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Preferred Capital Structures and the Question of Filing

Paul M. Shupack*

INTRODUCTION

This Article started from a moment of cognitive dissonance that occurred last academic year. First I read a proposal by then Professor, now Dean, Douglas Baird that recommended bringing the law of secured transactions into line with law and economics scholarship. According to Dean Baird, the law ought to be changed so that it "facilitates the creation of strictly hierarchical capital structures."[1] His suggestion followed from Professor Alan Schwartz's similar recommendation that this change would bring the law into alignment with the actual preferences of creditors and debtors.[2] Then I read a passage in a draft of Revised Article 8 that last appeared as part of Comment 10 to Revised UCC section 9-115. In relevant part that passage read:

> It is quite common for securities firms to prearrange agreement to pledge financing facilities with many different banks, and, when such financing is needed, to obtain it from several different banks, using different collateral for each. This is a rather different financing pattern from the usual inventory financing arrangement for merchants and

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* Professor of Law, Cardozo School of Law, Yeshiva University. My thanks to Carl Bjerre, William Bratton, David Carlson, Howard Ruda, and Barry Zaretsky, whose critiques of earlier drafts of this paper have added to its virtues. The remaining vices are entirely my own.

1. The quoted passage appeared in an early manuscript version of a paper Dean Baird prepared for the symposium *Revision of Article 9* held at the University of Virginia Law School, October 15-16, 1993. The published version of this paper, Douglas G. Baird, *Security Interests Reconsidered*, 80 VA. L. REV. 2249 (1994), does not contain this passage. Instead, it concludes that "strictly hierarchical capital structures are not self-evidently desirable." *Id.* at 2259. Dean Baird defines strictly hierarchical capital structures as those in which "a single creditor will have a security interest in all the assets of a firm and other creditors will all take a position that is junior to this single creditor's position." *Id.* at 2258.

2. Alan Schwartz, *A Theory of Loan Priorities*, 18 J. LEGAL STUD. 209, 216-18, 240-41 (1989).

manufacturers of goods, who typically have working capital financing arrangements with a single lender.[3]

These two views of creditor behavior do not easily coexist. One way of reconciling them would be to declare the securities industry *sui generis*. Yet that way of eliminating this tension struck me as depending on assertions about the structure of the economy for which the evidence is not altogether clear. Nor is it altogether clear that the evidence could be forthcoming.

If Dean Baird is right, then Article 9 does not facilitate the creation of strictly hierarchical capital structures. Firms without strictly hierarchical capital structures thus would result from responses to current law rather than creditor and debtor preferences concerning capital structures. To justify the existence of the Article 9 filing system, data must reflect the existence of firms with non-strictly hierarchical capital structures, and a theory needs to support the conclusion that the empirical data do not simply reflect behavior produced by existing law.

I. THE CASE AGAINST FILING

The case against filing reduces itself to two basic points: filing is unnecessary and filing is mischievous. The debate concerning preferred capital structures directly relates to the objection that filing is unnecessary. Simply put, filing provides only that information already known to those for whom filing is relevant. If debtors have strictly hierarchical capital structures, then the information filing provides is unnecessary to the top creditor in the hierarchy. In addition, debtors will have adequate incentives to reveal their capital structures to other interested parties.[4] The duplication of effort that filing imposes causes unnecessary direct costs on debtors and creditors.

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3. AMERICAN LAW INSTITUTE, UNIFORM COMMERCIAL CODE, REVISED ARTICLE 8. INVESTMENT SECURITIES (WITH AMENDMENTS TO ARTICLE 9. SECURED TRANSACTIONS) 156 (Proposed Final Draft 1994). This passage does not appear in the 1994 Official Text with Comments of Revised Article 8 propounded by the American Law Institute and the National Conference of Commissioners on Uniform State Laws.

4. As stated by Schwartz:

> The key question is whether good borrowers can make credible communications of their debt status at acceptable cost.
>
> There are several reasons to believe that these credible communications would be made. Initially, it is cheap to disclose debt status .... In sum, though a financer would have no reason to know of *all* prior credit transactions to which a potential borrower is party, it would learn of any transaction of sufficient magnitude as to affect materially the likelihood that its loan will be repaid.

Schwartz, *supra* note 2, at 220-21.

The vision of the world that makes filing unnecessary is grounded in well-established principles of modern financial economics—agency costs.[5] This theory asks us to believe only that each actor will pursue its self-interest. Applied to relationships between debtors and creditors, this principle tells us that debtors will take advantage of opportunities to speculate with other people's money. A debtor will attempt to obtain loans, claiming that the loans represent a low level of risk. After obtaining loans bearing an interest rate commensurate with a low level of risk, the debtor will substitute projects with a higher risk than those contemplated by the lender. If the riskier projects pay off, then

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5. This part of finance economics builds on the work of Modigliani and Miller:

> Simply put, the Modigliani-Miller position is based on the idea that no matter how you divide up the capital structure of a firm among debt, equity, and other claims, there is a conservation of investment value. That is, because the total investment value of a corporation depends on its underlying profitability and risk, it is invariant with respect to relative changes in the firm's financial capitalization.

JAMES C. VAN HORNE, FINANCIAL MANAGEMENT AND POLICY 273 (9th ed. 1992) (footnote omitted).

The Modigliani-Miller ("M-M") theory depends on heroic assumptions. Once M-M became part of the fabric of financial economics, the work of financial economics became to identify those places in which the imperfections in any actual market permit an enterprise to increase its worth by its capital structure.

A more detailed overview of the post—M-M literature can be found in Milton Harris & Artur Raviv, *The Theory of Capital Structure*, 46 J. FIN. 297 (1991), which identifies four "categories of determinants of capital structure." *Id.* at 299. These four categories are:

> 1) The agency cost explanation. Mixing debt and equity ameliorates conflicts of interest among various groups with claims to the firm's resources.
>
> 2) The asymmetric information approach. Mixes of debt and equity mitigate information asymmetries between management and the capital markets by conveying information and mitigating inefficiencies in the firm's investment decisions.
>
> 3) Product markets. Mixes of debt and equity influence the nature of the products the firm produces and the nature of product market competition.
>
> 4) Corporate control contests. Mixes of debt and equity influence the outcome of control contests by affecting the distribution of votes and distribution of cash flows.

Id. at 300-25.

One recent practitioner-oriented book summarized the literature this way:

> Although the proposition [the M-M theory] itself is of extreme importance to an academic, the impact of the M&M proposition to a practitioner is most evident when it is inverted:
>
> *If* financial policies matter, that is, if risk management policies are going to have an impact on the value of the firm.
>
> *Then* it must be that the financial policies impact taxes or transaction costs or the firm's investment policies.

CLIFFORD W. SMITH JR. ET AL., MANAGING FINANCIAL RISK 362-63 (1990).

the debtor will be better off—by a lot—and the creditor will be no better off than if the debtor had invested in the original project and earned enough to pay the debt.

Of course, riskier substitute projects have a greater risk of failing and place the debtor's equity at greater risk. Yet, there exists a range of projects with moderately greater risks in which the debtor's expected value for riskier projects exceeds the expected value to the debtor for the original proposal. The debtor will reap the exclusive benefit of this increase in expected value. Under these circumstances, a rational self-interested debtor will pursue its own well-being and undertake the riskier project that results in a lower expected profit for the joint enterprise consisting of both the debtor and its creditors. The joint enterprise, however, does not concern any debtor who can increase the probability of total gain for its part of the joint enterprise.[6] Debtor project substitution will increase the risk of non-payment, but creditors will receive no corresponding compensation for the increased risk either by means of a higher interest rate or by some type of participation in the up-side potential.

Creditors, of course, will not idly permit debtors to take advantage of them in this way. Creditors will attempt to minimize the injury debtors can cause them by requiring elaborate covenants in the loan agreement to prevent the debtor from engaging in activities riskier than those contemplated at the time of the original loan.[7] Substantial evidence supports the financial theory account of creditor and debtor behavior. Take, for example, the conclusion of one study comparing publicly held loans with relatively weak covenants to privately placed loans with restrictive covenants:

> The protection provided by covenants affords private market investors greater flexibility in assessing credit strength than that enjoyed by the rating agencies in evaluating public market securities. Without such protection, the agencies' ratings are necessarily skewed toward a paternalistic and consistently conservative view . . . . Many times, then, what may appear to be unduly conservative credit ratings by the major

6. *See* Hedeki Kanda & Saul Levmore, *Explaining Creditor Priorities*, 80 VA. L. REV. 2103, 2106-11 (1994) (debtor's gain comes at a cost to its creditor and to society).

