additionally, Article 9 is one of many corporate laws companies can use to shield themselves from the consequences of tort liability.<sup>51</sup> These devices become particularly striking when companies with low liquidity that engage in risky enterprises, and these are precisely the kinds of entities that can only receive credit on a secured basis. Take, for example, the New York City cab industry. In the 1990s, the number of accidents involving New York taxis rose dramatically.<sup>52</sup> Many victims of accidents involving the cabs, including injuries to bystanders, found themselves unable to collect their tort awards because secured debt fully encumbered the taxi medallions, even though they were worth approximately \$275,000.<sup>53</sup> In some cases, the debt pre-dated the tort award, but in other cases, the medallion owners procured additional secured debt after the finding of liability in order to make the medallions judgment proof.<sup>54</sup>

Typically, these types of enterprises or individuals, such as medical professionals, would remain answerable to tort victims through general liability or malpractice insurance.<sup>55</sup> Nevertheless, often these debtors are often under-insured, which causes a substantial level of exposure for the debtor itself.<sup>56</sup> A debtor could theoretically work around this exposure by fully encumbering its assets with secured debt, with the intention that, between the inadequate insurance and secured debt, the debtor would never pay the full amount of tort damages for which it is responsible.<sup>57</sup>

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51. See generally LoPucki, *supra* note 13.

52. Yeon-Koo Chee & Kathryn E. Spier, *Strategic Judgment Proofing*, 39 RAND J. ECON. 926, 926–27 (2008). Although Chee and Spier provide an excellent economic analysis of some strategies used to defeat judgment proofing, they have a more optimistic view of secured debt as an incentive to prevent torts by the debtor. “The secured senior debtholders face a lower risk of nonrepayment than the holders of junior claims and, as a consequence, require a lower interest rate. This lower interest rate makes bankruptcy less likely, leading the entrepreneur to better internalize the social harm from the risky activity.” *Id.* at 927. This assertion does not fully make sense, as judgment proofing requires that the debtor *never* pays its tort liabilities and instead externalizes the cost of its wrongdoing by making tort victims bear the burden of their injuries.

53. *Id.* at 926.

54. *Id.* at 926 n.1.

55. See *id.* at 927.

56. *Id.* (describing various judgment-proofing techniques that physicians and other corporate actors used).

57. In theory, a debtor who deliberately encumbers assets with secured debt for the specific purpose of avoiding tort liability could be subject to corporate veil piercing and liability for fraudulent transfer.

*B. The Problem of Tort Victims*

Many have strongly criticized the justifications for secured credit because of its failure to account for the problem of tort victims, who are in the position of creditors because of the debtor's wrongdoing. The traditional economic justification for tort liability is that it promotes the efficient allocation of the resources: the internalization of the costs of wrongdoing incentivizes the companies to find ways to avoid causing harm.<sup>58</sup> However, the Article 9 priority system is at odds with this aim. As Baird stated,

[a] firm is more likely to engage in hazardous activity if any of its investors, including secured creditors, can prime tort victims. As long as investors can enjoy the benefits when a firm engages in a hazardous activity, but avoid some of the costs, a firm will not fully account for the harm it causes to others.<sup>59</sup>

Not only is the priority scheme Article 9 established in apparent opposition to the aim of tort liability, it is difficult to extend efficiency rationales for Article 9 to account for tort victims because these parties never intended to enter into a creditor-debtor relationship in the first place.<sup>60</sup> The creditor's bargain model, for example, assumes that secured credit reflects the relationship that creditors would choose if they could have bargained for their positions *in rem*.<sup>61</sup> The model assumes that creditors consent to their respective positions in relation to the debtor and that secured creditors agree to charge lower interest rates in return for unsecured creditors assuming the monitoring costs.<sup>62</sup> However, this assumption does not account for the fact that tort victims do not have the option of charging a premium in return for subordinate status to secured creditors, as they never anticipated becoming creditors in the first place.<sup>63</sup>

Ordinarily, the law looks askance when two parties enter a contract and agree that third parties will bear the risk of loss if one of the parties is unable to honor its obligations.<sup>64</sup> Yet, according to

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58. See, e.g., WILLIAM M. LANDES & RICHARD A. POSNER, *THE ECONOMIC STRUCTURE OF TORT LAW* 1 (1987); GUIDO CALABRESI, *THE COSTS OF ACCIDENTS* 26 (1970) ("I take it as axiomatic that the principal function of accident law is to reduce the sum of the costs of accidents and the costs of avoiding accidents.").

59. Baird, *supra* note 2, at 1429.

60. See LoPucki, *supra* note 9 at 1901–02.

61. See Jackson & Kronman, *supra* note 2, at 1164.

62. See *id.* at 1147–61.

63. See LoPucki, *supra* note 9, at 1893.

64. See Warren, *supra* note 2, at 1375.

critics of Article 9, secured credit allows just such an arrangement to take place.<sup>65</sup> Article 9's treatment of involuntary creditors is one of a number of devices in U.S. corporate law, such as the rise of the limited liability company, that shield corporate entities from tort liability.<sup>66</sup> Criticism of secured credit's role in this arrangement began with scholars such as Lucian Bebchuk, Jesse Fried, Elizabeth Warren, and Lynn LoPucki. LoPucki reformulated the creditor bargain model's characterization of secured credit as an agreement between the debtor, secured creditor, and unsecured creditor as an "agreement between [debtor] and [secured creditor] that [the unsecured creditor] take nothing."<sup>67</sup> To the extent that secured creditors recover despite the injury to involuntary creditors, it compounds the already existing injury done to third parties.<sup>68</sup>

Another charge leveled at secured credit is that it may encourage the lender to behave badly. While proponents of secured credit have posited that it encourages efficient monitoring of debtors, Bebchuk and Fried have suggested the opposite: that security is used in place of actual monitoring or efficient loan covenants, the latter of which may accurately reflect the true bargain between the parties and which the creditor may not effectively police.<sup>69</sup> If a lender knows that a security interest protects its investment, the existence or non-existence of tort victims does not change its recovery if the debtor becomes insolvent; therefore, it is not motivated to encourage the debtor to take precautions to limit its tort exposure.<sup>70</sup> Furthermore, secured credit also involves increased contracting costs, which may discourage larger firms that have access to unsecured credit from using secured debt.<sup>71</sup>

Other scholars critical of secured credit have argued that Article 9 unfairly redistributes wealth from involuntary creditors—and tort

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65. *Id.*

66. See Leebron, *supra* note 49, at 1565–69 (1991) (discussing the role that limited liability plays in protecting investors from tort liability).

67. See generally *Uneasy Case 1*, *supra* note 2; Warren, *supra* note 2; see also LoPucki, *supra* note 9, at 1899.

68. LoPucki, *supra* note 9, at 1917 ("Article 9 is highly complex, unintuitive, and notoriously deceptive. In order to protect secured creditors, it rejects what are, for anyone other than an expert in Article 9, basic principles of justice.")

69. *Uneasy Case 1*, *supra* note 2, at 899–902.

70. *Id.* at 898–99.

71. *Id.* at 877 (discussing how establishing a "priority right" can increase transaction costs; see generally Ronald J. Mann, *Explaining the Pattern of Secured Credit*, 110 HARV. L. REV. 625 (1997). Mann's article begins with a telling quote from a corporate president: "I would say that there's a lower cost in an unsecured situation because of all the brain damage in going out and getting appraisals and all that other bullshit [in a secured situation], where in an unsecured deal you just do the deal and you get the money . . ." *Id.* at 625.

victims in particular—to secured creditors.<sup>72</sup> The most common call for reform of the secured credit system that accounts for involuntary creditors is to give those creditors super-priority over secured creditors.<sup>73</sup> Others have called for partial priority through the institution of a carve-out in bankruptcy for involuntary creditors that would reserve a certain percentage of value for them that would otherwise go to pay secured claims.<sup>74</sup> Bebchuck and Fried have pointed out that various Chapter 11 mechanisms already operate to give secured creditors what amounts to partial priority. They have suggested several alternatives to absolute priority, including a carve-out and an adjustable priority scheme that would accommodate non-adjusting creditors like tort victims.<sup>75</sup>

Even some defenders of secured credit have been receptive to super-priority for tort victims. Advocates of secured credit argue that the current system is simply recognizing the inevitable, as Article 9 reflects the bargain that creditors would choose to make for themselves.<sup>76</sup> Even “if the law denied debtors the power to prefer some creditors over others through a system of security agreements, a similar network of priority relationships could be expected to emerge by consensual arrangement between creditors.”<sup>77</sup> However, defenders of secured credit, such as James J. White, have opined that the question of whether secured credit is efficient is completely irrelevant because banks and other secured lenders will not abandon absolute priority, and any alternative to Article 9 would be even less efficient than the current arrangement due to higher transaction costs.<sup>78</sup>

White dismisses both the possibility of elevating involuntary creditors in priority and mandating that debtors procure insurance to

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72. See generally Warren, *supra* note 2; LoPucki, *supra* note 9; *Uneasy Case 1*, *supra* note 2.

73. See Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 STAN. L. REV. 311, 340 (1993) (“Ideally, nonconsensual claimants would have highest priority in any sort of firm.”); Leebron, *supra* note 49, at 1650 (“In order to limit the externalities, and hence the inefficiencies, created by the limitation of liability, tort claimants should be given priority over both secured and unsecured financial creditors.”); Mark J. Roe, *Commentary on “On the Nature of Bankruptcy”: Bankruptcy, Priority, and Economics*, 75 VA. L. REV. 219, 227 (1989) (“A rule of priority for nonbargain creditors seems efficient.”); Painter, *supra* note 11, at 1081 (“Tort-claim superpriority over secured creditors is, therefore, the most efficient and equitable solution.”).

74. See, e.g., *Uneasy Case 1*, *supra* note 2; Memorandum from Professor Elizabeth Warren, Harvard Law School, to the Council of the American Law Institute regarding “Article 9 Set Aside for Unsecured Creditors” (Apr. 25, 1996), reprinted in UCC Bull., Oct. 1996, at 1.

75. *Uneasy Case 1*, *supra* note 2, at 904–11.

76. See Jackson & Kronman, *supra* note 2, at 1164.

77. *Id.* at 1157.

78. James J. White, *Work and Play in Revising Article 9*, 80 VA. L. REV. 2089, 2089–91 (1994).

protect such claimants *ex ante* as having “evil consequences,” including the ultimate ruination of secured credit.<sup>79</sup> He argues that ensuring payment for involuntary creditors would cause secured debtors to seek alternative ways to ensure full payment outside of Article 9.<sup>80</sup> White concludes that Article 9 correctly ignored involuntary creditors and that equitable concerns in favor of certainty are “the true way.”<sup>81</sup> The idea of granting super-priority to involuntary creditors does pose a challenge to the pre-debate defense of Article 9 as incentivizing lending to risky borrowers, since lenders may not want to extend credit if they know the claims of tort victims may impair their claim to the collateral.<sup>82</sup>

### C. Conclusion: The State of the Debate

Nonetheless, the debate over secured credit remains unresolved. Defenders of Article 9 maintain that many companies would not be able to obtain financing at all without secured credit; as a result, any change in the priority system would negatively influence the availability of credit and cause the eventual downfall of Article 9 as an institution.<sup>83</sup> Critics of the current system have noted that the available empirical evidence does not indicate that any of these consequences would actually materialize if involuntary creditors—tort victims in particular—received super-priority or partial priority ahead of secured creditors.

