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REVISED ARTICLE 9 MEETS THE BANKRUPTCY CODE: POLICY AND IMPACT

STEVEN L. HARRIS AND CHARLES W. MOONEY, JR.*

INTRODUCTION

The development of the law governing security interests in personal property has been characterized by repeated judicial and legislative battles between unsecured and secured creditors. The principal point of conflict has been when and under what circumstances the former may reach collateral claimed by the latter.¹ For many years, under Article 9 of the Uniform Commercial Code, debtors generally have been able to secure any and all of their obligations with any and all of their existing and after-acquired personal property. This state of affairs will continue under Revised Article 9.²

Revised Article 9 will become effective in at least 31 states and the District of Columbia on July 1, 2001.³ It has been introduced in 20 other jurisdictions, and plans are at hand to introduce it in others.⁴ Accordingly, this is a propitious time to examine closely the substantive rules and standards that Revised Article 9 embodies and to anticipate the likely social effects of the revision. Inasmuch as the distributive effects of secured credit are most pronounced when a debtor becomes insolvent, it is particularly appropriate to address the likely effects of Revised Article 9 in bankruptcy.

The articles in this symposium issue will provide a valuable resource for practitioners, judges, and academics alike as we begin to live with Revised Article 9 not as a proposal but as the governing law.

This article begins by addressing the relationship between Revised Article 9 and the policies that underlie the Bankruptcy Code. We argue in part I that Revised Article 9 is fully consistent with those policies. We then consider in part II the revised Article's likely impact, in both quality and degree, on a debtor's unsecured creditors. Part II.A.

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¹ See 1 GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY chs. 1-8 (1965).

² As used in this article, "Revised Article 9" and "the revised Article" refer to the 2000 official text of Article 9. References to "§ 9-XXX" and "section 9-XXX" are to sections of Revised Article 9. "Former Article 9" and "the former Article" refer to the 1995 official text of Article 9. References to "former § 9-XXX" and "former section 9-XXX" refer to sections of Former Article 9. References to the "Bankruptcy Code" are to 11 U.S.C. §§ 101 *et seq.* (1994).

³ See Uniform Law Commissioners, Introductions and Adoptions of Uniform Acts, *available at* http://www.nccusl.org/uniformact_factsheets/uniformacts-fs-ucca9.htm (last visited April 4, 2001).

⁴ *Id.*

suggests that Revised Article 9 will not materially reduce the amount of assets available for distribution to unsecured creditors in bankruptcy. Parts II.B. and III analyze the effects on unsecured creditors under the assumption that we are mistaken in Part II.A., *i.e.*, that the revised Article will materially reduce the amount of unencumbered assets in bankruptcy. Part II.B. argues that, even under this assumption, Revised Article 9 may afford nonbankruptcy benefits to unsecured creditors that more than offset reductions in free assets in bankruptcy. Part III raises the possibility that, even under this assumption, Revised Article 9 may on balance redound to benefit of unsecured creditors in bankruptcy.

I. REVISED ARTICLE 9 AND BANKRUPTCY POLICIES

In this part we explore the relationship between security interests (in particular, under Revised Article 9) and the policies underlying bankruptcy law.⁵ One of the most enduring and contentious topics in the law, and certainly in the law of bankruptcy and reorganization, has been the extent to which security interests should be effective in bankruptcy. Secured transactions also have featured prominently in the ongoing debates about the policies underlying bankruptcy law.⁶ As we have observed previously:

Concerns about the effect of bankruptcy on the effectiveness of security interests are not peculiar to the academy. A principal motivation for taking security is the desire to increase the likelihood of payment in the event of bankruptcy. The purposes and benefits of giving and taking security would be undermined considerably if security interests were not generally honored in bankruptcy.⁷

When Professor Ray Warner invited us to write for this symposium issue, he suggested that we might wish to counter a proposition that he intended to advance: Revised Article 9 is inconsistent with or adverse to bankruptcy policies.⁸ Our

⁵ This part expands on our brief discussion of the relationship between security interests and bankruptcy policy in an earlier article. See Steven L. Harris & Charles W. Mooney, Jr., *A Property-Based Theory of Security Interests: Taking Debtors' Choices Seriously*, 80 VA. L. REV. 2021, 2067-71 (1994) [hereinafter Harris & Mooney, *Property-Based Theory*].

⁶ For a balanced and thoughtful survey of the academic debates on bankruptcy policy, see Douglas G. Baird, *Bankruptcy's Uncontested Axioms*, 108 YALE L.J. 573 (1998). Baird contrasts and analyzes what he sees as the two prevailing sets of axioms about bankruptcy law. He bifurcates bankruptcy scholars into two groups holding competing views, the "traditionalists" and the "proceduralists." We believe this to be the first use in the bankruptcy law literature of the "proceduralist" label to refer to the perspective most frequently identified as the "economic" approach. However, one of us embraced the proceduralist banner some years earlier in the context of business bankruptcy. See Charles W. Mooney, Jr., *Hosing Down Senior Claims with a Quicker and Dirtier Chapter 11*, 72 WASH. U. L.Q. 1153, 1158 (1994) ("Bankruptcy is civil procedure—no less but absolutely no more."

⁷ Harris & Mooney, *Property-Based Theory*, *supra* note 5, at 2067. For a recent survey and critique of the arguments made by other participants in the normative debate on the utility of secured credit, see Robert E. Scott, *The Truth About Secured Financing*, 82 CORNELL L. REV. 1436 (1997) [hereinafter Scott, *Truth*].