7. *See* Schwartz, *supra* note 2, at 221 ("The ubiquitous presence of elaborate covenant protection suggests that those who obtain it plausibly believe that they are initial creditors."); *see also* Robert E. Scott, *A Relational Theory of Secured Financing*, 86 COLUM. L. REV. 901, 922 (1986) ("[L]oan covenants in term loans typically forbid the debtor from either incurring additional debt or issuing dividends without permission, and place restrictions on future investment policy, mergers, and similar activity.").

rating agencies are explained by concern over future acquisitions or other management policies that might materially and quickly alter a company's risk profile. Sophisticated investors, by contrast, can and do reduce the risk of dramatic changes in credit quality through the use of financial covenants.[8]

The creditor has a substantial incentive to monitor the debtor and to see that the debtor abides by the covenants. This dominant creditor will actively monitor to ensure compliance with the covenants and has little use for the information that a filing system provides because the creditor has already acquired that information. Debtors and creditors will benefit from a capital structure containing a single dominant creditor because a single dominant creditor reduces agency costs that otherwise would result from the presence of multiple creditors. Yet, to the extent that the filing system facilitates the creation of creditors with superpriority over an otherwise dominant creditor, then the filing system operates to prevent the creation of dominant creditors.[9]

The other branch of the case against filing is that filing can be mischievous. Mischief results because anyone can err and current law punishes missteps with draconian force.[10] The usual result of a filing error is the loss of all contracted-for and relied-upon priority rights in bankruptcy. The mischief that can result with the current filing system would suggest an equally draconian solution—abolish filing entirely. To the best of my knowledge, no one has seriously proposed abolishing filing solely to control the capacity it has to cause mischief. Instead, we have James White's proposal that filing errors should not count in priority battles between secured parties and lien creditors, although filing would continue to matter in battles between and among secured creditors.[11] Professor White's argument makes us recognize a cost to secured creditors inherent in the existing statutory arrangements. His solution preserves the benefits of filing for secured parties, but does not address the question of whether these benefits are illusory. This latter claim occupies this Article.

8. Dennis Emerick & William White, *The Case for Private Placements: How Sophisticated Investors Add Value to Corporate Debt Issuers*, J. APPLIED CORP. FIN., Fall 1992, at 83, 87.

9. *See* Schwartz, *supra* note 2, at 247 ("The optimal loan priority contract will prohibit the debtor from incurring nontrivial later debt except for routine trade credit and purchase-money loans up to specified amounts.").

10. *See, e.g.*, James J. White, *Revising Article 9 to Reduce Wasteful Litigation*, 26 LOY. L.A. L. REV. 823, 829-30 (1993).

11. *Id.* at 823-34.

The arguments concerning the disutility of filing ought to be taken seriously, but as of now they have not affected the proposed revisions to Article 9.[12] The revised Article 9 should not include filing simply by force of inertia. Instead, some reason should justify filing. If filing does make sense, then the case for filing depends on a description of capital structures in which debtors and creditors would prefer, if left alone by the law, not to form strictly hierarchical capital structures.

II. THE CASE FOR FILING

This Article does not challenge the claim that for a large part of the American credit market, the story told by agency theory has significant support from the available evidence. Under no circumstances does this Article contend that the standard account is wrong. This Article claims instead that agency theory is incomplete. The account drawn from agency theory, concluding with hierarchical creditor structures backed by loan covenants, tells only one strand of a more complex story.

My moment of cognitive dissonance now requires that I address three types of questions: 1) what empirical data exist concerning debtors with non-strictly hierarchical capital structures, 2) what benefits does a filing system provide to these transactions, and 3) can a theoretical framework supplement without contradiction the standard account from finance theory and explain why some debtors and creditors would prefer a non-strictly hierarchical capital structure? Thus, the questions to be addressed are: do these creditors and debtors exist, does filing serve a useful purpose for these debtors and creditors, and why is it that these debtors and creditors exist?

A. Empirical Evidence of Non-Strictly Hierarchical Capital Structures

Some creditors lend relying on assets rather than on a debtor's general capacity to pay. Examples of these types of creditors are part of our common experience. A bank considering making a home mortgage to an individual or a car dealer making a car purchase loan will want adequate assurance that the property offered as security has value at least equal to the loan, and that it is not already subject to claims of others. In the commer-

12. *See* Permanent Editorial Board for the Uniform Commercial Code, PEB Study Group, Uniform Commercial Code Article 9: Report 8 & n.22 (1992). [hereinafter PEB Report]

cial context, available evidence, although thin, suggests that these creditors who rely on assets exist, and exist in relatively large numbers. One study estimates that approximately thirty-four percent of commercial credit and industrial lending fits more nearly the story of creditors relying primarily on assets than the agency-cost account, with creditors engaging in due diligence and demanding heavily covenanted loan agreements.[13]

Loans between the very largest financial institutions and their substantial debtors and loans between small debtors and financial institutions illustrate complexities inconsistent with the finance theory account. The evidence most directly relevant to the issue of filing arises from the loans between small debtors and the financial institutions that service them. This evidence suggests that at least some creditors and debtors do not seek, nor do they want, a single dominant creditor. Instead, the creditors of these debtors look to the collateral, rather than to the debtor, for reassurance that they will be paid. In these instances, the collateral dominates the creditor-debtor relationship.

Yet it would be too easy, and also wrong, to say that these asset-based lenders look only to the collateral. An asset-based lender has to be concerned about the debtor's honesty, and, to the extent that the collateral could unreasonably depreciate by reason of debtor abuse, the asset-based lender must monitor some aspects of the debtor's behavior. Moreover, these lenders would, all other things being equal, prefer repayment to availing themselves of their creditors' rights.

Asset-based lenders are not indifferent to the industry-specific nature of collateral. If the collateral is specialized to an industry, for example oil drilling equipment, then the asset-based lender has to be concerned with the reason that a debtor suddenly gives hints of repayment problems.[14] Repayment problems that result from a fundamental problem existing in the debtor's industry, rather than circumstances peculiar to the specific debtor, will cause collateral specialized to the industry to lose value at the time the asset-based lender will look to it for its security. This point, of course, is not limited to tangible collateral. Receivables generated by credit sales to a particular industry can slump both in amount and value if that industry or trade has its difficulties.

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13. Michael D. Sherman, *Survey of Asset-Based and Other Competitive Lending Activities*, SECURED LENDER, Nov.-Dec. 1993, at 18, 18. Professor Sherman's estimate is for 1992. *Id.*

14. Baird, *supra* note 1, at 2251.

These points, however, do no more than constitute a cautionary footnote. At issue is the question of the appropriate adverb: do asset-based lenders "significantly" or "primarily" rely on the assets against which they lend? Regardless of the adverb, these asset-based lenders certainly do not fit the model of creditors who rely solely, primarily, or significantly on the debtor's cash flow. Asset-based lenders do not have the same incentives as dominant creditors to know the capital structure of their lenders and will not engage in extensive due diligence with respect to their debtors. Without this sort of due diligence, the sorts of information concerning other creditor relationships to the debtor will remain unknown to this creditor. If the creditor's concern is significantly or primarily the asset, then a means by which the creditor can learn about specific assets will have obvious informational efficiency compared to a system requiring all creditors to know everything about every debtor. This sort of creditor will not reward its debtor for having a strictly hierarchical capital structure. Instead, this sort of creditor prefers a capital structure consisting of many little peaks. The creditor wants only to be the king of its own little mountain.

Professor Sherman's survey of the members of the Commercial Finance Association ("CFA"), who, in 1993, had $102 billion in loans outstanding,[15] constitutes the bulk of available empirical information concerning the asset-based lending segment of credit markets.[16] In 1993 the CFA consisted of 232 members, of

15. COMMERCIAL FINANCE ASSOCIATION, 1993 MARKETING SURVEY FOR THE ASSET-BASED FINANCIAL SERVICES INDUSTRY tbl. 1 (1993).

16. *See* Sherman, *supra* note 13, at 18. The Commercial Finance Association is an organization that describes itself as "the trade group for commercial finance companies, factors, banks, and other financing agencies engaged in the asset-based financial services industry on an international, national, regional and local basis." This definition is printed on the title page of *The Secured Lender*.