New commercial realities that led to the global financial crisis, such as asset securitization and other forms of risky debt packaging, have reignited concerns about creditor priorities. As Scott points out, secured lenders are much more likely to be aware of and even participate in business decisions—including those decisions that were profitable in the short term and devastating in the long term,

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79. *Id.* at 2099–2101.

80. *Id.* at 2099.

81. *Id.* at 2096, 2102. Kenneth Klee described the reaction to Warren’s proposal to give super-priority to involuntary creditors as “hysterical efforts to entrench wealth in the hands of banks, insurance companies, and finance companies at the expense of tort creditors, tax creditors, environmental creditors, and, perhaps, employees and trade creditors.” Kenneth N. Klee, *Barbarians at the Trough: Riposte In Defense of the Warren Carve-Out Proposal*, 82 CORNELL L. REV. 1466, 1468 (1997).

82. *See* White, *supra* note 78, at 2099 (“To grant priority to tort claimants, retirees or others in Article 9 is to take a step toward its abolition. Once the competitors to the Article 9 security interest become sufficiently numerous, they will stimulate secured creditors to do exactly what they would do if Article 9 were repealed, namely to find alternative modes of priority . . .”).

83. *See id.*



such as asset securitization.<sup>84</sup> Thus, giving those creditors priority over tort victims rewards bad behavior at the expense of injured parties. Then again, it may be that those firms that are mostly likely to have a high number of involuntary creditors tend not to use secured debt.<sup>85</sup> This may not be optimal since secured lending could serve an important monitoring function and be useful in curtailing risky behavior.<sup>86</sup> The imposition of tort victim super-priority might actually encourage secured lending, as it might incentivize commercial lenders to secure their place in line if they know certain parties' claims will take precedence in the event of the debtor's insolvency.

Ultimately, because both sides of the debate lack empirical support, examining areas of the law which structure creditor priority differently is useful. Maritime law has prioritized certain involuntary creditors for centuries without any disastrous consequences to credit markets. Indeed, while companies in non-maritime industries have traditionally had limited access to secured credit, the shipping industry—also subject to high levels of tort exposure and potentially devastating environmental fines—has had no such difficulty. In fact, secured debt has traditionally been and continues to be the primary source of financing in the maritime context.

## II. TORT CLAIM PRIORITIES UNDER MARITIME LAW

The maritime industry is a working example of how giving super-priority to tort victims would not necessarily make credit unavailable to potential borrowers who have liquidity problems or who otherwise do not have access to large amounts of ready cash. The ocean-faring industries do not appear to suffer a lack of potential lenders and creditors, secured or unsecured, despite the fact that they are high-risk industries that are very sensitive to market conditions and subject to a variety of external and internal risks.<sup>87</sup> Further, much of the scholarly debate over secured credit has focused on giving tort victims priority or partial priority under Article 9. Maritime law gives super-priority to tort victims by way of an *in rem* action against a vessel. This Part considers the treatment of tort victims under maritime law. The following Part examines whether the general commercial context could integrate that treatment.

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84. See Scott, *supra* note 34, at 948.

85. See Listoken, *supra* note 14, at 1044.

86. See Scott, *supra* note 34, at 948.

87. ALAN BRANCH & MARTIN STOPFORD, MARITIME ECONOMICS 200 (2013).

A. *The Maritime Lien*

Under U.S. maritime law, several classes of involuntary creditors have the highest priority under the maritime lien. There are two broad categories of these liens: first is the preferred maritime lien, which tort victims, wage claimants, contract-based claims receive for services to the vessel (“necessaries”) pre-dating preferred ship mortgages, claims for general average,<sup>88</sup> and salvage providers.<sup>89</sup> Second are preferred ship mortgages that post-date the preferred maritime liens.<sup>90</sup> Indeed, there is one type of secured creditor in nearly every *in rem* action: the holder of a preferred ship mortgage.<sup>91</sup> Although Article 9 does not apply to maritime *in rem* actions, preferred ship mortgages must be properly recorded in accordance with federal law, and commercial banks follow Article 9 filing requirements to ensure that their claim has priority if the vessel owner becomes bankrupt.<sup>92</sup>

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88. General average is an equitable rule analogous to that of contribution—when losses or debts are incurred during a voyage that benefit all parties to the venture, all parties will share in responsibility for the loss or debt. See Thomas H. Jackson & Robert E. Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditor's Bargain*, 75 VA. L. REV. 155, 171–72 (1989) (comparing the situation on the eve of corporation bankruptcy to an event giving rise to general average). The simplest example is jettison, when cargo must be thrown overboard to prevent the ship sinking. The parties responsible for that loss include the vessel owner, the charterer, and the crew, as “what is given for the benefit of all should be made good by the contribution of all.” J. Lowell, *General Average*, 9 HARV. L. REV. 185, 187 (1895). Note that it is possible to contractually waive or subordinate a maritime lien—and this is often a standard request of charterers and vessel owners when contracting for services—but one must alert the other party to clauses to that effect in order to be valid. See 46 U.S.C.A. § 31305; 1 THOMAS J. SCHOENBAUM, *ADMIRALTY AND MARITIME LAW* § 9-4 (4th ed. 2004). Related, some debate whether foreign parties can use choice of law clauses in contracts in order to invoke American law and obtain a maritime lien for necessities—which is only recognized in the US. See generally Charles S. Donovan, *Picking the Shipowner's Poison—Choice of Law Clauses and Maritime Liens*, 14 U.S.F. MAR. L.J. 185 (2001); *Lauritzen v. Larsen*, 345 U.S. 571 (1953).

89. Salvage providers engage in the recovery of a vessel, its cargo, or any part of either after the vessel has been wrecked, run aground, or in some other way incapacitated. Bankruptcy is sometimes analogized to salvage, with the aim of bankruptcy being first “to salvage whatever can be salvaged,” with *pro rata* distribution of the remaining assets to those who “entrusted their cargo to the now-failing” vessel. Warren, *supra* note 2, at 1389–90. The exception to this approach is the Article 9 full priority rule. See *id.* at 1389.

90. Raymond P. Hayden & Kipp C. Leland, *The Uniqueness of Admiralty and Maritime Law: The Unique Nature of Maritime Liens*, 70 TUL. L. REV. 1227, 1248 (2005).

91. Technically, a maritime lienholder is also a secured creditor, but holders of preferred ship and fleet mortgages are almost always secured creditors for the purposes of Article 9 as well, as banks insist on filing UCC financing statements over the mortgaged vessels.

92. See 46 U.S.C. § 31322(d). Courts have held that UCC securing interests are preempted by maritime liens; see, e.g., *Midlantic Nat'l Bank v. Sheldon*, 751 F. Supp. 26, 28–30 (E.D.N.Y. 1990).

Maritime liens are creatures of civil law and have an impressive historical pedigree—the first written mention of what we now call the maritime lien appears in the 6th century CE Digest of Justinian, and some maritime law scholars have argued that the lien actually dates back an additional thousand years to the Rhodian sea law of the 8th century BCE.<sup>93</sup> The maritime lien is not possessory, like a mechanic's lien, but gives the holder an inchoate property right in a vessel or other maritime property that the filing of an action *in rem* perfects.<sup>94</sup> The lien arises as of right the moment that the underlying debt is incurred, and only the payment of the obligation or, in the event of non-payment, judicial sale of the vessel extinguishes the lien.<sup>95</sup>

Some refer to maritime liens as “secret liens”<sup>96</sup> because, unlike secured claims or possessory liens, maritime liens do not need to be recorded.<sup>97</sup> Historically, recordation was not feasible. In the course of a single voyage, a vessel may sail halfway around the world and accrue maritime liens in half a dozen countries.<sup>98</sup> Additionally, maritime liens arise the very moment that the lienholder provides services or the vessel's actions injure the person, and only the payment of the underlying debt or judicial sale can discharge the lien.<sup>99</sup> It is possible to file a lien with the proper authority in the country where the vessel is registered, but such filing is at the discretion of the lienholder, and failure to file has no effect on the either the claim or its priority with respect to other liens against the same vessel.<sup>100</sup>

Further, only paying the underlying debt can satisfy a lien or, failing that, judicial sale of the vessel. The sale of a vessel by its owner does not extinguish the lien—indeed, because of the doctrine of personification, the lien remains with the vessel. The difficulty in discharging the liens makes U.S. maritime liens unique and controversial among maritime nations, as the idea that the maritime lien can be asserted against a vessel even when the

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93. Alexander McCabe, *Demosthenes and the Origins of the Maritime Lien*, 42 J. MAR. L. & COM. 581, 581 (2012).

94. Michael J. Ende, *Adrift on a Sea of Red Ink: The Status of Maritime Liens in Bankruptcy*, 11 FORDHAM INT'L. L. J. 573, 575 (1988).

95. See William Tetley, *Arrest, Attachment, and Related Maritime Law Procedures*, 73 TUL. L. REV. 1895, 1925, 1929–37 (1999).

96. See *Krauss Bros. Lumber Co. v. Dimon Steamship Ltd. (The Pacific Cedar)*, 290 U.S. 117, 125 (1933). Note that, although filing perfects Article 9 security interests, maritime liens are not the only “secret liens.”

97. Tetley, *supra* note 95, at 1930.

98. *Id.*

99. See, e.g., *The Rock Island Bridge*, 73 U.S. (6 Wall.) 213, 215 (1867).

100. See George Rutherglen, *The Contemporary Justification for Maritime Arrest and Attachment*, 30 WM. & MARY L. REV. 541, 549–50 (1989).

owner—the source of the wrongdoing—has changed runs counter to notions of equity.<sup>101</sup> Indeed, the United States alone makes the vessel, instead of its owners, responsible to maritime lienholders.<sup>102</sup> To be clear, vessel owners may be personally liable for other debts they incur, but under the doctrine of personification only the vessel itself is liable for maritime liens, not its owners.

The legal fiction of personification is the lien's underlying premise: the vessel itself is treated as a legal person who may incur liabilities and debts during the course of its voyages, just as an individual could.<sup>103</sup> Although this approach seems odd, it reflects a time when creditors needed the ability to seize the vessel at any point when it reentered a nearby port, regardless of any changes in ownership subsequent to the incursion of the debt.<sup>104</sup> Historically, a vessel could avoid liability by simply sailing away.<sup>105</sup> The arrest of the vessel to pay maritime liens developed in response to the vessel escaping.<sup>106</sup> Before the invention of satellites and global tracking devices, one could not reliably track a vessel once it had departed from port, so injured parties needed a way to ensure that they were paid before the vessel vanished, possibly never to be seen again.

With respect to tort claimants, the vessel should be made to compensate to victims, as it was the means by which the injury was inflicted. As Justice Story explained:

The ship is also by the general maritime law held responsible for the torts and misconduct of the master and crew thereof,

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101. See Martin Davies, *In Defense of Unpopular Virtues: Personification and Ratification*, 75 TUL. L. REV. 337, 339 (2000). The alternative justification for the *in rem* action used in other jurisdictions is the procedural theory, which “conceives of the action *in rem* as simply a device for forcing the appearance of the shipowner *in personam* rather than truly as an action against the ship itself.” *Id.* at 341.