⁸ See G. Ray Warner, *The Anti-Bankruptcy Act: Revised Article 9 and Bankruptcy*, 9 AM. BANKR. INST. L. REV.

understanding of bankruptcy policies leads us to conclude that this proposition is incoherent. Indeed, we argue here that Revised Article 9 and other nonbankruptcy laws allocating property rights (such as priorities) *cannot* conflict with bankruptcy policies.

Given the ongoing debate about the essential components and boundaries of bankruptcy policies, can we confidently advance the proposition that Revised Article 9 is consistent with those policies? We believe so. We base our argument on property-related policies inherent in the Bankruptcy Code.⁹ Central to the analysis is the Bankruptcy Code's overarching respect for nonbankruptcy law's allocation of rights with respect to particular assets in which the bankruptcy debtor has an interest. Bankruptcy law gives effect to a debtor's prebankruptcy transfers of property (including security interests) and, correspondingly, to the rights of the holders of property interests that do not belong to the debtor.¹⁰ Security interests, like other property interests, benefit from these policies.

Indeed, nonbankruptcy law's allocation of property interests lies at the core of the Bankruptcy Code's provisions for allocating value between the debtor and its creditors. One can neither understand nor implement the bankruptcy allocation without reference to legal entitlements established by nonbankruptcy law. Commencement of a case under the Bankruptcy Code creates an "estate"¹¹ that includes "all legal or equitable interests of the debtor *in property* as of the commencement of the case."¹² The Bankruptcy Code defers to nonbankruptcy (generally, state) law as to what constitutes "property" and as to who holds legally recognizable interests in property. This is so

3, 4 (2001). Professor Warner's critique of Revised Article 9 in the context of bankruptcy policy is a particular extension of the standard critique of secured credit by bankruptcy traditionalists. *See, e.g.*, Lynn M. LoPucki, *The Unsecured Creditor's Bargain*, 80 VA. L. REV. 1887, 1888-89 (1994) ("The institution of security has a . . . bad reputation. Its most persistent image is that of families forced from home or farm through foreclosure. Most non-economists wish that things could be different. We are rooting for the underdog, which means we are rooting against security.") (footnote omitted). In marshaling his critique, Professor Warner considers the components of bankruptcy policy (including "normative values"), the history of non-possessory secured credit and its relationship to fraud and public notice, the academic debates over the full priority of security in bankruptcy, perceived deficiencies in the uniform law process, the history of bankruptcy in the United States, and the underlying theory of the "strong-arm" power of the trustee in bankruptcy, among other matters. Although we take a more focused, positive approach here, we wish to make clear that our silence on much of Professor Warner's discussion does not necessarily signal our agreement.

⁹ We take, as a given, that the Bankruptcy Code reflects federal bankruptcy policy. In that sense, our claim concerning the relationship of Revised Article 9 to bankruptcy policies is descriptive not normative. We note, however, that there is substantial support for the view that the policies on which our claim relies—those that give effect in bankruptcy to non-bankruptcy property interests—have much to commend them. Others disagree. *See, e.g.*, Baird, *supra* note 6, at 578, 590-92. This article does not attempt to resolve these normative debates. To the extent that Professor Warner advocates bankruptcy policies not reflected by the Bankruptcy Code, we are unclear as to the theoretical and normative bases for those policies. *See Warner, supra* note 8, at 5 (arguing that bankruptcy policy should embody "normative values" that "encourage reorganization"). Weighing in on the normative debate, Professor Warner asserts that policies favoring respect for non-bankruptcy entitlements in bankruptcy would mean that "[b]ankruptcy law is *merely* procedural." *Id.* at 20 (emphasis added). We place a much higher value on the crucial role played by civil procedure in our legal system.

¹⁰ The avoiding powers of the trustee in bankruptcy present exceptions. We discuss these exceptions below.

¹¹ 11 U.S.C. § 541(a).

¹² *Id.* § 541(a)(1) (emphasis added).

even though, conceptually, what is "property" under Bankruptcy Code section 541 is a question of *federal* law, and the particular label that state law may ascribe to the debtor's rights is not controlling.¹³

By defining the property of the estate by reference to the debtor's nonbankruptcy property interests, the Bankruptcy Code respects the property interests of persons other than the debtor who hold property interests in property of the estate (i.e., in property in which the debtor also holds an interest). Thus, in the leading case of *Butner v. United States*,¹⁴ the Supreme Court explained:

Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding. Uniform treatment of property interests by both state and federal courts within a State serves to reduce uncertainty, to discourage forum shopping, and to prevent a party from receiving "a windfall merely by reason of the happenstance of bankruptcy." *Lewis v. Manufacturers National Bank*, 364 U.S. 603, 609. The justifications for application of state law are not limited to ownership interests; they apply with equal force to security interests, including the interest of a mortgagee in rents earned by mortgaged property.¹⁵

These bankruptcy policies are striking in particular for the depth and breadth of their deference to non-bankruptcy law. Subject to extremely limited exceptions, the Bankruptcy Code offers a blank check to the makers of non-bankruptcy law to define and delineate property law principles that will prevail in bankruptcy. "Congress clearly left the door open for secured creditors to take everything in bankruptcy."¹⁶

The Bankruptcy Code's distributional scheme evidences the deference to property interests held by secured parties and other non-debtors. The scheme generally provides that property claimants recover their property or its value.¹⁷ In an effort to insure that the promised recovery is forthcoming, the Bankruptcy Code entitles the non-debtor property claimant to "adequate protection" of its interest.¹⁸ When adequate protection

¹³ See, e.g., *Bd. of Trade of Chicago v. Johnson*, 264 U.S. 1 (1924) (holding that seat on exchange is property in bankruptcy case although not considered to be property under applicable state law; restrictions on transfer applicable under state law were effective in bankruptcy).