The text, by relying on Professor Sherman's survey, in all probability understates substantially the amount of asset-based lending that occurs in this country. No one can doubt that equipment leasing represents an alternative to purchasing that same asset using secured credit. The Equipment Leasing Association estimated that in 1993 its members constituted a $125 billion industry. Judy Temes, *Leasing's Advantages Offset Interest Burden*, CRAIN'S N.Y. BUS., Apr. 11, 1994, at 24, 24. The Federal Reserve does not distinguish between secured and unsecured loans made by domestic finance companies. It reports, however, that these finance companies had outstanding $310 billion in business loans at the end of 1993. FED. RESERVE BULL., Sept. 1994, at A36, tbl. 1.52. These numbers suggest that the CFA data report only a fraction of the relevant material.

whom fewer than half were commercial banks.[17] The membership "spans the spectrum of secured lending: purchased accounts receivables, secured, fully monitored collateral loans, balanced cash flow/collateral loans, 'business value' loans, and partially secured, partially 'air ball' acquisition loans."[18] Although the CFA statistics cannot serve as a perfect surrogate for asset-based lending with this mixture of activity, the primary focus of the member organizations, whether banks or independent financers, remains asset-based lending.

The lending patterns of banks doing asset-based lending and finance companies doing similar work remain somewhat distinct.[19] Professor Sherman describes the contrasting lending patterns of commercial banks and commercial finance companies. For banks, the "fundamental basis for their lending is the creditworthiness of such borrowers and, though declining in importance, their long-term banking relationship with them."[20] Conversely, Sherman notes that

> finance company relationships with borrowers are much more transient, their lending much more short-term, and their willingness to lend based much less on the character of their customers and much more on their ability to liquidate their position at a profit and on short notice. More traditional commercial lenders require that a firm borrow a fixed amount and then repay the loan over a relatively long period of time. This often creates a mismatch between borrower assets and liabilities; more difficult monitoring problems; the need for extensive and self-defeating covenant protection; and greater lender risk exposure due to the underlying long-term uncertainty of loan repayment and asset liquidation value.[21]

Sherman's survey reports that nearly fifty-six percent of the commercial finance companies in the survey stated that their borrowers came to them after being turned down by commercial banks.[22] These borrowers generally could not obtain unsecured

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17. David H. Pendley, *CFA Convention Keynote Address*, SECURED LENDER, Jan.-Feb. 1994, at 40, 40.

18. *Id.* at 42.

19. "Due to their historical preference for relationship and cash flow lending, many banks directed their new ABL units away from collateral only, toward more dependence upon the cash flow aspects of a credit." *Id.*

20. Sherman, *supra* note 13, at 18.

21. *Id.* at 20.

22. *Id.* at 28. This account of why debtors give security provides yet another solution to the puzzle of secured transactions. The question goes back to the pioneering work of Alan Schwartz, *Security Interests and Bankruptcy Priorities: A Review of Current Theories*, 10 J. LEGAL STUD. 1 (1981). Starting from Modigliani-Miller assumptions, Schwartz showed that a debtor would not necessarily improve its position by issuing secured debt. Any improvement in position resulting from issuing secured debt could be lost by the increased cost of un-

credit on any terms in the financial markets. As a result, contrary to the standard assumption that secured lending will be at lower interest rates than unsecured lending, these customers borrow at somewhat higher interest rates on their loans, usually 1.5-4 percentage points higher than commercial bank rates.[23] These customers are predominantly manufacturing and wholesale businesses,[24] and principally borrow from these lenders to finance accounts receivable, inventory purchases, and lines of credit.[25] These lenders "prefer shorter term, collateralized loans"[26] and borrowers understand that their lenders believe that the "loans are designed to be self-liquidating, and at the first hint of repayment problems, commercial finance companies will enforce liquidation of their position."[27]

Professor Sherman's view of the relationship between creditors, debtors, and collateral differs sharply with Robert Scott's 1986 description of relational lending.[28] Scott described the asset-based financing market as

> dominated by a few national finance companies, large commercial banks with national coverage and an increasing number of regional banks .... What remains after the integration of the private financing industry, therefore, are lenders holding a financial portfolio of both unsecured and secured loans premised on the existence of an inverse relationship between a borrower's balance sheet strength and the benefits of collateral control.[29]

These lenders do not rely principally on recovery of the collateral upon default and "frequently note that they are not content to realize on defaulted loans by foreclosure proceedings even where repayment is assured."[30]

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secured debt. For a history of this idea in the law reviews see Paul M. Shupack, *Solving the Puzzle of Secured Transactions*, 41 RUTGERS L. REV. 1067 (1989). *See also* David Gray Carlson, *On the Efficiency of Secured Lending*, 80 VA. L. REV. 2179, 2198-212 (1994).

The fact that over half of those who borrow on a secured basis from finance companies have been turned down by banks offers a simple solution to the puzzle of secured transactions. For these debtors, the risk that offering security for a loan will raise the cost of its unsecured debt is irrelevant, as these companies are unable to obtain unsecured debt on any terms being offered in financial markets.

23. Sherman, *supra* note 13, at 20.
24. *Id.* at 21 tbl. 3.
25. *Id.* at 27 tbl. 5.
26. *Id.* at 34.
27. *Id.* at 20.
28. Scott, *supra* note 7.
29. *Id.* at 943-44.
30. *Id.* at 944.

The difference between Sherman's and Scott's descriptions of asset-based lending is partially explained by the increased presence of commercial finance companies in the asset-based lending market from the beginning of the 1980s to the beginning of the 1990s. Before 1986, commercial banks constituted seventy-two percent of the CFA membership. By 1993, however, fewer than half of the CFA's members were commercial banks.[31] Dean Scott assumed that the partial integration of commercial banking with asset-based lending observed in 1986 would continue and used the description of commercial banking practices as the appropriate model to describe the asset-based lending industry. What Dean Scott saw as an incoming tide of commercial banks into the asset-based lending market was instead its high-water mark.

The president of the CFA confirmed the sea change that occurred in the latter half of the 1980s. He reported that banks largely withdrew from the market for business loans under $1 million.[32] During the late 1980s, banks acquired some of the "larger independents [i.e., commercial finance companies]," which resulted in displacing "key personnel of these independents," many of whom left because of "professional incompatibility with the more regulated environment" within which they now were forced to act.[33] By the late 1980s, there existed "a void in the market and the availability of experienced asset-based lenders with strong entrepreneurial organizational experience."[34] Explosive growth of independent commercial finance companies quickly filled this gap. Although banks "still dominate the market in total assets employed in asset-based credits,"[35] they have tended to maintain their "historical preference for relationship and cash flow lending."[36] These banks directed their new ABL units away from collateral only, and "toward more dependence upon the cash flow aspects of a credit."[37] Recent CFA membership patterns provide substantial reasons to believe that during this past decade, a diminution, rather than an increase, in the relative importance of bank-like lending practices in the asset-based lending market has occurred.

31. Pendley, *supra* note 17, at 40.
32. *Id.*
33. *Id.*
34. *Id.*
35. *Id.*
36. *Id.* at 42.
37. *Id.*

B. EMPIRICAL EVIDENCE OF BENEFITS A FILING SYSTEM PROVIDES TO DEBTORS AND CREDITORS

Filing serves a useful, and possibly a necessary, function for the asset-based lending industry by reducing the cost of acquiring information. The debtor's capacity to give collateral is a major inducement for the creditor to make the loan. Because these lenders look to assets, they have substantial concern about their ability to assert unambiguous claims to the assets upon which they relied when they made their loans. I therefore agree with Peter Alces when he emphasizes the claim-staking purposes underlying security arrangements.[38] Nonetheless, I believe that the information-providing function of filing matters more to lenders than his account would suggest. Because asset-based lenders do not make the sort of examination of the debtor that could be described as due diligence, the information produced from filings does not duplicate information already known by these lenders.