102. See *id.* at 339.

103. *Id.* at 337. In a 1902 opinion, Justice Oliver Wendell Holmes poetically explained the doctrine of personification.

A ship is born when she is launched, and lives so long as her identity is preserved. Prior to her launching she is a mere congeries of wood and iron—an ordinary piece of personal property—as distinctly a land structure as a house, and subject only to mechanics' liens created by state law and enforceable in the state courts. In the baptism of launching she receives her name, and from the moment her keel touches the water she is transformed, and becomes a subject of admiralty jurisdiction. She acquires a personality of her own; becomes competent to contract, and is individually liable for her obligations, upon which she may sue in the name of her owner, and be sued in her own name. Her owner's agents may not be her agents, and her agents may not be her owner's agents.

Tucker v. Alexandroff, 183 U.S. 424, 438 (1902).

104. See SCHOENBAUM, *supra* note 88, at § 9-1.

105. The John G. Stevens, 170 U.S. 113, 122–23 (1898).

106. See SCHOENBAUM, *supra* note 88, at § 9-1.

whether arising from negligence or a wilful [sic] disregard of duty; as for example, in cases of collision and other wrongs done upon the high seas or elsewhere within the admiralty and maritime jurisdiction, upon the general policy of that law, which looks to the instrument itself, used as the means of the mischief, as the best and surest pledge for the compensation and indemnity to the injured party.<sup>107</sup>

The purpose of the maritime lien, including the lien for a maritime tort, is two-fold: keeping vessels moving in commerce “while not allowing them to escape their debts by sailing away.”<sup>108</sup> The lien was created as a form of protection for the flow of maritime commerce, as the holders of maritime liens are typically members of the shipping industry such as sailors, stevedores, and shipwrights.<sup>109</sup> These industry members were crucial to maintain the uninterrupted continuation of trade. The policy of keeping the ship in service is a consistent theme throughout the rules of maritime indebtedness. “The whole object . . . is to furnish wings and legs to the forfeited hull, to get back [to sea] for the benefit of all concerned; that is, to complete [the] voyage.”<sup>110</sup> These objectives mirror the motivation behind the creation of Article 9: the non-possessory security interest allows the debtor to use the collateral without interruption of business while at the same time ensuring repayment to the secured creditor.

### 1. The Priority Scheme

The Maritime Lien Act, which follows the traditional common law ranking of maritime liens, sets out the order of lien priorities under U.S. maritime law.<sup>111</sup> The priority rules are flexible—federal courts acting in their maritime jurisdiction have considerable equitable powers and may subordinate otherwise superior claims when it appears that the debtor and secured lender are cooperating to

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107. *The Malek Adhel*, 43 U.S. 210, 234 (1844).

108. *In re Riffe Petroleum Co.*, 601 F.2d 1385, 1389 (10th Cir. 1979).

109. See Robert Force, A.N. Yiannopoulos & Martin Davies, *Marine Insurance*, in 2 ADMIRALTY AND MARITIME LAW 205, 262 (Thomas Schoenbaum ed., 4th ed. 2004).

110. GRANT GILMORE, JR. & CHARLES L. BLACK, *THE LAW OF ADMIRALTY* 586–89 (2d ed. 1975).

111. 46 U.S.C. §§ 31301–31343.

shield the vessel from maritime liens.<sup>112</sup> Generally, preferred maritime liens have priority over preferred ship mortgages, and all maritime liens have priority over perfected Article 9 secured claims in the maritime *in rem* action.<sup>113</sup> The Maritime Lien Act ranks three categories of creditors in descending order of priority: preferred maritime liens, preferred ship mortgages, and maritime liens for necessities.<sup>114</sup> All other non-maritime claims, including the claims of secured lenders, follow.<sup>115</sup>

Within the category of preferred maritime liens, the general maritime law ranks seamen's wages first, then salvage claims, tort claims, and trade creditor claims for necessities (including repairs, supplies, towage, wharfage, and pilotage).<sup>116</sup> The Supreme Court in *The John G. Stevens* observed that the reason for giving tort victims preferred status over liens for necessities (and, by extension, all other creditors with inferior priority, including non-maritime creditors) is that everyone who has contributed to the vessel is, in a way, responsible for the vessel's wrongdoing:

All the interests, existing at the time of the collision, in the offending vessel, whether by way of part ownership, of mortgage, of bottomry bond, or of other maritime lien for repairs or supplies, arising out of contract with the owners or agents of the vessel, are parts of the vessel herself, and as such are bound by and responsible for her wrongful acts.<sup>117</sup>

In other words, although the repair provider, secured creditor, or unsecured creditor have not directly done wrong, each of them contributed to the business of the debtor, which in turn was the cause of the tort victim's injury. Therefore, they are responsible for absorbing some of the tort victim's loss.

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112. As, for example, in the case of a fraudulent transfer. *See, e.g.*, *Custom Fuel Services v. Lombas Industries*, 805 F.2d 561, 562–66 (5th Cir. 1986) in which the court equitably subordinated the claim of a prior-in-time secured creditor (the holder of a preferred ship mortgage) to that of a maritime lien for necessities a charterer held. The court found that the debtor and the secured creditor had conspired to transfer title to a wholly owned subsidiary of the secured creditor, making it the nominal owner in return for a preferred ship mortgage in amount equal to value of vessel. *Id.* at 566. In the court's view, this was done to insulate the vessel from maritime liens. *Id.*

113. 46 U.S.C. §§ 31301–31343.

114. *Hayden & Leland*, *supra* note 90, at 1248.

115. *Id.*

116. General maritime law, which is federal common law, rather than statute, sets out this ranking. *See id.* at 1244–45.

117. *The John G. Stevens*, 170 U.S. 113, 123 (1898).

## 2. Ranking of Creditors within Priority Classes: Last in Time, First in Right

The ranking of creditors within the same priority classes in maritime law is the reverse of the ranking of creditors under Article 9. The UCC ranks secured creditors “first in time, first in right,” so that the creditor who first perfected his secured claim by following Article 9’s filing procedures will be paid ahead of other secured creditors.<sup>118</sup> By contrast, priority among maritime lienholders is “last in time, first in right,” with the most recent claimant being paid first.<sup>119</sup> This ranking system is traditionally defended using the proprietary interest theory, which is that the lienholder’s interest, like other proprietary interests in a vessel, is subject to all maritime perils, including subsequent torts, collisions, and repairs.<sup>120</sup>

A more satisfactory explanation is that, traditionally, the vessel was the only security for a marine service provider’s claim.<sup>121</sup> Thus, only the assurance that their potential claim would trump any existing claims guaranteed that service providers would perform their duties.<sup>122</sup> Another explanation is that those who provided services to the vessel most recently are also those most directly responsible for the vessel’s seaworthiness and ability to be sold.<sup>123</sup> Yet another explanation is that, as a practical matter, maritime liens are subject to laches, and a lienholder must exercise some degree of diligence to maintain a lien when the vessel has been sold.<sup>124</sup> Thus, the last in time rule may incentivize lienholders to seek timely payment to avoid losing the lien altogether.

The order of lien priority under Article 9 is directly opposed to the maritime system in part because Article 9 is a notice-based system. In order to ensure that secured creditors comply with the filing requirements of Article 9, the creditor who fails to do so in a

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118. U.C.C. § 9-322(a)(1); cf. Ronald J. Mann, *The First Shall Be Last: A Contextual Argument for Abandoning Temporal Rules of Lien Priority*, 75 TEX. L. REV. 11, 14–15 (1996) (“In American law, the central principle for determining priority between competing lienholders is the simple notion that first in time is first in right”).

119. Hayden & Leland, *supra* note 90, at 1249–50.

120. *The John G. Stevens*, 170 U.S. at 120; Note, *Priorities of Maritime Liens*, 69 HARV. L. REV. 525 (1956).

121. Note, *supra* 120, at 528.

122. *Id.*

123. See *The De Smet*, 10 F. 483, 490 (E.D. La. 1881) (“The reason for the rule that maritime lines are entitled to priority in the inverse order in which they attach, is that in the case of contracts the benefit rendered at the latest hour preserves the res to satisfy the earlier claims, and thereby earns a superior equity in respect to the common fund.”).

124. Circuit courts approach the laches determination in different ways. One example is the Fifth Circuit’s requirement of “reasonable diligence.” See, e.g., *Merchants & Marine Bank v. The T.E. Wells*, 289 F.2d 188, 190 (5th Cir. 1961).



timely manner may find that another creditor who filed first trumps his priority even if the first-filing debtor actually extended credit later in time. Many have heavily criticized the maritime ordering system because it is incongruent with Article 9's approach and because it works to the prejudice of creditors with older claims.

### 3. The *In Rem* Action

An *in rem* action perfects and enforces maritime liens.<sup>125</sup> An *in rem* action is a legal action against property, in contrast to an action *in personam*, which is against the person. A maritime lien holder is entitled to bring an action *in rem* to perfect its lien by filing the action in the federal district court whose jurisdiction encompassed the location where the property to be seized.<sup>126</sup> Rule C of the Federal Rules of Civil Procedure Supplemental Rules for Admiralty (the Supplemental Rules) sets forth this procedure and requires that the lienholder provide a verified complaint that describes the property to be seized with reasonable particularity and states that it is located within the district.<sup>127</sup>

Once the lienholder has filed a complaint meeting these requirements, the court will issue a warrant, which the United States Marshals carry out for the arrest of the vessel.<sup>128</sup> Depending on the vessel's location at the time of its arrest, it could remain in the custody of the Marshals, or, if the vessel was in a repair yard or other facility, it could remain at the wharf. The Marshals or the wharf owners' expenses are *custodia legis*, i.e. legal costs that proceeds from the sale must pay.<sup>129</sup>

Other parties with an ownership claim in the seized vessel have fourteen days from the initiation of the *in rem* action to file a statement of interest indicating that they also have a claim to the

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125. Douglas Lind, *Pragmatism and Anthropomorphism: Reconceiving the Doctrine of the Personality of the Ship*, 22 U.S.F. MAR. L.J. 39, 46 (2010).

126. Article III of the United States Constitution gives federal courts exclusive jurisdiction over maritime law, although there are limited exceptions by way of the "savings to suitors" clause of the Judiciary Act of 1789 (now found in the United States Code), which allows seamen to bring common law claims in state court. U.S. CONST. art. III, § 2; 28 U.S.C. § 1333(1); *Lewis v. Lewis & Clark Marine, Inc.*, 531 U.S. 438, 444–46 (2001). This exception does not apply to *in rem* actions, which remain exclusively with federal courts sitting in admiralty jurisdiction. See *Lewis*, *supra* at 446.

127. FED. R. CIV. P. SUPP. C(2).

128. *Id.* at C(3)(a).