¹⁴ 440 U.S. 48, 55 (1979). See generally CHARLES JORDAN TABB, *THE LAW OF BANKRUPTCY* § 5.5 (1997).

¹⁵ *Butner*, 440 U.S. at 55 (footnote omitted).

¹⁶ Harris & Mooney, *Property-Based Theory*, *supra* note 5, at 2070.

¹⁷ See, e.g., 11 U.S.C. §§ 506(d) (governing determination of secured status), 724 (addressing distributions to holders of non-avoidable liens), 1129 (articulating fair and equitable requirement for secured claims in connection with confirmation of plan of reorganization).

¹⁸ See, e.g., *id.* § 363(e) (providing that person with interest in property to be used, sold, or leased by trustee is entitled to adequate protection). The concept of "adequate protection" is explained in 11 U.S.C. § 361. Adequate protection may consist of cash payments to the person with an interest in the property, additional or replacement liens to protect that person's interest, or "other relief, other than entitling [that person] to compensation allowable

is required but is not forthcoming from the trustee or debtor in possession, the Bankruptcy Code entitles the non-debtor to obtain relief from the automatic stay.¹⁹ When the non-debtor property claimant holds a security interest, this relief permits the claimant to recover the collateral and enforce its security interest.²⁰ While the most common instances of stay-lifting litigation no doubt involve secured creditors, the breadth of Bankruptcy Code's language in this context is striking. The principal operative provisions for relief from the stay do not address security interests in particular, but refer broadly to "an interest in property" and "property."²¹

The Bankruptcy Code also generally defers to non-bankruptcy law concerning other, non-property-based legal entitlements, such as ordinary unsecured claims. The Bankruptcy Code defines a "claim" that is cognizable in bankruptcy²² to include a "right to payment" and a "right to an equitable remedy for breach of performance if such breach gives rise to a right to payment."²³ But, as in the case of property interests, the question whether a right to payment or an equitable remedy actually exists is a matter of non-bankruptcy law. It follows that the Bankruptcy Code defers to non-bankruptcy law as to both elements of a secured claim—the validity of a secured creditor's interest in property and the existence of the obligation that the security interest secures.²⁴

Of course, the Bankruptcy Code's deference to non-bankruptcy law concerning property and claims is not absolute.²⁵ (Were it otherwise, bankruptcy would function solely as a means for an individual debtor to obtain a discharge.) The trustee in bankruptcy has the power to avoid certain pre-petition transfers of property and the

under § 503(b)(1) of this title as an administrative expense, as will result in the realization . . . of the indubitable equivalent of [that person's] interest in such property." *Id.* § 361(3).

¹⁹ *Id.* § 362(d)(1) (granting relief from stay for cause, including lack of adequate protection).

²⁰ See TABB, BANKRUPTCY, *supra* note 14, § 3.16.

²¹ See 11 U.S.C. § 362(d); see also *Holtkamp v. Littlefield (In re Charles Holtkamp)*, 669 F.2d 505 (7th Cir. 1982) (deciding that holder of unsecured claim was entitled to relief from stay; persons entitled to relief from stay are not limited to holders of secured claims). Professor Warner appears uncertain, even skeptical, that a security interest is an interest in property. See Warner, *supra* note 8, at 21. However, "security interest" is defined to mean "an interest in personal property or fixtures." 11 U.S.C. § 1-201(37).

²² See 11 U.S.C. § 726 (providing distribution of property of estate).

²³ *Id.* at § 101(5).

²⁴ Federal bankruptcy law may, however, govern the *time* that a claim arises. See *Piper Aircraft Corp. v. Calabro*, 169 B.R. 766 (Bankr. S.D. Fla. 1994) (holding that debtor's pre-petition manufacture of aircraft combined with *post*-petition crash of aircraft, gave rise to a claim cognizable in chapter 11 case). Moreover, in seeking to effectuate the bankruptcy policy of affording a "fresh start" to qualifying individuals, bankruptcy law materially dilutes non-bankruptcy law entitlements. See, e.g., 11 U.S.C. §§ 727(a) (discharging debts); 522(f) (permitting avoidance of otherwise valid liens that impair exemptions).

²⁵ We have mentioned the automatic stay provisions, which normally condition the secured party's enforcement of its rights during the bankruptcy case on the entry of a court order. See 11 U.S.C. § 362(a), (d). The Supreme Court has held that the secured party need not be compensated for any delay in receiving the value of its collateral. See *United Sav. Ass'n v. Timbers of Inwood Forest Assocs., Ltd.*, 484 U.S. 365, 382 (1988). And although the Bankruptcy Code does not create an obligation where none exists under non-bankruptcy law, it does give effect to certain obligations that would not be enforceable outside of bankruptcy, for example, because the obligation is contingent, unliquidated, or unmatured. See, e.g., 11 U.S.C. §§ 101(5) (providing definition of "claim"), 726(a) (articulating distribution scheme).