1. Tangible Collateral

A lender against either tangible or intangible assets generally cannot claim rights to the collateral superior to those of the debtor, and thus the creditor takes the debtor's interest subject to that claim.[39] If the collateral consists of goods, one risk is that the debtor acquired collateral with impaired title. As to that risk, inherent in any business enterprise, filing has little relevance. Secured parties seeking protection against the debtor's impaired title generally must rely on the rights given to bona fide purchasers for value outside of Article 9.[40] Similarly, filing cannot help to solve title problems arising out of the debtor's acquisition of intangible collateral.[41]

38. *See* Peter A. Alces, *Abolish the Article 9 Filing System*, 79 MINN. L. REV. 679, 680 (1995) ("Claim-staking lies at the heart of the filing system's rationale.").

39. *But see* Donald P. Board, *The Scope of Article 9 Is Only One Quarter as Great as Is Commonly Supposed*, 47 U. MIAMI L. REV. 951, 953-60 (1993) (arguing that the common reading of UCC § 9-201 requires giving priority to all security interests unless some provision of the Code protects those interests from the later-created security interest).

40. *See, e.g.*, U.C.C. § 2-403(1) (1990) (rights of a good-faith purchaser for value from one having only voidable title); *id.* § 2-702 (rights of a good-faith purchaser for value against the original owner); *id.* § 3-205 (rights of a holder in due course); *id.* § 4-210 (security interests arising out of the collection process); *id.* § 7-502 (rights of a person to whom a document of title has been duly negotiated).

41. These risks include the debtor fraudulently creating the appearance of having accounts receivable, or having non-fraudulently created accounts worth

For a creditor lending against tangible collateral, especially goods, filing provides protection against competing transferees of the debtor. Article 9 protects a lender who has filed against collateral from claims by a competing transferee who is out of the ordinary course.[42] Filing here can serve as its own justification—we could say that the out-of-the-ordinary-course buyer should have checked the public records and thus caused its own injury. This justification, however, does not, in principle, depend on filing because a legal system without a public record of security interests could nonetheless preserve a secured party's interest in property sold out of the ordinary course. A legal system that preserved the secured party's interests, but did not require public notice of that interest, would increase the costs of such dispositions because the purchaser would not have an easy method of discovering the impaired state of the seller's title. Insofar as filing constitutes a cheap and easy means of obtaining this type of information, filing reduces the search costs of a would-be purchaser who wants to confirm the title of an out of the ordinary course seller. Filing has the effect here of increasing the resale value of the debtor's goods and thus provides modest gains resulting from informational efficiencies.

2. Intangible Collateral

When the collateral consists of intangible assets, especially accounts receivable, filing offers distinct advantages over other forms of conveying information concerning the collateral. Transfers of interests in intangible assets have a shorter history than transfers of interests in tangible property, but a strong need to provide these transactions with stable law existed at the time of the writing of Article 9.[43] The Article 9 filing system now has the effect of a title registration system for the sale of accounts, protecting buyers from the risk that either a prior-in-time or a subsequent-in-time transferee with superior rights to the property might come into existence.[44] As intangible property continues to

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what they appear to be because the account debtors can assert their UCC § 9-318(1) defenses against the creditor relying on those accounts.

42. U.C.C. § 9-301.

43. *See* 1 GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 8.6 (1965) (discussing subsequent accounts-receivable statutes).

44. One problem with accounts was their relative immaturity as a species of property. By the time of adoption of the UCC, the majority rule was that an owner of an account would by sale divest itself of its capacity to sell again that which it had already sold. Under that rule the second purchaser acquired only whatever interest the seller had (usually none) in the sold account. There was, however, a minority rule, under which a second-in-time buyer would acquire

become an increasingly important part of commercial activity, the benefit, if any, resulting from filed interests with respect to intangibles will increase rather than decrease.

Some evidence exists to support the conclusion that transferees of debtors prefer the search ease that a filing system creates for sales of accounts to the effort otherwise required. That evidence comes from the current debates concerning whether a revised Article 9 should apply to sales of general intangibles for money due or to become due. Article 9 presently defines accounts as streams of payments arising from the sale of goods or services. Selling the rights to a stream of payments has, in the past decade, become a commercially important means by which owners liquidate those rights through asset securitization transactions.[45] In the common form of these transactions, the originator transfers its rights through a transaction that bankruptcy law regards as a "true sale."[46] The payment streams that are the subject of these asset securitization deals include accounts, but also may include rights to payments not presently covered by the UCC, such as franchise fees or intellectual property license fees. Because these payment streams do not arise from the sale of goods or services, they are excluded from the scope of Article 9.[47]

Excluding these payment streams from Article 9 has created uncertainty for the asset securitization industry because a specific transaction may not unambiguously fall on one side of the boundary. To solve the boundary issue, Article 9 could either not apply to the sale of accounts or, conversely, could include the sale of general intangibles for the payment of money due or to become due. In response to this perceived need of the emerging asset securitization industry, the UCC Article 9 Study Committee recommended that Article 9 apply to the sale of general intangibles for the payment of money due or to become due.[48] At no point in

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rights superior to those of the first buyer. A third rule, under which the relative priority of rights of two competing purchasers would be decided by the order of notification received by the account debtor, also existed. *See* 2 *id.* §§ 25.6-.7.

45. The Public Securities Association reports that in 1993, $60 billion worth of securitized assets were sold in public capital markets. As recently as 1985, that number was approximately $1 billion. The total of private and public sales of these new forms of asset-backed securities in 1993 was in the neighborhood of $130 billion. Information available from the Public Securities Association, 40 Broad Street, New York, NY, 10004-2373.

46. If bankruptcy law recognizes the transfer of the asset to be a "true sale," then the asset may not be reached in a reorganization of the originator.

47. Article 9 is limited to the sale of accounts, U.C.C. § 9-102 (1990), and accounts are defined to include only rights to payments arising out of sales of goods or services. *Id.* § 9-102.

48. PEB REPORT, *supra* note 12, at 43 (Recommendation A.1.A).

the discussions did anyone, whether from the asset securitization side or from the more traditional financing side, suggest resolving the boundary issue by removing the sale of accounts from Article 9. As the Drafting Committee wrestles with text to implement this recommendation, the ABA Task Force on Asset Securitization has urged that the Drafting Committee give weight to the title-affirming characteristics of the Article 9 filing system as it chooses among various ways to implement the Study Committee's recommendations.[49]

This brief examination of the informational benefits that filing provides to transactions with tangible and intangible collateral is necessarily inconclusive. Although some benefits result from filing, these benefits, though important for some parties and for some types of assets, are not vital to the structure of the market for credit. If filing were abolished, those transactions that filing eases would, in all probability, continue to occur in modified and more expensive forms. In calculating the benefits of filing, the following two circumstances in which filing is relevant also should be considered.

3. Purchase Money Security Interests

Purchase money security interests ("PMSIs") and their superpriority under current Article 9 represent a special case of asset-based lending. Whether it is "good"[50] that the law allows second-in-time creditors to have rights to specific assets prior to those of first-in-time creditors is not clear.[51] Moreover, filing is

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49. *See* Memorandum from the Securitized Asset Financing Task Force to Article 9 Drafters 1 (Sept. 13, 1994) (on file with author).

50. The term here is used in the sense elaborated by Walter C. Seller and Robert J. Yeatman in their book 1066 AND ALL THAT: A MEMORABLE HISTORY OF ENGLAND (1931), which asserts that England's history includes, among other things, "one hundred and three good things."