129. See, e.g., Geoffrey H. Longenecker, Comment, *Developments in the Law of Maritime Liens*, 45 TUL. L. REV. 574, 577–78 (1971).

proceeds of the vessel's sale.<sup>130</sup> Under Rule E of the Supplemental Rules, the vessel owner is entitled to a prompt hearing in which to challenge the claimed lien, including a challenge based on no valid lien.<sup>131</sup> The maritime *in rem* action is subject to two particular safeguards. First, the courts generally require an *in rem* plaintiff to post a bond as security with the court.<sup>132</sup> Second, the vessel owner can counterclaim an *in rem* action for wrongful seizure and, if successful, can recover *custodia legis* and attorney's fees, as well as any lost profits suffered as a result of taking the vessel out of commerce.<sup>133</sup> There are thus significant financial consequences to bringing an *in rem* action when there is no valid lien to be enforced.

The *in rem* action coupled with the maritime lien provides exceptionally an powerful tool for parties injured while providing services to vessels. The arrest of the vessel pursuant to the filing of the *in rem* action, which has the potential to take the vessel out of commerce, incentivizes maritime debtors to resolve claims as quickly as possible.

### B. Priority in Bankruptcy

A long-standing conflict exists between bankruptcy law and admiralty law, particularly with respect to maritime liens.<sup>134</sup> Article 9 applies to bankruptcy proceedings involving maritime corporate actors, and, under that priority system, maritime lienholders are unsecured creditors. Thus, a bankruptcy court can sell off vessels burdened with maritime liens as assets of the debtor and distribute the proceeds according to Article 9. The inconsistency in the treatment of tort victims and other maritime lienholders in and out of bankruptcy is the result of a conflict between maritime and bankruptcy jurisdiction. However, in most cases the sale of a vessel in a bankruptcy proceeding does not extinguish any maritime liens.

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130. FED. R. CIV. P. SUPP. C(6)(a). Local rules may provide for a different period where notice by publication is required after the property is released on bond. FED. R. CIV. P. SUPP. E(4). In the Eastern District of Louisiana, for example, parties have twenty-one days to file a Statement of Interest if notice of the arrest is required to be made by publication. E.D. La. LAR 64.1.

131. See FED. R. CIV. P. SUPP. E(4)(f).

132. *Id.* at E(5)(a).

133. *Custodia legis* fees include the cost of holding the vessel, which can be considerable. The U.S. Marshals service requires a minimum deposit of \$10,000 to arrest a vessel, and private wharfage and dockage fees can be even higher. See SEAFARERS' RIGHTS, *Ship Arrest for Seafarers' Wages in the United States of America* 4.1, available at [http://seafarersrights.org/wp/wp-content/uploads/2014/10/USA.SUBJECTGUIDE.ARRESTFORSEAFARERSWAGES\\_2013\\_ENG.pdf](http://seafarersrights.org/wp/wp-content/uploads/2014/10/USA.SUBJECTGUIDE.ARRESTFORSEAFARERSWAGES_2013_ENG.pdf).

134. See Ende, *supra* note 94, at 574.

Most courts have held that only a judicial sale of the vessel by a court sitting in admiralty jurisdiction can free the vessel of maritime liens.<sup>135</sup> As a result, secured creditors can be highly motivated to negotiate with maritime lienholders in bankruptcy.<sup>136</sup> For example, in 2011, General Maritime (“GenMar”), owner of one of the largest fleets of crude oil tanker vessels in the world, entered Chapter 11 bankruptcy.<sup>137</sup> Most of GenMar’s value was in its thirty-three tankers, and, although the maritime lienholders were subordinate to the secured lenders in priority, their liens on the vessels would have survived bankruptcy if the assets were insufficient to pay their claims after the secured claims were satisfied.

Mindful of this, the secured lenders included the maritime lienholders in their plan to keep GenMar in business. Those secured creditors—including first preferred ship mortgage holders, conventional lenders, and a significant shareholder—negotiated a plan of reorganization that included lockup arrangements with the existing lenders and a debtor-in-possession financing from one of the secured creditors.<sup>138</sup> As part of this plan, involuntary creditors who had supplied GenMar vessels were paid with bankruptcy court approval.<sup>139</sup> The secured creditors did not view this as shrinking the pool of assets available to creditors generally. Instead, they did this to prevent the involuntary creditors from initiating *in rem* actions to satisfy their maritime liens after the bankruptcy proceedings were complete.<sup>140</sup> This cooperation between secured creditors and lienholders may demonstrate the continuing power of the maritime priority system, even in bankruptcy. Additionally, the inability of bankruptcy proceedings to discharge maritime liens could lessen

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135. See *id.* Case law supports the position that only an admiralty court may sell a vessel free of maritime liens. See, e.g., *Morgan Guar. Trust Co. v. Hellenic Lines Ltd.*, 38 B.R. 987, 998 (S.D.N.Y.), modified, 585 F. Supp. 1227 (S.D.N.Y. 1984); *Johnson v. Home State Bank*, 501 U.S. 78, 84 (1991) (holding that “a bankruptcy discharge extinguishes only one mode of enforcing a claim—namely, an action against the debtor in personam—while leaving intact another—namely, an action against the debtor *in rem*.”). But cf. *In re Penrod*, 50 F.3d 459, 462–63 (7th Cir. 1995) (concluding that chapter 11 plan of reorganization can modify lien, force holder to accept indubitable equivalent, or even extinguish lien); *In re Millennium Sea Carriers, Inc.*, 275 B.R. 690, 698 (S.D.N.Y. 2002) (“bankruptcy courts are perfectly capable of adjudicating maritime lien claims”).

136. *Ende*, *supra* note 94, at 577–78.

137. Stephen T. Whelan & Marc E. Richards, *That Sinking Feeling: Lessons Gleaned from Recent Maritime Bankruptcies*, ABF JOURNAL, March 2013, available at <http://www.blankrome.com/index.cfm?contentID=37&itemID=3032>.

138. *Id.*

139. *Id.*

140. See *id.* (“This was a strategic decision: rather than being viewed as siphoning cash from the debtors, this approach was meant to prevent vendors, with liens under maritime law, from exercising their remedies, arresting the related vessels and hence endangering the opportunity for an effective reorganization.”).

the incidence of debtors choosing to liquidate their own assets outside of bankruptcy in order to pay off “favored” creditors.<sup>141</sup>

### C. Protection & Indemnity Insurance

Any discussion of a shift away from secured creditor priority raises the question of how such creditors would respond to protect their investment. One of the responses in the maritime industry is that secured creditors demand proof of Protection and Indemnity (P&I) insurance from potential borrowers.<sup>142</sup> P&I insurance is a unique feature of the maritime industry that initially evolved in response to the historical unreliability of traditional marine insurers.<sup>143</sup> The uncertainty of losses was a serious problem for shipping companies given the potential costs of maritime liens, the disruption of the industry by war and piracy, and, later, the heavy fines imposed for violation of marine pollution laws.<sup>144</sup> Modern P&I policies generally cover claims for personal injury and death, passenger liability (including luggage), liability for cargo loss and damage, collision, wreck removal, pollution, loss of property on the insured vessel, damage to fixed and floating objects, towage, and general average.<sup>145</sup>

Unlike typical marine insurance, which can cover damage to the vessel and cargo, “clubs,” rather than insurance companies, issue P&I insurance. These clubs are non-profit organizations composed of vessel owners and operators, charterers, and other industry actors; thus, they are not beholden to their shareholders the way insurance companies are.<sup>146</sup> The clubs are incorporated so that members do not seek to enforce their rights against each other, but

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141. See Lynn LoPucki, *Should the Secured Credit Carve-Out Apply Only in Bankruptcy?*, 82 CORNELL L. REV. 1483, 1494 (1997) (arguing that any change in the creditor priority structure must apply both inside and outside of bankruptcy, lest debtors liquidate their own assets and sell them to favored creditors outside the bankruptcy preference period).

142. Anecdotal evidence suggests that maritime lenders do not always require P&I insurance from smaller borrowers such as LLCs that own two or three vessels that they charter to other companies.

143. See DAVID SEMARK, *P&I CLUBS: LAW AND PRACTICE* 1–7 (2013).

144. See *id.*

145. *Id.*

146. See *id.* at 1. In the U.S., the right of vessels owners to insure themselves against their own negligence has long been upheld. See, e.g., *Hanover Fire Ins. Co. of New York v. Merchants' Transp. Co.*, 15 F.2d 946, 948 (1926) (citing *Waters v. Merchants' Louisville Insurance Co.*, 36 U.S. 213 (1837)).

against the corporation.<sup>147</sup> A management company whose sole client is the club generally supervises the members.<sup>148</sup> All members of the P&I clubs contribute to a common pool to pay out the claims of involuntary creditors, provided those claims are settled in accordance with club rules.<sup>149</sup> P&I clubs also do not pay any claims until the member has paid the claimant. There is a tribunal process to determine whether the claims falls within club rules.<sup>150</sup>

Ordinarily, insurance has the undesirable effect of disincentivizing the insured from taking the proper precautions to avoid accidents, which leads to moral hazard.<sup>151</sup> Since the members of P&I clubs, unlike traditional insurance companies, have the benefit of expertise in the field, they know whether the actions of a member fall within an acceptable range of precautionary activities or whether those actions are outside the acceptable range. If they are outside the acceptable range, the club denies P&I coverage, and the actor alone bears cost of those actions. Thus, P&I clubs represent an example of private rulemaking or ordering that requires that the debtor, along with a group of similarly situation actors, bear the risk of loss.<sup>152</sup>

#### D. *The Availability of Secured Credit in the Maritime Context*

Giving priority to involuntary creditors has not frozen the credit available to maritime borrowers. To the contrary, the shipping industry has historically suffered from a surplus of available credit, even for under-capitalized shipowners.<sup>153</sup> In the mid-1990s, banks even complained about the competition in providing financing to the shipping industry.<sup>154</sup> The cost of doing business on the open water is very high, with shipping vessels sometimes costing hundreds of millions of dollars, and the shipping market can be

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147. SEMARK, *supra* note 143, at 7.

148. *Id.* at 9, 12.

149. See John D. Kimball, *The Central Role of P&I Insurance in Maritime Law*, 87 TUL. L. REV. 1147, 1148–49. (2013).

150. SEMARK, *supra* note 143, at 9, 12.

151. See Louis Kaplow, *An Economic Analysis of Legal Transitions*, 99 HARV. L. REV. 509, 537 (1986). Moral hazard is a situation in which a party fails to take steps to minimize the possibility of harm because it does not bear the risk of loss. *Id.*; see generally Tom Baker, *On the Geneology of Moral Hazard*, 75 TEX. L. REV. 237 (1996); Mark V. Pauly, *The Economics of Moral Hazard: Comment*, 58 AM. ECON. REV. 531, 535 (1968); Steven Shavell, *On Moral Hazard and Insurance*, 93 Q.J. ECON. 541, 541 (1979).

152. See Steven L. Schwarcz, *Private Ordering*, 97 NW. U. L. REV. 319, 327 (2002).

153. BRANCH & STOPFORD, *supra* note 86, at 200.

154. *Id.* at 201.

volatile. As a result, maritime finance tends to be fairly conservative—there are few publicly traded shipping companies, and most vessels are purchased either with equity, debt finance, or a blend of the two.<sup>155</sup>

Debt financing is the most common source of credit to vessel owners and typically takes the form of a term loan from a commercial bank.<sup>156</sup> More than one hundred banks extend credit to the maritime industry, and many of these banks do so on a secured basis and have monitoring capabilities.<sup>157</sup> It is possible that secured credit is the primary form of financing in the maritime industry because the security device the creditors employ—the preferred ship mortgage—has a priority position in the *in rem* action, although it is behind involuntary creditors.<sup>158</sup> As a result, these banks already have systems in place to account the debtors' potential significant tort exposure, which has super-priority in an *in rem* action against the vessels being built, purchased, or leased back. The maritime industry thus offers an extreme example of a setting in which risk is high and most financing is through secured debt, even though involuntary creditors may be repaid before secured debt out of the sale of the debtor's personal property. Of course, most maritime financing is secured due to the priority scheme. It is possible that the priority of maritime liens in the *in rem* action deters unsecured creditors, since most of the value of maritime companies is in the vessels.