incurrence of certain pre-petition obligations.²⁶ To a significant extent these "avoiding powers" are rooted in or closely connected with non-bankruptcy law. For example, Bankruptcy Code section 548 incorporates longstanding non-bankruptcy principles of fraudulent transfer law.²⁷ Moreover, Bankruptcy Code section 544(a), the trustee's "strong-arm" provision, looks solely to applicable non-bankruptcy law for the rights of a hypothetical bona fide purchaser of real property or lien creditor, in both of whose shoes the trustee stands for purposes of avoiding pre-petition transfers.²⁸ The same can be said of Bankruptcy Code section 544(b), under which the trustee may exercise the avoiding powers of an actual creditor under applicable non-bankruptcy law.²⁹

The avoidance of preferential transfers in bankruptcy is much less rooted in or connected with non-bankruptcy law and principles.³⁰ Although scholars disagree about the essence of the anti-preference policies embodied in Bankruptcy Code section 547 and the precise details of preference doctrine, there is little doubt that preference law reflects a distinct bankruptcy policy.³¹ Yet even in the context of preference avoidance, the Bankruptcy Code looks to non-bankruptcy law.³²

The Bankruptcy Code's avoiding powers, like its provisions on adequate protection and relief from the automatic stay,³³ generally do not distinguish security interests from other transfers of property by a debtor. For example, preference law addresses not only transfers of security interests but also other transfers, including payments.³⁴

²⁶ See, e.g., 11 U.S.C. §§ 544, 545, 547, 548. Other bankruptcy doctrine, in some sense roughly analogous to the avoiding powers, also balances non-bankruptcy entitlements against perceived bankruptcy policies. *Id.* § 365 (assumption and rejection of executory contracts and leases).

²⁷ Compare 11 U.S.C. § 548(a)(1) (actual fraud), and § 548(a)(2) (constructive fraud), with UNIF. FRAUDULENT CONVEYANCE ACT § 7, 7A U.L.A. 509 (1918) (actual fraud), and §§ 4-6, 7A U.L.A. 504-07 (1918) (constructive fraud), and UNIF. FRAUDULENT TRANSFERS ACT § 4(a)(1), 7A U.L.A. 652 (1984) (actual fraud), and §§ 4(a)(2), 5(a), 7A U.L.A. 653, 657 (1984) (constructive fraud).

²⁸ See 11 U.S.C. 544(a); see also TABB, BANKRUPTCY, *supra* note 14, §§ 6.3, 6.4.

²⁹ See TABB, BANKRUPTCY, *supra* note 14, § 6.5.

³⁰ See 11 U.S.C. § 547. However, some states do have preference-avoidance statutes. See, e.g., GRANT GILMORE & DAVID GRAY CARLSON, GILMORE AND CARLSON ON SECURED LENDING § 2.07 (2d ed. 2000).

³¹ Harris & Mooney, *Property-Based Theory*, *supra* note 5 at 2069, n.143:

The two most commonly proffered explanations of preference law relate to distributional concerns (i.e., that preference law promotes equality of treatment among creditors) and to wealth maximization (i.e., that it deters creditors from diminishing the going-concern value of the debtor by stripping away assets). See, e.g., John C. McCoid, II, Bankruptcy, Preferences, and Efficiency: An Expression of Doubt, 67 Va. L. Rev. 249, 260-61 (1981). Although McCoid refers to maximization of the debtor's estate as "an infrequently stated companion goal," *id.* at 261, more recent scholarship has emphasized this goal more than equality of distribution. See Steven L. Harris, Deterrence, Equality and Preferences: A Challenge to Current Theories (unpublished manuscript, on file with the Virginia Law Review Association). One of us has suggested elsewhere that the treatment of security interests under Bankruptcy Code § 547 appears more concerned with blunting the advantage that particular creditors might otherwise enjoy than with preventing wealth-destroying "last-minute grabs" by secured parties. *Id.* at 33.

Id.

³² See 11 U.S.C. § 547(e) (containing rules for determining when a "transfer" occurs).

³³ See *supra* text accompanying notes 19-21 & 25.

³⁴ See 11 U.S.C. §§ 101(54) (defining "transfer"), 547(b) (specifying elements of an avoidable transfer).

The avoiding powers are fully consistent with our thesis that Revised Article 9 *cannot* violate bankruptcy policies. To the extent that non-bankruptcy entitlements are avoided in bankruptcy, the Bankruptcy Code's policies triumph and non-bankruptcy law—whatever its substance—must yield. In the case of an avoidable security interest, any assertion that non-bankruptcy law (e.g., Revised Article 9) is adverse to bankruptcy policies clearly would be wrong, inasmuch as bankruptcy policies carry the day. Alternatively, to the extent that the avoiding powers do not affect a non-bankruptcy property entitlement, respect for that entitlement is fully consistent with bankruptcy policies, and in particular the policy of generally respecting non-bankruptcy interests in property. The same analysis applies with respect to other exceptions to the Bankruptcy Code's general deference to non-bankruptcy entitlements, such as the automatic stay. It is manifest that non-bankruptcy law does not, and cannot, have an adverse effect on bankruptcy policies.³⁵

To be clear, we make no claim that the Bankruptcy Code is indifferent to normative issues such as distributional justice or efficiency. Rather, we believe that, to the extent that Congress resolved those normative issues, the resolution is reflected in the Bankruptcy Code's policy of leaving most questions of property allocation to non-bankruptcy law.³⁶