51. This is not the place to enter into an extended discussion of the merits of a legal system barring special priority for PMSIs. The articles are numerous and the debate has not ended. *See, e.g.*, F.H. Buckley, *The Bankruptcy Priority Puzzle*, 72 VA. L. REV. 1393, 1395 (1989) (PMSI superpriority cannot be justified on efficiency grounds); David Gray Carlson, *Purchase Money Under the Uniform Commercial Code*, 29 IDAHO L. REV. 793, 852 (1993) (advocating that the priority mess be cleaned up); Kanda & Levmore, *supra* note 6, at 2114 (discussing the advantages and disadvantages of late-in-time priorities); Schwartz, *supra* note 2, at 260 (treating the choice of order of distribution as an optimal contracting problem); Paul M. Shupack, *Defending Purchase Money Security Interests Under Article 9 of the UCC from Professor Buckley*, 22 IND. L. REV. 777, 788 (1989) (the existing order can be rationally defended). It is easy to show that PMSIs can harm prior-in-time creditors. *See* Paul M. Shupack, *Defining Purchase Money Collateral*, 29 IDAHO L. REV. 767, 773-74 (1993). It is also easy to show that PMSIs do not necessarily harm prior-in-time creditors. Take the case of a debtor

not necessary to this type of asset-based lending. A legal system could permit arrangements equivalent to PMSIs without having a filing system. A seller of goods could, as part of the contract of sale, reserve title in the goods until fully paid. Using property law, Germany has a legal regime that enforces title retention by sellers against third parties, in particular creditors of the buyer. The German regime also has enough flexibility to give financing banks benefits equivalent to those given to title-retaining sellers.[52]

Using property law to create the equivalent of PMSIs is, of course, achieved at some cost. At a minimum, the crude protection of section 9-312(3), which protects first-in-time lenders that rely on inventory as collateral from suffering a degradation of their positions by the debtor's subsequent inventory purchases, cannot occur under a system in which no notice is possible.[53] Without notice, the first-in-time creditor will risk significant risk-altering behavior by the debtor without the capacity to defend its interest, except by extremely close monitoring. The law could free the first-in-time creditor from any need to monitor the debtor by giving the first-in-time creditor priority rights in any of the debtor's property over any later creditor. In this scenario,

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who owes its only creditor ("C") a fixed sum and who has run through all assets available on default. If that debtor were to propose a project that was both risky and risk-altering—e.g., the purchase of a lottery ticket whose payoff would exceed the amount the debtor owed C—and if that debtor found a creditor willing to finance this venture by taking a PMSI in the lottery ticket for the price of the ticket, C would heartily approve. Under these circumstances C would have nothing to lose, as there is nothing left to lose, and a possibility of sharing in the gain, however remote.

This simple example differs not in kind, but in degree, from cases involving a debtor who has creditors, is underwater financially, and has no assets available on default. In that case, short of some circumstance occurring that would subject the existing creditors to lender liability claims, nothing the debtor can do by contracting to create PMSIs will injure the existing creditors, whether secured or unsecured. More complex examples could be analyzed. These would show differing circumstances in which PMSIs can (but do not necessarily) benefit prior-in-time creditors. Thus, the question of whether PMSIs do on balance help prior-in-time creditors remains open as an empirical matter.

52. Conversation with Bernhard Schlink, Professor of Public Law and Philosophy of Law, Humboldt University, Berlin, and Justice of the Constitutional Court of the State of Nordrhein-Westfalen, Germany (Oct. 1993).

53. The need for notice could also be eliminated by a legal regime that would enforce a first-in-time creditor dominant position against any later-in-time contract entered into by the debtor. This type of solution, which creates property interests in favor of the first-in-time creditor regardless of the contract terms between the later-in-time creditors and their common debtor, would, of course, eliminate the possibility of a later-in-time seller being able to both sell goods and reserve title to them.

any creditor fearing that it might be second-in-time and right would need to examine the debtor's affairs thoroughly to ascertain that no prior creditors exist with trumping rights. The fact that these creditors then will know what filing would reveal, is, of course, exactly why Alan Schwartz proposed abolishing filing.[54]

A statutory change to abolish filing would, in effect, abolish asset-based lending. The existence of a large asset-based lending industry, however, suggests that this sort of statutory change would result in substantial transition costs. Of course, the existence of the industry does not prove its value. Before addressing that question directly, there is a need to consider one more circumstance—one in which the absence of filing matters.

4. Information Provided to Trade Creditors From an Absence of Filing

There is one corner of the commercial world in which the actors, at first glance, do improbable things. Debtors, typically merchants or manufacturers in an inventory-intensive business, refuse to permit security interests to be created against their inventory.[55] Although a debtor may have a secured creditor with perfected interests in accounts receivable and other personal property, the debtor will not permit inventory to be the subject of a filed security interest.[56] These debtors receive unsecured trade credit from inventory suppliers, who, the debtor believes, will cut off a debtor instantly if the debtor permitted a filing against its inventory.

Thirty years after the widespread adoption of Article 9, one might expect that all inventory suppliers, not just floor planners,[57] would file against their common debtor using the PMSI

54. *See supra* note 2.

55. I have been told this story by several separate sources, so I have to believe that it occurs with some frequency.

56. This creditor indifference to security interests in assets other than inventory can be quite reasonable. The enterprises that are these sorts of debtors will typically be selling the inventory that is or results from the trade creditor supplied goods, i.e., "pooled" inventory. To the extent other collateral is equipment or fixtures, these will in all probability increase the chances of the trade creditors' goods turning over. As sales are the expected end product, to the extent that the debtor borrows against the receivables, these creditors will see the receivable loan as a cash anticipation loan. All it does is accelerate the debtor's having cash as a consequence of the sale, and these creditors expect to be paid with that cash.

57. *See* 1 GILMORE, *supra* note 43, § 4.3. The term "floor planner" originally was given to finance companies that financed automobile dealers on a secured

superpriority to keep their several interests distinct.[58] With security interests in pooled inventory, if the debtor is a manufacturer, to the extent that the goods supplied have lost their identity by becoming part of the debtor's end product, UCC section 9-315 provides for pro-rata sharing—i.e., the same result as in a bankruptcy proceeding.[59] Suppliers would gain another benefit from having perfected security interests in pooled inventory. They would not have to worry about non-consensual claimants.[60] Yet, the reports persist. Trade creditors continue to insist on keeping "pooled" (as distinct from floor-planned) inventory free from security interests.

Howard Ruda[61] has offered an explanation for this persistent pattern of pooled inventory trade creditors neither taking inventory security interests nor permitting their common debtor

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basis. These finance companies received a security interest in the cars on the dealer's showroom and the proceeds of the sale. Wholesale automobile financing thus became known as "floor planning," but that term now applies to secured financing of almost any sort of inventory. *See, e.g.*, E. ALLEN FARNSWORTH ET AL., CASES AND MATERIALS ON COMMERCIAL LAW 769 (1993).

58. Whether PMSIs can be used to keep several secured interests distinct is currently open to question. The holding of Southtrust Bank v. Borg-Warner Acceptance Corp., 760 F.2d 1240 (11th Cir. 1985) (inclusion of an after-acquired property clause and a future advances clause in security agreements converted secured creditor's PMSI into an ordinary security interest), has unfortunate consequences for any secured party who depends on PMSI superpriority and who is engaged in ongoing transactions with the same debtor. So long as that decision is good law those creditors who rely on the trade pattern discussed here rather than their PMSI superpriority may well have the last laugh. The consequences of *Southtrust* have been widely discussed. *See* D. Benjamin Beard, *The Purchase Money Security Interest in Inventory: If It Does Not Float, It Must Be Dead!*, 57 TENN. L. REV. 437, 480-84 (1990); Robert M. Lloyd, *Refinancing Purchase Money Security Interests*, 53 TENN. L. REV. 1, 9 (1985); Shupack, *Defining Purchase Money Collateral*, *supra* note 51; Mark B. Wessman, *Purchase Money Inventory Financing: The Case for Limited Cross-Collateralization*, 51 OHIO ST. L.J. 1283 (1990). The Uniform Commercial Code Article 9 Study Group recommended amending Article 9 to overrule *Southtrust*. PEB REPORT, *supra* note 12, at 97-101.

59. *See* Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, § 726, 11 U.S.C. § 726 (1988); U.C.C. § 9-315 (1990). However, foreclosing upon commingled or processed goods is difficult, and the value attributable to a specific vendor's components is highly problematic.

60. *See* Lynn M. LoPucki, *The Unsecured Creditor's Bargain*, 80 VA. L. REV. 1887, 1963 (1994) (arguing that subordination of involuntary creditors is wrong as a matter of social policy). In practice, however, a Chapter 11 filing in bankruptcy almost always precedes, and precludes, effective enforcement of lien claims. Under current law, a PMSI is effective where a reclamation or judgment lien right is not.