None of this is to say that the shipping industry has never suffered from a lack of ready credit. However, the reasons for dry spells in the maritime credit market relate to the volatility of the

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155. *Id.* at 211–16.

156. *Id.* at 216–18.

157. *Id.* at 229.

158. See Bruce G. Paulsen, Paula Odysseos & Cassandra L. Savicki, *New Horizons: An Analysis of Public Markets Financing of Shipping Ventures and the Impending Wave of Shipping Securities Litigation*, 81 TUL. L. REV. 1541, 1543 (1997). As Bebchuck and Fried explain, the pattern of credit observed in the 1990's suggested that many companies borrow from sophisticated creditors on an exclusively unsecured basis. See *Uneasy Case 1*, *supra* note 2, at 854 n.4 (citing John D. Leeth & Jonathan A. Scott, *The Incidence of Secured Debt: Evidence from the Small Business Community*, 24 J. FIN. & QUANTITATIVE ANALYSIS 379, 387 (1989) (reporting that only about fifty percent of small businesses with commercial bank loans in study provided assets of the business as collateral)); James R. Booth, *Contract Costs, Bank Loans, and the Cross-Monitoring Hypothesis*, 31 J. FIN. ECON. 25, 40 n.10 (1992) (noting that few firms with public unsecured debt borrow from banks on secured basis); LoPucki, *supra* note 9, at 1925 n. 148 (reporting Federal Reserve statistics on lending by commercial banks to the effect that only 42.7% of \$41.2 billion in short-term loans were secured and only 64.7% of \$3.7 billion in long-term loans were secured).

industry and the global markets, not maritime liens for tort claims and their super-priority in the *in rem* action.<sup>159</sup>

Why has the maritime industry not scuttled its ancient lien system in favor of the more pro-lending Article 9 treatment of involuntary creditors? Why has it not done away with the *in rem* action that allows involuntary creditors to seize vessels and keep them out of commerce? Secured lenders in the maritime industry have not called for such changes possibly because the current system is, in fact, efficient. However, despite the evidence pointing towards the ready availability of credit in the maritime context, no evidence shows the impact of tort victims' super-priority one way or the other on the *cost* of credit. Secured financing may be offered at higher rates in response to the lack of preferred treatment for the lenders. However, as discussed in Part III *infra*, secured lenders demand proof of insurance and negotiate strict loan covenants that cover most tort claims before agreeing to lend, so increased credit prices may not be the reality. These are additional costs to both the debtor and lender, although, at least in the maritime context, these additional costs have not deterred secured lending.

This system's success indicates that the maritime industry has been able to allocate resources in such a way as to compensate for negative externalities without impairing at least the availability of secured credit. This is especially relevant to the Article 9 debates, as a major criticism of giving tort victims priority is that this will make it nearly impossible for borrowers with liquidity problems to obtain credit, since no one would lend to such a company without the protection of security.<sup>160</sup> The maritime industry offers proof that it is possible to give super-priority to tort victims without freezing the availability of credit.

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159. See, e.g., *Global Shipping Firms Cite Credit Crunch as Leading Challenge Facing Industry*, GENCO, <http://www.genco.com/Logistics-Articles/article.php?aid=800705950> (last visited Feb. 22, 2014). The lack of ready credit the global financial crisis caused was not changing traditional maritime financing through secured debt, as “[d]espite a dearth of credit, 43 percent of [shipping company] respondents maintained that bank lending will remain their primary source of funding over the next two years.” See also Standard & Poor’s, *Declining Asset Values Are Putting International Shipping Companies at Risk of Breaching Loan Covenants*, RATINGS-DIRECT, Dec. 7, 2011 (discussing how falling shipping rates and a potential oversupply of vessels in the form of Chinese tanker ships combined with the global financial crisis acted to restrict credit markets).

160. See White, *supra* note 78, at 2090 (rebutting arguments that Article 9’s priority rules are inefficient by pointing out that any change to Article 9 could result in a reversion to the pre-UCC disorganized state of security laws).



### III. MARITIME LAW AND THE DEBATE OVER SECURED CREDIT

The question, then, is whether and to what extent the treatment of tort victims under the maritime priority system may shed light on the debate over Article 9. Essentially, the maritime law example shows that it is possible to give tort victims super-priority over secured creditors without freezing the availability of secured credit. This, in turn, undermines one of the primary arguments against elevating the priority of tort victims. The real question may be whether the maritime law system, or aspects of that system, holds up outside of the maritime context. While the priority of tort victims pursuant to a maritime lien has been a feature of the maritime commercial landscape for much longer than Article 9 has existed, unique aspects of the maritime industry might suggest that tort-victim priority would not be successful outside of that industry. While it is not difficult to identify those aspects of maritime commerce that offer special justification for tort-victim priority, it is difficult to demonstrate that those aspects categorically rule out the adoption of tort victim priority in the non-maritime context. There are, however, differences that bear mentioning, as well as problems in the general commercial context that the maritime law example does not necessarily address in a satisfactory way.

Any analysis of what lessons can be gleaned from the treatment of creditors in maritime law must begin by acknowledging that, in many ways, the maritime industry is *sui generis*. Shipping involves the transportation of people and goods over the open water; thus, it is subject to a number of potentially devastating sources of loss that are not necessarily implicated in other industries. Moreover, maritime law developed separate from other commercial doctrines and is the product of at least a thousand years of special relationships between shipowners, seafarers, and sources of finance. Thus, what works in the maritime context may not work outside of it. Yet the maritime priority system does substantiate some arguments in favor of secured credit while, at the same time, debunking some arguments against giving some protection to involuntary creditors.

#### A. *Incorporating Aspects of the Maritime System Outside of the Maritime Context*

Given the differences between maritime and non-maritime commercial actors and tort victims, non-maritime commercial actors are unlikely to adopt wholesale the maritime system. Still, it may be possible to follow the maritime example of giving super-priority to tort

victims outside of bankruptcy. Giving tort victims super-priority or partial priority is the most commonly advanced solution to the problem of uncompensated tort victims.<sup>161</sup> Some scholars have limited their arguments to bankruptcy, while others advocate a change in involuntary creditor priority across the board.<sup>162</sup> The maritime approach is an example of tort victim super-priority across the board, but because of the conflict between admiralty and bankruptcy jurisdiction, secured lenders maintain their Article 9 priority status in bankruptcy proceedings, subject to tort claimants' maritime liens. Thus, secured lenders are not only protected, but they are also encouraged to actively monitor debtors to ensure that involuntary creditor claims are paid in a timely manner while the debtor company is still doing business so that the overall pool of assets is maintained in bankruptcy. To effect a similar result in the non-maritime context might be difficult, since it is a jurisdictional conflict that allows maritime and Article 9 priority systems to coexist, but the priority of creditors under maritime law at least provides some concrete evidence that tort claim super-priority is workable and does not necessarily cut off small business from secured credit. Other aspects of the maritime law system, such as a stronger judgment lien, might also protect the claims of tort victims.

### 1. Granting Super-Priority & Strengthening the Judgment Lien

The first step towards achieving full protection for tort victims is to grant them super-priority, but a second step might be to strengthen the power of the judgment lien. Currently, the debtor's collateral that is subject to the judgment lien varies from state to state, as do the filing requirements.<sup>163</sup> Once a tort claimant has obtained a judgment in her favor, that judgment gives rise to a lien. The lien may be superior to secured claims that are perfected after the recording of the lien, but even if the lien does predate the secured claim, it may not extend to the all of the debtor's property that is subject to the secured claim.<sup>164</sup> In some states, the judgment lien extends over all of the debtor's real property, which makes it a lien *in rem*, provided that the lien was recorded by filing a UCC

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161. See, e.g., Jackson & Kronman, *supra* note 2; Warren, *supra* note 2; Baird, *supra* note 2; Adler, *supra* note 2; *Uneasy Case 1*, *supra* note 2.

162. See, e.g., Buckley, *supra* note 12.

163. See 0130 SURV. 11, *50 State Survey: Real Property: Liens: Priority of Judgment Liens* (2014).

164. See, e.g., Charles W. Hendricks, *Offering Tort Victims Some Solace: Why States Should Incorporate a 20% Set-Aside into Their Versions of Article 9*, 104 COM. L. J. 265, 266-68 (1999).

filing statement in the appropriate records office.<sup>165</sup> In other states, because of the priority of secured debt, a valid mortgage or other secured claim filed against that real property, even if filed after the date of judgment, will prime the judgment lien.<sup>166</sup> Thus, advocates of tort victims who become aware of the mortgage are discouraged from seeking to enforce the judgment lien.<sup>167</sup>

Perhaps even worse for tort claimants, many secured claims cover the debtor's present and after-acquired property, which means that even property of the debtor that did not exist at the time that the secured claim was perfected will be subject to the secured claim, thus removing that property from the reach of a judgment lien.<sup>168</sup> To correct this problem, granting the holder a security interest in the same collateral that a secured creditor's claim has would make the judgment lien more powerful. This would happen if states followed the example of Maine, whose judgment lien statute grants a judgment creditor a lien over "proceeds of any disposition of the property, real or personal . . . to the extent that a secured party would have an interest in the proceeds."<sup>169</sup>

In addition, making the judgment lien extend to the same collateral as a secured creditor's claim may serve an important incentivizing function. In maritime law, the maritime lien covers an identified vessel. Even though the secured lenders have a priority claim over all of the debtor's personal property, the vessels are often the debtor's most valuable asset.<sup>170</sup> If it is true that secured credit encourages institutional lenders to monitor their debtors and to pressure them into making sensible business decisions, financial consequences should promote this monitoring. Secured creditors in the shipping industry monitor debtors closely in order to ensure that the claims of involuntary creditors are paid promptly, either through insurance or directly.<sup>171</sup> Relatedly, an involuntary creditor's lien on the very property that secured creditors wish to preserve may encourage the secured lenders to pay or push for settlement of involuntary creditor claims, as the alternative is judicial

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165. See 0130 SURV., *supra* note 163.

166. *Id.*

167. LoPucki, *supra* note 13, at 14–15.

168. See Hendricks, *supra* note 164, at 267 n.16.

169. 14 MAINE REV. STAT. ANN. § 1331(9).

170. Consider, e.g., that the container ships and tanker vessels can cost up to \$125 million, roughly the same as a jumbo jet. BRANCH & STOPFORD, *supra* note 86, at 200. Additionally, the market for vessels can fluctuate wildly depending on market conditions. For example, during the 1980s, demand for ship transportation rose so astronomically that vessels were valued at up to 800% their original purchase price. *Id.* at 26.