One response to our thesis might take the following outline: The Bankruptcy Code was drafted in the shadow of a set of expectations about the shape and substance of non-bankruptcy law. More specifically, the Bankruptcy Code's generally applicable

³⁵ Professor Warner asserts that a generally applicable non-bankruptcy law violates bankruptcy policy if it has "the effect of undermining bankruptcy policy." Warner, *supra*, note 8, at 22. In support of this assertion, he points to a number of provisions of the Bankruptcy Code, including §§ 365, 502, 545, 546, and 552. *Id.* at 22-24. But the fact is inescapable that Professor Warner's chief complaint is that no avoiding power or other provision of the Bankruptcy Code will override many security interests created and perfected under Revised Article 9. Professor Warner relies on provisions of the Bankruptcy Code to illustrate bankruptcy policy, an approach with which we obviously concur. But, this reliance undermines his claim that *non-avoidable* security interests under Revised Article 9 conflict with bankruptcy policy. Other than his approval of "normative values," the source of Professor Warner's bankruptcy policy is unclear. *See supra* note 9.

³⁶ Whether the Bankruptcy Code *should* defer to non-bankruptcy law in this respect lies at the heart of the normative debate. *See Baird, supra* note 6, at 578, 590-92. Professor Baird and President Thomas H. Jackson have been the leading advocates, in the normative debate, for generally respecting non-bankruptcy entitlements in bankruptcy. *See, e.g., Douglas G. Baird & Thomas H. Jackson, Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. CHI. L. REV. 97, 103 (1984):

Nonbankruptcy concerns, we believe, should not be addressed by changing bankruptcy policy. Our view derives from two related observations: first, that bankruptcy law is, and should be, concerned with the interests of those (from bondholders to unpaid workers to tort victims to shareholders) who, outside of bankruptcy, have property rights in the assets of the firm filing a petition, and, second, that in analyzing the interests of these parties with property rights, our baseline should be applicable nonbankruptcy law. A collective insolvency proceeding is directed toward reducing the costs associated with diverse ownership interests and encouraging those with interests in a firm's assets to put those assets to the use the group as a whole would favor.

Id. For a critique of the Baird and Jackson "creditors' bargain" analysis, *see Robert E. Scott, Through Bankruptcy with the Creditors' Bargain Heuristic*, 53 U. CHI. L. REV. 690 (1986).

deference to non-bankruptcy law, at least in the context of secured transactions, was based on the expectation that something very much like the 1972 version of Article 9 would govern secured transactions. Having materially altered the basic attributes of secured transactions law, Revised Article 9 has upset the expectations underlying the Bankruptcy Code's deference. Consequently, Revised Article 9 is adverse to the policies and spirit of the Bankruptcy Code, albeit not the letter of the statute.³⁷

The problem with the analysis just presented is that it is based on a false premise. Revised Article 9 most assuredly *does not* embody a material alteration of the basic attributes of secured transactions law.³⁸ As we explain more fully below, the revision clarifies, tinkers at the edges, refines, and generally seeks to make the statute more user friendly and more precise.³⁹ The argument might have more plausibility (although we would reject it nonetheless) had Revised Article 9 made a fundamental change that would materially affect the powers of the trustee in bankruptcy. For example, had Revised Article 9 provided that an *unperfected* security interest prevails over the rights of a lien creditor,⁴⁰ the revised Article would have disabled the trustee from using the "strong-arm" powers to avoid unperfected security interests.⁴¹ This change was urged by at least one scholar;⁴² however, the proposal received no support from the Drafting Committee or any of its many advisors and observers and was not seriously pursued.⁴³

³⁷ Professor Warner appears to make this argument. See Warner, *supra* note 8, at 29-35.

³⁸ Even if Revised Article 9 did work such a material alteration we would remain unpersuaded that it would conflict with established bankruptcy policy. The argument made in the preceding paragraph proceeds on the assumption that the Bankruptcy Code's overlay on Former Article 9 somehow produced an optimal or near-optimal bankruptcy regime. It also assumes that the Bankruptcy Code's deference to non-bankruptcy property rules was premised on a static legal regime that would feature no major non-bankruptcy reforms. We seriously question those assumptions.

³⁹ See *infra* text accompanying notes 53-62, 76-88.

Professor Warner apparently thinks that Revised Article 9 is *less* user friendly, which undercuts his claim that Revised Article 9 will materially reduce distributions to unsecured creditors in bankruptcy.

"The old law was fairly simple and easy to understand for most transactions, if you learned some general rules and a couple exceptions," says [Professor G. Ray] Warner, but the "new law is extremely complicated and has different sets of rules for different transactions. It's a real pain. Everything is broken up in ways that are not intuitive, and it's often hard to locate the provision you want."

As a result, the law "is a potential mine field for an attorney who doesn't do this regularly," he says.

.....

The complexity of the law is also expected to generate litigation. "For the first 10 years, there will be lots of litigation over what every word in this statute means," predicts Warner.

James L. Dam, *Lawyers Scramble to Learn New Rules on Secured Transactions*, LAW. WKLY. USA, Jan. 22, 2001, at 1, 21. We address in Part II.A., *infra*, the claim that bankruptcy distributions will be materially reduced under Revised Article 9.

⁴⁰ Of course, the rule was to the contrary under former § 9-301(1)(b): an unperfected security interest was subordinate to the interest of a lien creditor. Section 9-317(a)(2) adopts this rule, with refinements.

⁴¹ See 11 U.S.C. § 544(a)(1).