61. Howard Ruda is of counsel for the New York firm of Hahn & Hessen, and is the editor of the four-volume work ASSET BASED FINANCING: A TRANSACTIONAL GUIDE (1993).

to grant security interests to others. To an unknown degree, these sellers have a visceral feeling that the inventory should be "theirs" because they supplied it; they thus become unwilling to see a secured party with a floating lien have superior rights to "their" goods. These creditors apparently believe (or at least hope) that, in the event of a bankruptcy, they will receive a decent percentage of the amounts due to them. This expectation has been reinforced by some trade creditors who experienced bankruptcies of customers and received substantial sums from the proceedings.[62] These creditors have a reasoned belief that some, or even much, of the value represented by the inventory will be available to them in the event of their debtor's insolvency. Moreover, these creditors may value their reclamation rights, which an inventory security interest would cut off.[63]

Despite the risk of becoming an unsecured creditor in their common debtor's bankruptcy, trade creditors prefer a credit sale to not selling. Faced with inventory on hand and the choice of making no sales or selling on an unsecured basis to people who represent risk, the trade creditors will choose to sell. Sale with a hope of some payment is better than no sale at all, especially when the seller is overstocked or incurs high fixed costs for under-utilized production capacity.

These trade creditors protect themselves against their debtor's possible insolvency by coordinating payment and shipping cycles. When these trade creditors detect signs of customer distress, they will take steps, short of cutting off all sales, to protect themselves. To minimize exposure to their debtor's insolvency, trade creditors may shorten the credit term, ship less, and above all, receive payment for any previous shipment before making the next shipment. Again, they rely on their basic rule—a sale with hopes of payment is better than no sale at all.

These actions by trade creditors may not be irrational. The trade creditors do not see themselves as producers selling in perfect markets. Instead, they act in the belief that further produc-

62. In the recent Federated-Allied bankruptcy, trade creditors were split into three classes, the top two classes being paid 100% principal plus interest, and the third being paid 67% of principal. *Federated Has Better Quarter Performance*, Daily News Record, June 19, 1991, at 2. These numbers are unusual, but they occur often enough to provide a rational basis for the described set of creditor expectations.

63. Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, § 546, 11 U.S.C. § 546 (1988 & Supp. IV 1992); U.C.C. § 2-702 (giving the seller the right to reclaim goods delivered within 10 days of the reclamation demand, but providing under § 2-702(3) that the seller loses this right if the buyer has transferred the goods to a good-faith purchaser for value, including a secured creditor).

tion would still be on the descending part of the marginal cost curve. They could reasonably see sales made to buyers with doubtful finances as incremental sales to which the seller would attribute only its direct (or marginal) costs. As a result, the sale would generate a greater than normal profit for which the seller would be willing to incur greater than normal risk. Moreover, trade creditors may self-insure against default more easily than financers. A trade creditor's markup (i.e., gross margin based on the sale price less the cost of goods sold) often exceeds a financer's yield (i.e., the interest rate earned less the cost of money). This difference, to the extent it exists, reflects, in part, varying degrees of risk. Yet, after the same number of successful shipping and payment cycles, a trade creditor will build a larger "cushion" to offset a buyer's default than will a financer.

Trade creditors would view the debtor's use of inventory as security as a public statement of the debtor's financial distress, particularly if the debtor had not previously done so.[64] In addition to the obvious probability of financial distress, the pledge of the inventory makes the seller's remedies on buyer's insolvency ineffective. Without a filing system, various creditors must monitor their common debtor or retain an independent service company to monitor the debtor on their behalf. Yet, the debtor could enter a private deal with one or more of its creditors granting a security interest in its tangible assets.[65] Filing, however, eliminates the fear of private deals between a debtor and one or more, but not all, of its suppliers, by requiring publicity as a condition of effectiveness. Monitoring public files is a much easier (and cheaper) task for an organization working on behalf of the trade creditors than monitoring the debtor. For this trade pattern, filing and its attendant publicity has obvious informational efficiency advantages over a legal system that gives priority to a creditor, but does not require the creditor to publicize its priority rights.

64. The fact that the debtor has pledged its inventory is not always a negative signal. It is possible that the debtor is doing well enough that it is undergoing some type of a credit crunch. It is possible that the debtor needs all the capital it can raise in order to expand its business. The trade creditors are well positioned to understand which of the contradictory meanings that can be given to the debtor's pledging its inventory is correct.

65. The circumstances here resemble the difficulties a cartel has in maintaining its cohesion. *See* D.K. Osborne, *Cartel Problems*, 66 AM. ECON. REV. 835, 843 (1976) (theorizing that a cartel is unstable, though not necessarily doomed, because it cannot control outside forces or cheating).

Whether this pattern exists frequently enough such that the savings resulting from the filing system outweigh the costs to those for whom filing is either unnecessary or potentially dangerous cannot be answered without some idea of both the frequency and the costs of each of the variables. We simply do not know how many trades and creditors engage in this type of financing. The frequency with which it appeared in conversations with knowledgeable people suggests that this pattern is not the result of a few commercial eccentrics. In the absence of data concerning this trade pattern, a certain caution concerning radical changes in the information generated by Article 9's filing system would be appropriate.

These various credit and trade practices strongly suggest the importance of asset-based lending to the economy and weakly suggest a connection between filing and asset-based lending for both secured and some unsecured creditors. If asset-based lending does represent a noticeable portion of industrial and commercial financing, and if filing does matter to this industry, then filing is not at all a foolish idea.

C. A Theoretical Justification of Non-Strictly Hierarchical Capital Structures and the Continued Existence of Filing

The case for filing is thus modestly favorable. There remains, however, one nagging doubt: do these structures that benefit from filing result from existing legal arrangements, or would debtors and creditors prefer these structures even under a legal regime that did not so vigorously encourage asset-based lending? The existence of a substantial finance industry that depends significantly on assets rather than on the debtor as the basis to make loans does not in itself demonstrate the wisdom of a statutory scheme that facilitates the industry's existence. The industry could merely reflect existing law, so that debtors and creditors would arrange their affairs consistently with finance theory if the background law were changed. Asset-based financing would diminish sharply. What is needed is a theory to support the belief that the current statutory arrangement reflects desires of debtors and creditors, much in the same way that standard finance theory explains why debtors and creditors desire strictly hierarchical capital structures. Two different propositions tend to dispute the claim that observable financial structures are primarily artifacts of existing law. One concerns creditor differences, and the other revisits agency theory itself.

1. Creditor Differences

Professor Alan Schwartz's *A Theory of Loan Priorities*[66] is grounded in finance theory, which has explored, during the past twenty years, various ways that imperfections in the real world create opportunities for gain that do not exist in theoretically perfect markets. One of the major headings for these inquiries has been the existence of asymmetric information.[67] Yet, one imperfection has remained virtually untouched—the assumption that creditors differ among themselves simply has not been part of the fabric of this discourse. To the extent that creditors differ from one another, these actual creditors will not conform their behavior to the simplifying assumption of agency theory—that all creditors will act in similar fashion as rational persons with similar information.[68]

One type of creditor differentiation relevant to asset-based lending is specialization in types of collateral. As a factual matter, the extent of this type of specialization is unknown. Anecdotal support, however, goes back to Dean Scott's article nearly ten years ago, which reported a high degree of specialization among secured creditors.[69] Asset-based lending allows creditors to profit from special capacities to monitor specific types of collateral, from special capacities to realize on the value of collateral, or from both. The growth of asset-based lending since Dean Scott published his article suggests that the degree of specialization may have increased.[70]

66. Schwartz, *supra* note 2.

67. *See* Harris & Raviv, *supra* note 5, at 306.

68. One fundamental assumption in the Modigliani-Miller model is that "[c]apital markets are perfect. Information is costless and readily available to all investors. There are no transaction costs and all securities are infinitely divisible. Investors are assumed to be rational and behave accordingly." VAN HORNE, *supra* note 5, at 272.

On at least one occasion, an attempt was made to introduce creditor differentiation into the theoretical debate concerning secured transactions. *See* James J. White, *Efficiency Justifications for Personal Property Security*, 37 VAND. L. REV. 473, 492-94 (1984) (discussing the advantages of granting security among creditors with differential risk aversion). That attempt was beaten back by Alan Schwartz in his responding article. Alan Schwartz, *The Continuing Puzzle of Secured Debt*, 37 VAND. L. REV. 1051, 1065-66 (1984) (rejecting White's argument for failing to demonstrate that banks lend to the least risky pool of debtors).