171. See *id.* at 183–85.

sale of the vessel.<sup>172</sup> Direct intervention from the secured lenders, who pay maritime liens and then ask for subrogation from the lienholders if there is no insurance coverage, can accomplish these settlements. As a result, they step into the shoes of the involuntary creditor and guarantee that no party is ahead of the secured lender in priority.<sup>173</sup>

However, even when the debtor does have sufficient unencumbered assets to pay a tort victim's claim, the debtor may still employ a number of strategies to prevent any payment. As discussed in Part I.C, a company can recruit one of its secured debtors to place a judicial hold on the execution of a tort judgment, or it can sell its assets in such a way that it is both seller and buyer, such as in a sale-leaseback.<sup>174</sup> Yet this might be impossible if tort victims had priority over secured creditors outside of bankruptcy. Thus, super-priority and a stronger judgment lien might have the effect of both protecting tort victims and preventing at least some forms of judgment proofing.

## 2. Enforcing the Judgment Lien

The modern commercial debtor is just as capable of moving its assets out of the grasp of involuntary creditors as yesterday's vessel owner once was.<sup>175</sup> The *in rem* action is frequently cited, along with maritime attachment, as one of the most powerful features of U.S. maritime law.<sup>176</sup> Giving this tool to involuntary creditors would provide strong incentives for debtors to take precautions against the existence of involuntary creditors in the first place. However, the *in rem* action should not be used to enforce a judgment lien. Even if it

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172. See, e.g., *Sasportes v. M/V Sol de Copacabana*, 581 F.2d 1204 (5th Cir. 1978); *Wilkins v. Commercial Inv. Trust Corp.*, 153 F.3d 1273, 1277 (11th Cir. 1998); *P. T. Perusahaan Pelayaran Samudera Trikora Lloyd v. Salzachtal*, 373 F. Supp. 267 (E.D. N.Y. 1974); *Brock v. S.S. Southampton*, 231 F. Supp. 280 (D. Or. 1964).

173. See *Sasportes*, 581 F.2d at 1207.

174. LoPucki, *supra* note 9, at 1914.

175. This is particularly true for companies seeking to avoid mass tort liability. These companies will create subsidiaries before bankruptcy in order to rid themselves of assets, as in the case of W.R. Grace & Co., which was able to shield \$3 billion in assets from asbestos claimants through reorganization before they filed bankruptcy proceedings. John C. Heenan, *Graceful Maneuvering: Corporate Avoidance of Liability Through Bankruptcy and Corporate Law*, 65 MONT. L. REV. 99, 114–15 (2004); see also Mark J. Roe, *Corporate Strategic Reaction to Mass Tort*, 72 VA. L. REV. 1 (1986) (discussing, amongst others, Mansville Corporation's 1982 bankruptcy filing); LoPucki, *supra* note 13; Lynn M. Lopucki, *Virtual Judgment Proofing: A Rejoinder*, 107 YALE L.J. 1413 (1998).

176. See Rutherglen, *supra* note 100, at 542.

is possible to seize all of a debtor's assets, it would likely cause severe disruptions in the debtor's business. Although the business of maritime debtors is disrupted when vessels are seized, a difference seems to exist between seizing a moveable piece of property like a vessel and seizing, for example, an entire grocery store and its inventory. Additionally, the enforcement of judgment liens is already an action *in rem*. Further, if tort victims had super-priority, such *in rem* actions to enforce judgment liens would not be susceptible to secured creditors' intervening actions to preserve their superior claim to the collateral.<sup>177</sup>

In maritime law, tort victims have super-priority outside of bankruptcy while the Article 9 priority system applies once bankruptcy proceedings have begun. This approach gives secured creditors some assurance that their claims will be paid in the event of bankruptcy. However, as discussed above, the fact that these two priority systems apply to maritime debtors in different actions is a result of jurisdictional conflicts between maritime and bankruptcy courts and was not deliberately undertaken to provide priority to both tort victims and secured creditors. Indeed, scholars have already discussed and dismissed the possibility of applying tort victim priority only in bankruptcy and not outside of it (the reverse of what happens in maritime law).<sup>178</sup> Super-priority inside of bankruptcy could only encourage debtors to dispose of their assets to favored creditors before bankruptcy proceedings took place.<sup>179</sup> By contrast, it is not clear whether super-priority outside of bankruptcy would only be a better solution, since secured creditors might simply file for involuntary bankruptcy in order to stay any *in rem* action judgment lienholders instituted. The better approach is likely to be the application one set of priority rules in and out of bankruptcy.

### 3. Protecting Debtors and Secured Creditors Through Insurance and Limitation of Liability

A natural consequence of giving tort victims super-priority might be lender reluctance to extend secured credit without some showing that the debtor is adequately insured against potential tort claims. Although many debtors do purchase some type of liability insurance, in many cases the debtors are underinsured and, even when they are not, general liability policies do not offer coverage

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177. See *supra* Part I.

178. See LoPucki, *supra* note 141, at 1509–10.

179. *Id.*

for intentional torts or activity that was within the policyholder's control.<sup>180</sup> Furthermore, many liability policies include self-insured retention (SIR) clauses, which require the insured to cover a certain amount of any claim before the policy is triggered.<sup>181</sup> An insolvent policyholder may be unable to pay the SIR.<sup>182</sup> Bankruptcy courts do not typically allow inability to pay to vitiate coverage altogether, but the insurer will only be responsible for the amount of coverage minus the SIR.<sup>183</sup> Thus, the tort claimant must seek that SIR amount from the debtor, who was unable to pay it in the first place.<sup>184</sup>

LoPucki has suggested that, in addition to giving priority to involuntary creditors, requiring debtors to purchase insurance for secured creditors could more fully protect creditors.<sup>185</sup> This insurance would operate like title insurance, with the insurer paying the secured creditor's claim against the debtor, whereupon it would be subrogated to its rights in debt collection.<sup>186</sup> This insurance would not be mandatory but would be available for the secured creditor to election and would presumably be something that creditors would only wish to obtain if the debtor was at risk of tort liability.<sup>187</sup>

Block-Lieb has criticized LoPucki's proposed secured creditor insurance as potentially creating inefficiencies under the Kaldor-Hicks criterion.<sup>188</sup> The Kaldor-Hicks criterion states that a result is more efficient if those who are made better off by an action or circumstance could compensate those that are made worse off.<sup>189</sup> Block-Lieb believes that LoPucki's suggestion is inefficient under this model because the increased number of involuntary creditors paid in full might result in increased transaction costs and limited credit availability.<sup>190</sup> But Kaldor-Hicks efficiency requires that a

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180. Erin L. Webb, *Bankruptcy Treatment of Self-Insured Retentions and Deductibles*, 22 INS. COVERAGE LITIG. (2012), available at [http://apps.americanbar.org/litigation/committees/insurance/articles/julyaug2012-bankruptcy-sirs-deductibles2.html#\\_edn2](http://apps.americanbar.org/litigation/committees/insurance/articles/julyaug2012-bankruptcy-sirs-deductibles2.html#_edn2).

181. *Id.* at 2.

182. *Id.*

183. See John F. O'Connor, *Insurance Coverage Settlements and the Rights of Excess Insurers*, 62 MD. L. REV. 30, 37–38 (2003).

184. Webb, *supra* note 180, at 2.

185. LoPucki, *supra* note 9, at 1912–13.

186. *Id.*

187. See *id.*

188. Susan Block-Lieb, *The Unsecured Creditor's Bargain: A Reply*, 80 VA. L. REV. 1989, 2005–09 (1994).

189. JULES L. COLEMAN, *MARKETS, MORALS, AND THE LAW* 98 (1998). Scholars have criticized the Kaldor-Hicks criterion itself as incapable of recognizing that equivalent amounts of compensation do not always represent equivalent amounts of welfare. See William J. Baumol, *WELFARE ECONOMICS AND THE THEORY OF THE STATE* 164–70 (2d ed. 1965).

190. Block-Lieb, *supra* note 188, at 2009.

party made worse off by another party's actions could be compensated, not that they actually receive any compensation or that such compensation is delivered in an efficient manner.<sup>191</sup> Because secured creditors' self-insurance might compensate them for any part of a secured claim lost to tort claim priority, such self-insurance does not seem to be necessarily inconsistent with Kaldor-Hicks.<sup>192</sup> Block-Lieb is concerned that self-insurance might give rise to moral hazard, which in turn could create inefficiencies, and that secured creditor insurance might be unavailable to many because of the transaction costs and the uncertainty surrounding potential tort claims.<sup>193</sup> As discussed below, the maritime example deals with that uncertainty by way of a limitation on liability.<sup>194</sup>

Another possible reaction of secured creditors to tort claim super-priority is selling secured debt in credit-default swaps or other asset securitization methods. To accomplish this, the secured lender would take its secured claim and sell it to a credit protection buyer for an upfront amount.<sup>195</sup> The buyer then pays a set amount periodically to the secured lender until the maturity of the swap or until a default event, such as the debtor's bankruptcy.<sup>196</sup> This might be a controversial move, given the role of credit default swaps in the recent global financial crisis, but it is one potential step secured lenders could take in response to tort claim super-priority.<sup>197</sup> Unlike purchasing insurance, however, credit default swaps might not result in higher transaction costs for the debtor. All of these possibilities demonstrate that secured lenders have the ability to protect their investments in ways that involuntary unsecured creditors like tort claimants cannot.

The maritime model is an example of the onus for purchasing insurance to cover potential tort claims resting with the debtor. One problem with this option outside the maritime context is that the cost could be prohibitive for smaller and mid-sized firms that traditionally rely on secured credit.<sup>198</sup> However, those firms may

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191. See LANDES & POSNER, *supra* note 58, at 17.

192. See *id.* at 16 ("We use *efficiency* . . . in the Kaldor-Hicks [ ] sense, in which a policy change is said to be efficient if the winners from the change could compensate the losers . . . whether or not there is actual compensation.")

193. Block-Lieb, *supra* note 188, at 2007—08.

194. See *infra* Part III.B.2.

195. See Douglas B. Levene, *Credit Default Swaps and Insider Trading*, 7 VA. L. & BUS. REV. 231, 233 (2012).

196. See *id.*

197. See Jeremy C. Kress, *Credit Default Swaps, Clearinghouses, and Systemic Risk: Why Centralized Counterparties Must Have Access of Central Bank Liquidity*, 48 HARV. J. LEGIS. 49, 59–60 (2011).

198. See, e.g., White, *supra* note 78, at 2090.



have less exposure to involuntary creditors than larger firms that are more likely to use unsecured credit, and, accordingly, the purchase of insurance may not be as costly for those smaller and mid-sized firms.<sup>199</sup> Further, if groups of debtors involved in the same industry provided insurance, like P&I insurance, they could also address the problem of moral hazard—that is, the tendency of insurance to take the place of the debtor’s proper precautions—that concerned Block-Lieb.<sup>200</sup> P&I insurance is only available when the club determines that a member took the proper precautions but still failed to prevent injury.<sup>201</sup> This is not unlike third-party general liability insurance, which typically will not cover the insured parties’ intentional or grossly negligent behavior, which may suggest that moral hazard problems are also avoidable, at least to some degree, in the context of debtor-purchased insurance.