⁴² See James J. White, *Revising Article 9 to Reduce Wasteful Litigation*, 26 LOY. L.A. L. REV. 823, 823-26 (1993).

⁴³ See Steven L. Harris & Charles W. Mooney, Jr., *How Successful Was the Revision of UCC Article 9: Reflections of the Reporters*, 74 CHI.-KENT L. REV. 1357, 1364 (1999) [hereinafter Harris & Mooney, *How Successful*].

The truly revolutionary impact on secured transactions law occurred when the original version of Article 9 was widely enacted in the 1960's.⁴⁴ Congress has since had ample time to adapt the bankruptcy law to these revolutionary changes in non-bankruptcy law. The Bankruptcy Code of 1978 reflects Congress's familiarity with Article 9, yet neither the original enactment nor the many amendments to it depart substantially from the traditional bankruptcy policies giving effect to non-bankruptcy entitlements.⁴⁵

We do not claim here, nor does our thesis require us to claim, that the Bankruptcy Code's avoiding powers are optimal in every respect. Surely there is much to criticize in both the substance and drafting style of the relevant provisions. Some who express concerns about Revised Article 9 may actually be arguing, or may be influenced by their belief, that the avoiding powers are underpowered and should be extended so as to make secured claims even more vulnerable. Perhaps they are correct; perhaps not. But that claim in no way suggests that *Revised Article 9* undermines any bankruptcy policy. It reflects only the view that the avoiding powers as they now exist do not adequately reflect the policies that the critics claim that the Bankruptcy Code *should* reflect. In effect, that is an argument that the *Bankruptcy Code* is inconsistent with bankruptcy policy.⁴⁶

Similarly, one dissatisfied with of Revised Article 9 might take exception with the Bankruptcy Code's largely unfettered deference to non-bankruptcy property law, such as the revised Article. But as in the case of dissatisfaction with the limits of the avoiding powers, this is a normative criticism of the bankruptcy policies as reflected in the Bankruptcy Code itself—*i.e.*, a complaint that the Bankruptcy Code does not reflect the policies that it should reflect. To the extent that it is a criticism of Revised Article

⁴⁴ In fact, some of the principal drafters and supporters of the original Article 9 project, including Peter F. Coogan, Grant Gilmore, and Homer Kripke, were themselves distinguished bankruptcy scholars, practitioners, or both.

⁴⁵ In 1980, Peter Coogan discussed the ways in which the 1978 Bankruptcy Code might change rights under Former Article 9. See Peter F. Coogan, *The New Bankruptcy Code: The Death of Security Interest?*, 14 GA. L. REV. 153 (1980). All of these ways fairly can be characterized as consistent with the general policy of affording the collateral or its value to the secured party.

A secured party, when informed of the way in which the new Bankruptcy Code affects his property and contract rights, may say that, even if this article cannot be entitled "Death of Contracts II," it should be entitled "Death of Security Interests." Either title, however, would overshoot the mark. The Bankruptcy Code is not a one-way street. It is new in the balancing act that a bankruptcy judge must perform"

Id. at 154-55.

Summarizing "[t]he fighting between commercial law and bankruptcy" since 1978, Steve Nickles asserts that "[e]ach is trying to undermine the principles and structures that allow the other to dominate. They are engaged in all out *mutual retaliatory deconstruction*." Steve H. Nickles, *CONSIDER PROCESS BEFORE SUBSTANCE, Commercial Law Consequences of the Bankruptcy System: Urging the Merger of the Article 9 Drafting Committee and the Bankruptcy Commission*, 69 AM. BANKR. L.J. 589, 590 (1995) (emphasis in original). Although we disagree strongly with his characterization, we observe that he supports his argument with examples of judicial construction, rather than legislative amendment, of the Bankruptcy Code.

⁴⁶ We do not address possible conflicts between Revised Article 9 and bankruptcy policy that is not reflected in the Bankruptcy Code. See *supra* note 9.

9, it is premised upon the *consistency* between the revised Article and the Bankruptcy Code.

It is obvious that some bankruptcy specialists believe that the *result in practice* of Revised Article 9 will be to provide greater distributions and power to secured creditors in bankruptcy and less to unsecured creditors and other holders of legal entitlements.⁴⁷ To a considerable extent, this concern is premised upon the view that Revised Article 9 affords secured parties fewer opportunities to make perfection-related, and thus avoidance-producing, mistakes. We examine this concern next, in Part II.A. For present purposes, we note that it in no way implicates any bankruptcy policies. We do not view the "strong-arm" power in Bankruptcy Code section 544(a)(1) as embodying a bankruptcy policy that an undefined amount of collateral should be made available to unsecured creditors on a haphazard basis, depending on the fortuity of the secured party's noncompliance with state-law perfection requirements. We certainly reject the idea that section 544(a)(1) embodies a bankruptcy policy that the non-bankruptcy law governing transactions in personal property should be cumbersome, difficult to comply with, or risky for the parties. Rather, we view this "strong-arm" power as nothing more than what it purports to be: a mechanism whereby unsecured creditors can reach in a bankruptcy case whatever property they could have reached through non-bankruptcy judicial process.⁴⁸

Yet the fact remains that, whether as a normative matter or one of personal preference or bias, many critics of Revised Article 9 would rather see smaller distributions to the secured claims and larger distributions to the other claimants.⁴⁹ As

⁴⁷ See, e.g., Warner, *supra* note 8, at 5-6.