69. Scott, *supra* note 7, at 943-52.

70. The CFA reports that its members had outstanding in 1985, the last year included in Dean Scott's research, $57.740 trillion in loans. By 1993, the comparable number was $102.084 trillion. Although inflation would account for some of this difference, the growth in the market for CFA member loans has to

Another significant creditor difference is suggested by the new literature on asset securitization. Despite the cost, companies create these deals to take advantage of the imperfections in the actual credit markets. The difference between these actual creditors and the model creditor can be seen most sharply in what Steven L. Schwarcz has called the alchemy of securitization.[71] By this, Schwarcz means that if streams of payments are divided to match creditor preferences, then the sum of the value of these different pieces can exceed the value of the undivided asset, even after taking into account the expenses incurred in splitting the asset. In these instances, asset securitization occurs because creditors differ systematically in their preferences.[72]

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account for a significant amount of the difference. COMMERCIAL FINANCE ASSOCIATION, *supra* note 15, at tbl. 1.

71. Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J.L. BUS. & FIN. 133, 134 (1994); *see also* Steven L. Schwarcz, *The Parts Are Greater Than the Whole: How Securitization of Divisible Interests Can Revolutionize Structured Finance and Open the Capital Markets to Middle Market Companies*, 1993 COLUM. BUS. L. REV. 139, 152-60 (arguing, as its title suggests, that creditors who divide their assets consisting of rights to payment into pieces can, in some circumstances, create assets whose total value exceeds the value of the undivided assets).

72. There are many reasons for the differences in creditor preferences. Let me take, by way of example, one difference that asset securitization values. The law limits some financial institutions to buying only AAA/aaa securities. That restriction creates a level of demand for these securities that is higher than that which would exist in the absence of investment restrictions. The market responds by manufacturing more AAA/aaa securities to meet this artificial demand. If we abolished these restrictions, the lower demand for AAA/aaa securities would not support the current level of legal, accounting, and financial activity required to manufacture these additional AAA/aaa securities.

This one example supports two opposite alternatives:

1. Abolish the investment restrictions and let the unrestricted market do its work and conform its behavior more nearly to a perfect-market model. This suggestion proposes that whatever benefits we as a society gain by restrictions on investment activities by some major actors are not worth the costs.

2. Alternatively, we could say that the restrictions serve other valid social policies and that these policies, although not easily monetized, are worth more than the now identified costs of an investment restriction. The investment restrictions apply often to capital market actors such as insurance companies or trust funds, both of which signal a high likelihood of risk aversity rather than risk neutrality. Demanding that these institutions pursue investment strategies consistent with their reasons for existing within the society does not appear *a priori* foolish.

Whether these restrictions are justified or not is well beyond the scope of this Article. For the purposes of this Article all that needs to be established is that in currently existing markets, these restrictions do exist, and to the extent they exist they prevent actual investors from acting as the creditors described in

The loan documentation that top-tier banks use strongly suggests that creditors differ in ways that matter to debtors.[73] In recent years, when very large financial institutions or consortiums of very large financial institutions have provided credit in the billion dollar and up range, the documentation for these loans has not contained the sorts of covenants that financial economics would lead us to expect.[74] This relative lack of covenants becomes all the more puzzling because these credit arrangements reflect commitments by financial institutions to make available large amounts of credit to debtors without receiving in return the network of promises that would bind the borrowers to only a limited range of activities. The credit commitments contained covenants of varying strength, though even the most strongly covenanted agreement had restrictions perhaps less binding than conventional finance theory would lead us to expect.[75] This difference between the behavior that finance theory

finance theory. Seen this way, asset securitization may turn out to be no more than a mechanism to reduce the social costs created by these restrictions.

73. During the summer of 1994, I was privileged to look at typical loan agreements entered into by a self-described "top-tier" bank. I understand the term to include those banks whose business it is to make nine- and ten-digit loans and create equal-sized credit facilities for major business enterprises. Obviously the top-tier banks also perform the ordinary lending to ordinary-sized debtors, so the label is more nearly one describing a function rather than a unique category. Because of confidentiality restrictions, I can name neither the bank nor the borrowers.

74. To the extent that covenants are absent, the borrowers are free to engage in risk-altering behavior without fear of sanctions from the lenders during the life of the loan. The absence of covenants also diminishes the lenders' incentives to monitor the debtor during the life of the loan. A monitoring lender that discovered a displeasing course of action would have, in the absence of a breached covenant, no leverage to influence the debtor's behavior. If monitoring can serve no purpose, it is unlikely to occur with the same vigor one expects to see in heavily covenanted loans.

75. Three agreements represent the two extremes and the mid-point of the set of documents. One of them, where the borrower is an extremely solvent major American corporation, has no affirmative or negative covenants concerning the company's business activities during the life of the credit facility. The midpoint documentation does contain some covenants, but their restrictive effect is extremely limited. The primary restriction, limiting the company's freedom to enter into secured loans and sales and lease-backs to a stated percent of the company's tangible assets, resembles in form covenants described as typical. Given the extraordinary value of this company's tangible assets, the restriction, as a practical matter, will permit the company very substantial freedom of action.

The most restrictive set of covenants belongs to a multi-billion dollar credit facility for a tangible asset-intensive business. These covenants occupy about 20 pages of the Credit Agreement, and they appear to limit the borrower's activity much as finance theory suggests would be the case. They start with a blunt no-risk alteration covenant. The borrower agrees not to undertake any business predicts and the actual behavior of debtors and creditors suggests the incompleteness of the finance theory account.

Compared to the variation in the strength of the covenants, far less variation existed in the language concerning the creditor's right to transfer the credit facility, either by assignment in whole or in part, or by sale of participations.[76] Every credit agreement severely restricted the right of the creditor to transfer the credit facility. In each case, the lender retained the right to transfer the loan only to its wholly-owned subsidiaries, and in most cases to a Federal Reserve Bank for discount. Otherwise, the lender could transfer the notes only with the prior affirmative consent of the borrower.[77] The most heavily covenanted

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which would change the general nature of the business engaged in by the borrower. There follow a series of financial covenants dealing with ratios that must be maintained between income and the fixed charges against that income. The ordinary restrictions on liens then appear, along with limitations on dividends and other payments by the borrower.

Though these covenants have the form of covenants designed to limit risk alteration, even the bank's general counsel described the documents as only mildly restricting the debtor actions. Close examination of the covenants tended to confirm this characterization. For example, the borrower is given virtually unlimited power to use secured transactions to extend its current business by acquiring its types of tangible assets. The limitation on incurring unsecured debt would permit the creation of unsecured debt in an amount of approximately 10% of the loan created by the credit agreement. (Remember this is a multibillion dollar loan.) The ratios the company promises to maintain between income and fixed charges, although somewhat restrictive, would not impair the debtor's freedom of action so long as it remained only modestly profitable. Even the restriction on the change of the general nature of the business engaged in by the borrower speaks in terms of judging the general nature of the business on a consolidated basis rather than on the basis of each division's separate endeavors. Within the constraints of this loan agreement, a debtor intent on risk substitution would nonetheless be able to inflict significant fiscal injury on its lender.

76. Current bank practice concerning loans includes assigning a loan, either in whole or in part, or selling participations. Actual transactions can blur the distinction between these two methods banks have of turning the future income streams that the loans represent into current funds. When a loan is assigned, the assignee takes over in all respects in performing the functions of the lender. When a loan is participated, the originating bank sells fractional interests in rights to receive the payments made on the loan, but the originating bank does maintain the banking relationship with the customer. The difference for the debtor between assignment and participation is that in the event the loan terms need renegotiation (i.e., if the loan has been assigned), the debtor must work with the assignee rather than the original bank; if the loan has been participated, however, the original bank still provides the banking relationship. This difference between assignment and participation is diminished, however, if the participation agreement provides (as it often does) that the lead bank cannot act to alter the terms of the original loan without the consent of the participants.

77. These restrictions are reinforced by a further term that limits the benefit of the terms and provisions of the credit agreement to the original banks, the

credit facility also required the lender to obtain the borrower's prior written consent before selling a participation or assigning the loan, but the agreement added "which consent shall not be unreasonably withheld." Although those words do not appear in the less heavily covenanted loan agreements, the lender nonetheless agrees that it will retain "the sole right and responsibility to enforce the obligations of the Borrower hereunder including, without limitation, the right to approve any amendment, modification or waiver of any provision" of the credit facility if it enters into participations of the loan.