Whatever type of insurance secured creditors might require, however, insurance’s full payment of the claim would extinguish the judgment lien or reduce it by the amount of coverage paid. This treatment is consistent with the nature of a maritime lien, which exists only as long as the debt remains unpaid and would also prevent double-recovery for involuntary creditors. Further, as a policy matter, there are many benefits to implementing a change in the law that ensures that as many debtor companies as possible have sufficient liability insurance. Of course, the problem of cost remains. It is true that small and midsize companies exist in the maritime context, and they do obtain secured credit while maintaining comprehensive insurance. However, comparing the maritime industry cannot definitively answer the question of whether the increased transaction and insurance costs that might accompany tort claim super-priority would put secured credit out for reach for small and midsize firms.

### *B. Comparison of Maritime and Non-Maritime Debtors*

In order to evaluate whether conclusions about the debate over the Article 9 priority scheme can be drawn from the maritime example, it may be useful to compare maritime and non-maritime companies. As discussed in Part II, tort claims traditionally receive high priority as a preferred maritime lien because all other

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199. See Listoken, *supra* note 14, at 1044.

200. See Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89, 103 (1985).

201. SEMARK, *supra* note 143, at 50.

lienholders have contributed to the debtor's business and are, in a sense, responsible for the tort victim's injury.<sup>202</sup> In addition, maritime tort victims have higher priority than holders of contract-based liens for necessities because the former obligation arises out of a legal duty without regard to any bargained-for liability.<sup>203</sup> A maritime debtor cannot use contract to maneuver around duties the law imposed upon it.

There does not seem to have been an economic or efficiency rationale behind the initial adoption of the rule, although there is a lack of scholarship on the subject. Even so, an ex post efficiency concern may justify the treatment of tort victims because it forces shipowners to bear the cost of their own injurious activities. However, some important differences between the maritime and non-maritime contexts may militate against the adoption of tort victim super-priority outside of the maritime context, including: the unique nature of the average maritime tort victim, the limitation of tort liability for shipowner, the importance of vessels as assets, and the taxation of maritime companies.

### 1. The Nature of Maritime and Non-Maritime Tort Victims

It is difficult, if not impossible, to characterize the "typical" tort victim in a general commercial context. Depending on the type of debtor, the average tort victim might be a slip and fall (grocery and retail stores), a defrauded investor (securities brokers), or a tortious interference of contract claimant (construction companies and subcontractors). Similarly, the nature of the maritime industry determines the nature of maritime tort victims. In order for a court to exercise admiralty jurisdiction over a tort claim, the incident must have occurred in a maritime location and have had a nexus to traditional maritime operations.<sup>204</sup> Although it is easy to see how

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202. See *supra* Part II.A.1.

203. *Stevens v. The White City*, 285 U.S. 195, 202 (1932) (citing *The John G. Stevens*, 170 U.S. 113, 122–23 (1898)). There is also a suggestion that tort claim priority over liens for necessities is an equitable rule based on the increased sympathy judges had for tort victims. See Wentworth J. Marshall, Jr., *Maritime Lien Priority*, 9 CLEV.-MARSHALL L. REV. 577, 580 (1960); Edward L. Willard, *Priorities Among Maritime Liens*, 16 CORNELL L. Q. 522, 527 (1930) ("There is a visceral reaction for the poor fellow who was hit in the face over the man who sold good for which he was not paid"). It seems equally likely that the reason why tort claims are elevated over liens for necessities is that the United States is unique in recognizing liens for necessities in the first place. Such claims did not (and still do not) give rise to maritime liens under the English maritime law. See *The John G. Stevens*, 170 U.S. at 122–23. Whatever the reason, tort victims have historically had a maritime lien, giving them priority over other (although not all) classes of creditors. *Id.*

204. *Grubart v. Great Lakes Dredge & Dock*, 513 U.S. 527, 534 (1995).

personal injury, death, and collision claims can satisfy these jurisdictional requirements when they occur at sea, maritime tort claims can involve products liability claims when those claims involve products associated with the vessels or other maritime equipment.<sup>205</sup> Further, just as in the general commercial context, employees who are the victims of their employers' negligence are subject to worker's compensation regimes. Under maritime law, either the Jones Act or the Longshore Harbor Workers Compensation Act covers the claims of tort victims who are employees of the tortfeasor, and these claims do not give rise to a maritime lien.<sup>206</sup>

Conceivably, one could argue that the maritime industry does involve a unique context in which injuries may occur because of the isolation of long sea voyages, especially in shipping. During those voyages, the vessel is highly dependent on the continuing labor of the workers aboard and those who provide fuel and other services to the vessel. Additionally, working at sea poses substantial dangers to everyone involved in the voyage. These risks include storms at sea, war, piracy, marine predation, drowning, cargo breaches, and equipment malfunctions. Because undertaking any sea voyage, no matter its duration, can involve any of these risks at any time, it is practical to offer some guarantee of redress should maritime workers suffer tortious injury before asking them to embark. Furthermore, a seaman is obligated to obey orders given by the ship's captain or master, even when he believes that such obedience is dangerous to himself. Thus, "[b]ecause of the unique status of seamen, necessitated by the rigors of the sea, the courts have long since decided that the burden of the risks incident to their calling should be borne by the shipowners."<sup>207</sup>

While these considerations may justify the unique priority of maritime tort claimants to some degree, it is not a particularly convincing argument for why tort claimants outside of the maritime context should not receive similar priority. As an economic matter, giving tort victims who are part of the trade priority makes sense. Additionally, the nexus requirement or the level of risk involved in maritime activity does not undermine either the equitable justification usually offered for extending super-priority to tort claimants or the argument that failing to protect tort victims allows debtors to externalize their wrong-doing. It is also probably no longer true

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205. See, e.g., *Matthews v. Hyster Co.*, 854 F.2d 1166, 1168 (9th Cir. 1988) (applying maritime law to a products liability claim based on injury caused by a forklift during cargo unloading operations).

206. See *Hayden & Leland*, *supra* note 90, at 1235.

207. *Hudson Waterways Corp. v. Schneider*, 365 F.2d 1012, 1014 (9th Cir. 1966).

that any vessel is ever entirely isolated during its voyages, as air or naval vessels can reach most commercial ships and satellite-based global positioning systems can probably detect them. Thus, there does not seem to be any feature of a maritime tort claimant that would substantiate an argument that non-maritime tort claimants should not receive similar priority.

## 2. Limitation of Liability and Insurance

In order to obtain secured financing, maritime debtors must furnish to their lenders a proof of several different types of insurance, including P&I insurance, which covers potential tort claims. The cost of such insurance depends, to an extent, on the predictability of the insured's potential tort exposure. As discussed above, scholars are concerned that uncertainty may make insurance premiums unaffordable for either the debtor or the secured creditor.<sup>208</sup> Personification also means that all liens against a vessel are extinguished once it has been judicially sold. Consistent with these principles, under the Limitation of Shipowner's Liability Act (the Limitation Act), the shipowner's liability for torts committed by one of its vessels is limited to the sale value of that vessel.<sup>209</sup>

Once tort liability has been established, a vessel owner may move for a limitation action, which subjects the vessel or vessels to a concursus proceeding.<sup>210</sup> Courts will deny limitation only if the shipowner cannot show, by a preponderance of the evidence, that it had no "privity or knowledge" of the negligent acts giving rise to liability.<sup>211</sup> If the shipowner can make this showing, the concursus proceeding requires that all claims against the shipowner and all of its assets be marshaled before the court, and the court may enjoin any other proceedings pending against the shipowner in order to accomplish this.<sup>212</sup> If there are insufficient funds to pay all claims in the proceeding, all claimants—whether or not they hold a maritime lien—receive a pro rata share of the fund due to the sale of the vessel.<sup>213</sup>

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208. See, e.g., Block-Lieb, *supra* note 188, at 2007–08.

209. 46 U.S.C. § 30505.

210. Frederick W. Swaim, Jr., *Limitation of Liability and Direct Actions: The Relevant Fund*, 7 LOY. MAR. L.J. 247, 247–49 (2009).

211. See, e.g., *Farrell Lines, Inc. v. Jones*, 530 F.2d 7, 10 (5th Cir. 1976).

212. See Dennis J. Stone, *The Limitation of Liability Act: Time to Abandon Ship?*, 32 J. MAR. L. & COM. 317, 326 (2001).

213. *Hayden & Leland*, *supra* note 90, at 1255.

The principle of limitation is found through maritime law since at least the twelfth century and is grounded in the difficulty of overseeing the ship's master once the vessel is at sea, as well as the inability to insure against potentially devastating money judgments.<sup>214</sup> In recent years, however, criticism of the Limitation Act has increased.<sup>215</sup> Shipowners are increasingly capable of remaining in contact with their captains and other crew via ship-to-shore technology, and new international management standards make it difficult to argue that the shipowner has no privity or knowledge of its captains' actions.<sup>216</sup> In addition, injured seamen are permitted to choose between bringing an action in federal court under maritime law or bringing an action in state court under the common law.<sup>217</sup> However, if a shipowner initiates a limitation action, the courts would enjoin a seaman's action in state court against the shipowner, and the seaman would have to bring the suit in the concursus proceeding.<sup>218</sup>

Despite its controversial nature, limitation is not as old as the maritime lien, and it likely arose in direct response to the problem of paying liens and obtaining the release of a seized vessel, although no authority specifically states this. There is therefore a link between the lien, limitation, and P&I insurance, the latter of which also arose in response to the lien and which will be paid even when limitation is not available, up to the coverage limit (subject to club rules). Although liability may be available for tort claims, it cannot be invoked to cover debt financing or credit extended to the shipowner because such credit has not been extended to a specific vessel.<sup>219</sup>

It could conceivably be argued that limitation might be responsible for the availability of secured credit in spite of tort claim super-priority, since the amount of the debtor's potential tort exposure is somewhat predictable. This seems unlikely, however, since limitation includes the full value of the vessel, which is generally all of the collateral the secured creditor's claim covers. Still, since limitation is generally available to shipowner debtors and not to others, it might weigh against the adoption of tort victim super-priority

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214. See *id.* at 1253–54.

215. See generally Stone, *supra* note 206, at 327–36; Jill A. Schaar, *The Shipowners' Limitation of Liability Act: Still Afloat or Sinking Fast?*, 24 TUL. MAR. L.J. 659 (2000); Mark A. While, *The 1851 Shipowners' Limitation of Liability Act: Should the Courts Deliver the Final Blow?*, 24 N. ILL. U. L. REV. 821, 835–44 (2004).

216. See Stone, *supra* note 212, at 327–28.

217. See *id.*

218. See *id.* at 330–32.

219. Hayden & Leland, *supra* note 90, at 1255.

outside the maritime context unless a similar limitation were available. Since most debtors that rely on secured credit are small and medium-sized businesses, the potential for ruinous tort awards is real without limitation.

The lack of limitation also raises the related question of insurance. Many businesses purchase general liability or other types of insurance intended to cover tort claims. But, as noted in Part III.C *infra*, even when companies are insured, they may be underinsured or they may discover that a policy exclusion prevents coverage for particular tort victims. Thus, if the maritime priority scheme were adopted, limitation is a potential legislative response that might have a two-fold effect: first, it would lessen the likelihood of devastating tort liability where the limitation can be invoked; second, it might make insurance more affordable, since limitation offers a form of predictability for insurance companies. Limitation thus weighs both for and against the maritime priority system. On the one hand, it weighs against the adoption of tort victim super-priority outside of the maritime context, but on the other hand, it might be an argument in favor of such adoption, as long as it is extended along with the super-priority.