⁴⁸ An involuntary bankruptcy is conceptually very much like a collective judicial lien, in that the bankruptcy court takes jurisdiction over the debtor's property for the purpose of using it to satisfy claims. See 11 U.S.C. § 303 (addressing filing of involuntary cases). Giving the trustee this same status in a voluntary case eliminates any costly manipulation and perverse incentives concerning the filing of a voluntary as opposed to an involuntary case. This metaphor fits less comfortably with the trustee's "strong-arm" power for transfers of real property, as to which the trustee has the rights of a hypothetical bona fide purchaser, not merely the rights of a judicial lien creditor. *Id.* at § 544(a)(3). The real-property "strong-arm" power is best viewed as an anti-secret lien policy that is more exacting than state law. See THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 76 n.3 (1986) (explaining that drafters of Bankruptcy Code "appear to have concluded that the trustee's strong-arm power principally addressed the evil of property interests with ostensible ownership problems that remained despite available curative measures under non-bankruptcy law"). As a matter of policy, perhaps non-bankruptcy real-property law should be reformed to the end that, for example, the rights of the holder of an unrecorded mortgage would be junior to those of a judicial lien creditor.

⁴⁹ We suspect that many of these critics may subscribe to the school of thought that we dubbed "Sympathetic Legal Studies" ("SLS," adherents to which are "Symps") in an earlier article. See Harris & Mooney, *Property-Based Theory*, *supra* note 5, at 2045-47.

What genuinely may concern many Symps about the pending revision of Article 9 is the prospect of a world in which slip-ups by secured creditors will be so rare that debtors in bankruptcy seldom will be positioned to upset the agreement of the parties by avoiding unperfected security interests. Reducing the opportunities to hold secured parties hostage means there may be less cash available for debtors to continue operating their businesses, pay their counsel, and make distributions to their unsecured creditors. On the other hand, the more difficult it is to figure out how to perfect or where to file, the more likely it is that slip-ups will occur. Thus the Symps' "symple" solution (although few Symps may be so bold as

we have explained elsewhere, we believe that these preferences are based on empirically suspect grounds and vacuous theory.⁵⁰

Finally, we must disagree with Professor Warner's claim that Revised Article 9 offends bankruptcy policy because it "is itself designed to operate as a bankruptcy-only redistributive rule" and that its "most important bankruptcy-related changes . . . were designed primarily to alter bankruptcy results, and not to further non-bankruptcy state law policies."⁵¹ Perhaps Professor Warner's point is that a non-bankruptcy legal rule violates bankruptcy policy if its primary application occurs in the bankruptcy context (even though the rule is not by its terms explicitly conditioned on bankruptcy or insolvency).⁵² In response, we question the accuracy of Professor Warner's characterization of the operation of the rules adopted by Revised Article 9. Clearly the new rules will operate in contexts other than bankruptcy. Moreover, even if they would not, there would be no presumptive conflict with bankruptcy policy, as we view it.

Consider some examples. One new rule permits perfection of security interests in instruments by filing a financing statement.⁵³ Is that change a "bankruptcy-only redistributive rule"? We believe that it is not. To be sure, perfection by filing would determine the secured party's seniority, as to an instrument, over the debtor's trustee in bankruptcy, who could not avoid the perfected security interest. But perfection by filing carries more water than that. Perfection also may afford priority over the debtor's creditors claiming non-Article 9 statutory liens, such as tax liens,⁵⁴ priority over security

to articulate this position frankly): Keep it cumbersome, encourage the slip-ups, and redistribute the secured creditors' property interests as the slip-ups (invariably) arise.

Given that security interests will not be abolished, the Symps should come forward with a principled basis for casting a cloud of doubt or suspicion about security interests generally. If they really wish to argue that the creation of security interests should be more difficult, time consuming, expensive, and risky, then they must explain why.

Id. at 2046-47.

We also are aware, of course, that there is a prevailing, if informal, norm in certain circles of the bankruptcy bar that favors recoveries for unsecured creditors at the expense of secured creditors. We wonder how important it is to the maintenance of that norm that in reality assets not available to secured creditors are *first* made available not to unsecured general creditors (populist rhetoric notwithstanding) but for the payment of administrative expenses, including the fees of professionals such as attorneys. See 11 U.S.C. §§ 507(a)(1), 503.

⁵⁰ See Harris & Mooney, *Property-Based Theory*, *supra* note 5, at 2045-47, 2070-71.

⁵¹ Warner, *supra* note 8, at 5.

⁵² See *id.* Professor Warner's emphasis on the putative purpose for which the revisions were "designed" suggests that he may believe that it is the subjective intentions or purposes of the drafters, sponsors, or adopting legislatures which somehow result in a violation of bankruptcy policy. See, e.g., *id.* at 5, 22 ("designed"); *id.* at 23 ("motive"). Divining the intentions of a collective body such as the Article 9 Drafting Committee, the American Law Institute, or the California legislature is difficult at best. Even if one can accomplish this task, and even in the unlikely event that these bodies share the same intentions among themselves and with the other UCC sponsors and other adopting legislatures, these intentions would not be relevant to the question under discussion, whether Revised Article 9 is inconsistent with bankruptcy policy.

⁵³ Under revised Article 9 a security interest in negotiable and nonnegotiable instruments may be perfected under by filing a financing statement or by the secured party's taking possession of the instrument. See §§ 9-312(a), 9-313(a). Under Former Article 9, only possession would suffice for long-term (as opposed to temporary) perfection. See Former § 9-304(1).