The limitations on transferring the loan by the creditors tells a story deserving our attention. Where creditor bargaining power created the credit facility with the most restrictive covenants, the restrictions on creditor transfer of the facility in whole or in part were still almost as substantial as those in the other credit agreements. This suggests that debtors consider restrictions on transfer an important negotiating point, an impression which the general counsel of the bank confirmed. These restrictions indicate that even top tier debtors—debtors extremely unlikely to default—will insist on the right to control who will be their creditors. From the debtor's point of view, all creditors do not look alike when the need to readjust terms of the ongoing lending relationship arise. Yet, one of the simplifying assumptions in the finance theory critique of filing is a uniformity of creditors. To the extent that uniformity is an assumption not confirmed by fact, the domain of the theoretical structure depending on that assumption is also limited.

If actual creditors do not behave in the same way as their counterparts in the financial economics models, then that difference helps to explain why the extraordinary outpouring of law review articles applying pieces of financial economics to questions concerning secured transactions[78] has had little effect on

Federal Reserve Banks, or to those assignees to which the borrower has given its express consent.

78. An authoritative listing of this literature appears as footnote 23 to the Permanent Editorial Board's Article 9 Report and includes: Buckley, *supra* note 51; Thomas H. Jackson & Alan Schwartz, *Vacuum of Fact or Vacuous Theory: A Reply to Professor Kripke*, 133 U. PA. L. REV. 987 (1985); Homer Kripke, *Law and Economics: Measuring the Economic Efficiency of Commercial Law in a Vacuum of Fact*, 133 U. PA. L. REV. 929 (1985); Schwartz, *supra* note 68; Schwartz, *supra* note 22; Scott, *supra* note 7; Shupack, *supra* note 22; and White, *supra* note 68. PEB REPORT, *supra* note 12, at 8 n.23.

Other notable contributions to this literature include Barry E. Adler, *An Equity-Agency Solution to the Bankruptcy-Priority Puzzle*, 22 J. LEGAL STUD. 73 (1993); Richard L. Barnes, *The Efficiency Justification for Secured Transactions:*

statutory reform. Those close to the market are acutely aware of the importance of differences among creditors. For them, the analysis and prescriptions based on uniform creditor behavior rings false, and is thus disregarded.

2. Variations on Agency-Cost Theory

Starting from agency-cost assumptions, a story can be told in mirror image to the story that has become part of the conventional account of secured lending. If we view the creditor as the self-interested actor and the debtor as the reacting party, then the creditor's only concern will be payment in full. The creditor has no interest in seeing the debtor do more than meet its obligations to the creditor. The creditor will restrict the debtor from accepting projects that increase the possibility of loss as a consequence of the proposed change in the joint enterprise's activity.[79]

Foxes with Soxes and Other Fanciful Stuff, 42 KAN. L. REV. 13 (1993); James W. Bowers, *Whither What Hits the Fan?: Murphy's Law, Bankruptcy Theory, and the Elementary Economics of Loss Distribution*, 26 GA. L. REV. 27 (1991); Carlson, *supra* note 22; Saul Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 YALE L.J. 49 (1982); Randal C. Picker, *Security Interests, Misbehavior, and Common Pools*, 59 U. CHI. L. REV. 645 (1992); and George G. Triantis, *Secured Debt Under Conditions of Imperfect Information*, 21 J. LEGAL STUD. 225 (1992).

79. *See* Henry Hansmann & Reinier Kraakman, *Hands-Tying Contracts: Book Publishing, Venture Capital Financing, and Secured Debt*, 8 J.L. ECON. & ORGANIZATION 628, 649-50 (1992). According to Hansmann and Kraakman:

> There is a much broader class of situations that give rise to the same basic problem—namely, how much control over a project to give to a party who participates disproportionately in losses as opposed to gains. An important example from this broader class is the choice between secured and unsecured debt.

Id. Unsecured creditors often insist on stringent loan covenants, and secured creditors often have both security and loan covenants that give them an "effective veto over almost any aspect of the borrower's business." *Id.* (citing Scott, *supra* note 7, at 925-29). The Hansmann and Kraakman article further explains that

> [t]his type of control has the often-noted advantage of preventing the borrower from opportunistically substituting riskier lines of business for safer ones at the lender's expense. But, at the same time, it can induce the inverse problem. Since a lender participates less in the firm's upside gains than in its downside losses, she has an incentive to be excessively conservative in permitting the borrower to enter new, jointly profitable lines of business. Thus secured or covenanted debt comes at a potential cost. Presumably this helps explain why unsecured debt is often issued even by firms that have assets that could be pledged as security. In effect, secured or heavily covenanted debt functions as investment without hands-tying while long-term debt that is free of such restrictions ties the lender's hands by permitting the debtor to continue, expand, or alter its projects without the lender's consent.

Id. at 649-50 (citations omitted).

The creditor, then, functions as a drag upon the activities of the joint enterprise, opposing actions that would benefit the debtor-creditor enterprise taken as a whole, but not the creditor exclusively.

This account suggests a direct benefit that asset-based lending can give to debtors. A creditor who looks primarily to certain of the debtor's pledged assets for assurance that the loan will be repaid has little incentive to control the debtor. If filing facilitates the creation of asset-based lending, then filing serves as a mechanism to allow debtors and creditors to control the agency costs that result from creditors' self-protective actions. To the extent that segregation of newly-acquired assets is necessary for debtor independence, then something like the current statute's superpriority for PMSIs begins to make sense. Thus, the agency-cost account that suggests the irrelevance of filing can be used in mirror image to suggest its necessity.

If these theoretical points have any validity at all, they suggest reasons to believe that asset-based financing is not solely an artifact of existing law, but instead a response by debtors and creditors to complications actual markets create. To the extent that existing theory does not allow for these complications, the theory and the analysis following from it are incomplete.

3. Social Theory and Social Fact

Asset-based financing is part of a larger set of interconnected financial practices. Isolating one financial practice for discussion risks missing the social roles that the entire set of financial practices performs. Without proper data, it is impossible to do more than merely suggest one possible connection between the credit practices represented by asset-based lending and society as a whole.

Asset-based financing is predominantly an American and English phenomenon. European credit structures, though they have security devices, function more nearly as finance theory describes preferred debtor-creditor structures. In caricature, European financial structures have been described as top-down. Major financial institutions provide mega-loans to giant enterprises, which in turn finance the smaller components of their businesses. That pattern conforms to the picture of creditors who, after performing due diligence on prospective debtors, make loans on the worth of an enterprise as a whole, rather than on the credit-worthiness of a specific asset.

Commercial finance companies provide what can be described, in caricature, as bottom-up financing, and virtually do not exist in European economies. It is far beyond the scope of this Article to argue, much less plausibly demonstrate, that some connection exists between bottom-up financing in this country and some of the observed flexibility of the American economy. We know just enough to make plausible the idea that some connection exists between the lending practices we call asset-based lending and the performance of the overall economy. To the extent that a connection does exist, so radical a change in the existing structure as the abolition of filing should be considered with only the greatest of caution.

CONCLUSION

The question of whether filing is a good idea has to be empirical. The data that would answer that question are not directly obtainable, so the best we can do is offer reasons to believe what the data would show if those data existed. The case against filing, built on the premise that the information the filings generate is already known to the relevant creditors, has both a sound theoretical basis and also significant data to support it.

This Article has made two basic arguments in support of filing. A noticeable number of creditors engage in lending in which the asset rather than the debtor is central to the transactions, and filing facilitates this type of lending. In addition, this type of lending constitutes a non-trivial part of the current American economy. In its second argument, this Article has suggested that the empirical points standing by themselves could prove nothing about the worth to the economy of this type of transaction. Their existence could easily be explained as an artifact of existing legal structures. In answer to that point, this Article has suggested reasons to believe that the standard proposed by finance theory is incomplete. The areas in which finance theory does not explain creditor behavior also provide the strongest theoretical basis to believe that the lending practices we call asset-based lending can be defended on theoretical, as well as practical, grounds.