### 3. Vessels as Primary Assets

Vessels are the primary financial asset of many maritime debtors. One could argue that there is already a procedure in place for debtors like maritime companies, that have most of their assets embodied in identifiable property. The Bankruptcy Code provides an exception to the automatic stay on all debt-collection actions by allowing, in certain circumstances, collection against single asset real estate.<sup>220</sup> This exception allows creditors with priority claims and liens on the real estate to foreclose on that property and distribute the assets among them.

Single-asset bankruptcy does not help the involuntary creditor.<sup>221</sup> Mortgages and liens that potentially consume all of the sales proceeds generally encumber real property. Furthermore, even where tort claimants exist, they are behind mortgage holders in priority as

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220. Kenneth P. Coleman, *The Scope of the "Single Asset Real Estate" Exception*, 114 BANKING L. J. 548, 548-49 (1997).

221. Scholars have heavily criticized the single asset exception to the automatic stay in bankruptcy as leading to gamesmanship on the part of creditors. *See, e.g.*, Daniel B. Bogart, *Games Lawyers Play: Waivers of the Automatic Stay in Bankruptcy and The Single Asset Loan Workout*, 42 UCLA L. REV. 1117 (1996).

well as behind statutory lien holders whose claims pre-date the tort judgment.

Thus, the real question with respect to the vessels is whether their existence as a single, identifiable source of collateral justifies tort victim priority in a way that does not apply outside of the maritime context. The existence of the vessel is likely a stronger justification for the maritime debt collection procedure, specifically the use of the *in rem* action to enforce a maritime lien, as opposed to an argument for the existence of the maritime priority scheme. Because the judicial sale proceeds of a vessel can satisfy the lien, the existence of the vessel or vessels does make satisfaction of tort judgments more clear-cut in some ways. In other ways, however, the existence of the vessel may work to the prejudice of tort claimants, since the limitation of shipowner's liability to the value of the vessel still applies when there is insurance coverage for the tort victim's claim—a state of affairs that has been challenged but has yet to change.<sup>222</sup> The existence of the maritime lien for tort claims is likely a major reason why most maritime debtors have P&I insurance, since secured lenders demand it before extending debt financing. Thus, the vessels and their value are not likely to be a reason to confine tort victim super-priority to the maritime context.

### C. *The Effect of Giving Tort Victims Super-Priority*

It is impossible to predict with absolute certainty what would happen if tort claimants were given super-priority. However, the success of secured credit in the maritime world seems to challenge a number of conclusions reached on both sides of the debate over secured credit—specifically, that secured credit necessarily encourages poor monitoring and the inefficient use of debt covenants and that involuntary creditor priority would make it impossible for debtors to obtain financing. Regarding the first assumption, there is no evidence that secured lenders in the maritime context are poor monitors or that they draft inefficient loan covenants. It is entirely possible that, given the maritime industry's susceptibility to dramatic fluctuations in energy and shipping demands, loan covenants are drafted to penalize debtors who engage in reckless financial behavior in an attempt to make up for or to inoculate against those market fluctuations.

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222. See generally Riaz Zaman, *Sailing on Troubled Waters—Antiquated U.S. Maritime Liability Limits for Death and Injuries of Ship Passengers: Options for Reform*, 42 DENV. J. INT'L L. & POL'Y 41 (2013).



Second, maritime law illustrates the incorrectness of the assumption that involuntary creditor super-priority would negatively affect the availability of credit. Secured credit is readily available to both large and small companies in the maritime context, although the cost of obtaining secured credit is higher for maritime debtors. This ready availability of secured credit could be attributed to the fact that, for most maritime debtors, the vessels represent the entirety of the collateral available to secure financing. Because the vessels may represent a large part of the debtor's value, there is an incentive to stake a claim on them. Moreover, since lenders know that there is always the possibility that maritime liens will arise, they could be incentivized to obtain a security interest that will at least offer some guarantee of a piece of the vessels in case of insolvency or bankruptcy. Thus, the maritime priority scheme itself might actually encourage secured lending, as opposed to stifling it.

Any change in the priority structure of credit invites criticism that it could freeze credit markets and dry up the availability of secured credit altogether, notwithstanding the maritime example.<sup>223</sup> On its face, this is not necessarily a bad thing—at least with respect to large, risky ventures that are likely to have involuntary creditors. While strengthening the judgment lien and giving it super-priority may mean that potential borrowers with low liquidity and high risk will not obtain financing or will pay more for, it is also possible that, as in the maritime industry, debtors and secured creditors will find ways to adjust. Commercial lenders are in the business of providing debt financing, and secured loans are still a safer option for lenders when it comes to extending financing to small and mid-size companies that do not have the assets to forego secured lending.

The real problem with granting tort victims super-priority could be the potential effect on the cost of secured credit to large, high-risk companies that have considerable potential exposure to tort liability. Yet these companies do not traditionally finance with secured debt.<sup>224</sup> In fact, many small businesses do not have involuntary creditors—or any creditors at all, other than their secured lenders.<sup>225</sup> Given this, why would a debate about secured credit be necessary, since the firms most likely to incur involuntary creditor claims do not even use it?<sup>226</sup> But one aim of the secured credit debate should be to persuade those large, high-risk companies to use secured credit in order to trigger the monitoring aspects

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223. See *supra* Part I.B.

224. *Id.*

225. Claire A. Hill, *Is Secured Debt Efficient?* 80 TEX. L. REV. 1117, 1166 (2002).

226. See Listoken, *supra* note 14, at 1040.

of security over those debtors who most need a watchful eye. On either side of the secured credit debate, there is a conflict between those who advance the monitoring function of secured credit and those who argue that secured credit takes the place of adequate monitoring.<sup>227</sup>

In the maritime context, all borrowers, no matter their size, are going to incur maritime liens—the question is whether timely payment can discharge those liens immediately or whether the debtor has so little ability to pay that an *in rem* action is the likely result. By contrast, smaller firms in the general commercial context are not likely to have many involuntary creditors.<sup>228</sup> Thus, if a priority scheme like the maritime approach were adopted in the general commercial world, the only parties that would have difficulty obtaining secured credit would be those with liquidity and credit problems that want to enter into high-risk ventures that expose them to an increased likelihood of tort liability or financial collapse. If, on the other hand, a company has poor credit but does not seek out businesses that expose it to potential tort liability or if the company seems able to pay its employees, the secured creditor may be less inclined to refuse to extend credit based on the proposed lien, since chances are better that the lien will never arise.

Finally, although the maritime example does show that additional costs are incurred in obtaining insurance and drafting loan documents with strict covenants, the additional transaction costs of this system may not be prohibitive, or, at least, do not have to be prohibitive. In fact, many lenders in the maritime industry are larger banks such as Citigroup, BNP Paribas, Regions Financial Corporation and U.S. Bancorp, all of which have equipment finance divisions that handle ship and fleet mortgages and provide secured financing for vessel construction.<sup>229</sup> The fact that these are the same institutions that provide secured credit to many non-maritime commercial debtors indicates that involuntary creditor super-priority

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227. See generally Jackson & Kronman, *supra* note 2, at 1149–61.

228. See Listoken, *supra* note 14, at 1051, 1057–59.

229. See, e.g., REGIONS BANK, REGIONS EQUIPMENT FINANCE (2007), available at [https://www.regions.com/virtualDocuments/cb\\_Equipment.pdf](https://www.regions.com/virtualDocuments/cb_Equipment.pdf); Jim Lawrence, *Dealmaker of the Year: Michael Parker and Citi*, MARINE MONEY, February/March 2013, at 16, available at [https://www.marinemoney.com/sites/all/themes/marinemoney/publications/awards/2012\\_Dealmaker.pdf](https://www.marinemoney.com/sites/all/themes/marinemoney/publications/awards/2012_Dealmaker.pdf); *Latest Awards & Rankings: BNP Paribas Awarded as the Editor's Choice by Marine Money*, BNP PARIBAS CORP. & INST. BANKING, <http://cib.bnpparibas.com/Products-services/Financing-your-business/Shipping-Finance/page.aspx/159> (last visited Feb. 26, 2015); *U.S. Bank Equipment Finance*, U.S. BANCORP, [https://www.usbank.com/cgi\\_w/cfm/commercial\\_business/products\\_and\\_services/equip\\_fin\\_ps.cfm?icid=PB\\_10412&WT.mc\\_id=r10412&original\\_ref=https%3A%2F%2Fwww%2Egoogle%2Ecom%2F](https://www.usbank.com/cgi_w/cfm/commercial_business/products_and_services/equip_fin_ps.cfm?icid=PB_10412&WT.mc_id=r10412&original_ref=https%3A%2F%2Fwww%2Egoogle%2Ecom%2F) (last visited Feb. 26, 2015).

has not stopped maritime lending. Further, it means that many institutional secured lenders already have systems in place that account for involuntary creditor super-priority. Thus, adopting a version of the maritime priority model with respect to tort victims would only require many larger lenders to do what they already know how to do. What is less clear is what steps secured lenders would take to protect their claims in a scheme in which they no longer have the highest priority. Whereas lenders in the maritime industry demand proof of insurance from debtors, LoPucki's suggestion to require insurance for lenders is possibly a more cost-effective option, especially for smaller companies.<sup>230</sup> Whether or not such costs would have a freezing effect on the availability of credit is difficult to predict, but the maritime example illustrates that such an effect is not the necessary result of super-priority for tort victims.

#### CONCLUSION

The case study of maritime law shows that both sides of the debate over secured credit may be operating under false assumptions or drawing false conclusions, and that a solution that protects the interests of both involuntary and secured creditors is possible. Perhaps the most striking insight the maritime priority scheme provides is that giving super-priority to involuntary creditors does not freeze the availability of credit, at least in certain contexts. In some ways, the maritime example reinforces the arguments of scholars who have called for revision of Article 9 to protect such creditors, but, in other ways, it supports the argument that secured credit provides a valuable monitoring function. The maritime system may thus be more efficient than the current Article 9 system, especially since the firms that society would most want monitored—that is, high-risk companies with significant potential tort exposure—are most likely to utilize secured credit. To the extent that the system could be modified to encourage lenders to demand secured credit before lending to these types of debtors, it should be considered whether some version of the maritime approach could be adopted.

Many aspects of the maritime priority system respond to the unique hazards of doing business on the open water. Additionally, secured lending may be so ubiquitous in the maritime context because of the value of the vessels, while other debtors may not have

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230. See LoPucki, *supra* note 9, at 1912–13.

so much of their capital in equipment or some other identifiable res. Thus, the maritime priority system cannot simply be adopted wholesale and without alteration for the non-maritime context. However, this system could be used to revise the priority of secured credit to create a more efficient model that costs society less and preserves economic gains. Most of all, the maritime law example illustrates that some of the fundamental assumptions underlying the debate over Article 9 may be incorrect, and that a closer study of the cost of secured credit to maritime debtors as well as the insurance and regulatory reactions to the maritime priority system may shed new light on the debate.