⁵⁴ See 26 U.S.C. § 6323 (1994) (discussing priority of federal tax liens).

interests perfected by later-filed financing statements,⁵⁵ and priority over purchasers that do not qualify for priority under a non-temporal priority rule.⁵⁶ Moreover, perfection by filing for security interests in instruments may have profound effects even *absent* an actual priority contest, as by materially reducing transactions costs.⁵⁷ Any argument that the effects of the new rule will be manifested only in bankruptcy proceedings is baseless.⁵⁸ Nor could that argument prevail in the context of another new rule—Revised Article 9's provision for automatic perfection for sales of payment intangibles.⁵⁹ This automatically perfected security interest affords protection not only against the rights of lien creditors (and the trustee's "strong-arm" power) but also against later-in-time purchasers, outside bankruptcy, as well.⁶⁰ A third example permits the consummation of effective secured transactions that simply would have been impossible under Former Article 9, by virtue of legal or contractual restrictions on assignment.⁶¹ Obviously, this change in law will permit the creation of perfected security interests that will be enforceable in bankruptcy. However, by making it possible for formerly nonassignable rights, such as those under liquor licenses and franchises, to be the subject of attached and perfected security interests, the principal effect of the new rule will be the facilitation of credit and, at the margin, keeping debtors *out* of bankruptcy.⁶²

⁵⁵ See § 9-322(a)(1).

⁵⁶ See *id.* § 9-330(d) (articulating priority for qualifying purchasers of instruments over non-possessory security interests).

⁵⁷ As we explained elsewhere, a perfection-by-filing rule "avoids the costs and impracticalities of taking possession when the collateral consists of large numbers of instruments." Harris & Mooney, *How Successful*, *supra* note 43, at 1361 n.16. It also "makes it unnecessary to determine whether a particular writing is an instrument or to make alternative assumptions, necessitating both filing and taking possession." *Id.* We address in more detail in Part II.B. the impact of Revised Article 9 outside of bankruptcy proceedings.

⁵⁸ We take exception to Professor Warner's claim that "[e]ssentially, perfection by filing gives priority only over lien creditors, and thus trustees in bankruptcy." Warner, *supra* note 8, at 34.

⁵⁹ See § 9-309(3).

⁶⁰ See §§ 9-317(a), (d), 9-322(a)(1). Clearly the automatic-perfection rule was not *motivated* by bankruptcy concerns. It was a second-best approach reflecting the Drafting Committee's inability to craft an adequate statutory line that would be meaningfully inclusive while protecting bank loan-participation transactions from a filing requirement. See Steven L. Schwarcz, *The Impact on Securitization of Revised UCC Article 9*, 74 CHI.-KENT L. REV. 947, 955 (1999).

⁶¹ See § 9-408(a), (c). Section 9-408 renders ineffective legal and contractual restrictions on the assignment of, *inter alia*, general intangibles to the extent that the restrictions "would impair the creation, attachment, or perfection of a security interest" or cause the assignment to give rise to a default or other remedy under the assigned general intangible. § 9-408(a), (c).

⁶² See § 9-408 cmt. 8:

The principal effects of this section will take place outside of bankruptcy. Compared to the relatively few debtors that enter bankruptcy, there are many more that do not. By making available previously unavailable property as collateral, this section should enable debtors to obtain additional credit. For purposes of determining whether to extend credit, under some circumstances a secured party may ascribe value to the collateral to which its security interest has attached, even if this section precludes the secured party from enforcing the security interest without the agreement of the account debtor or person obligated on the promissory note. This may be the case where the secured party sees a likelihood of obtaining that agreement in the future. This may also be the case where the secured party anticipates that the collateral will give rise to a type of proceeds as to which this section would not apply.

Id. Obviously, we believe that Professor Warner's assertion that "[t]he major bankruptcy-related changes in revised

Even if Professor Warner's "bankruptcy-only redistributive" characterization were accurate, we reiterate that Revised Article 9's rules in no way conflict with our view of bankruptcy policy. The Bankruptcy Code expressly contemplates the transfer of non-avoidable property interests by a debtor prior to bankruptcy.⁶³ And, where it disfavors transfers that are triggered by bankruptcy or insolvency, the Bankruptcy Code likewise is explicit.⁶⁴ Indeed, in the context of secured transactions, we doubt that anyone seriously questions that the *paramount* legal attribute of a security interest is the priority that it is afforded in bankruptcy.⁶⁵

Having considered Revised Article 9 under our vision of bankruptcy policies, we now assess the likely impact of Revised Article 9 on unsecured creditors, both inside and outside bankruptcy.

II. IMPACT OF REVISED ARTICLE 9 ON UNSECURED CREDITORS

A. Impact of Revised Article 9 Inside Bankruptcy

Before the Article 9 revision had been completed, the project already had been indicted by the usual suspects—bankruptcy practitioners⁶⁶ and traditionalist bankruptcy academics.⁶⁷ Professor Warner has articulated well the concerns typically expressed.⁶⁸ The basic move is to claim that Revised Article 9 will have material distributional effects in bankruptcy. In particular, the prediction is that secured claims will reach more of the assets in bankruptcy and the pools of free, unencumbered assets will shrink accordingly. Only time will tell whether these predictions will come to pass and whether there will be any relevant and reliable data to evaluate. Our intuition is that the effects of moving to a Revised Article 9 regime will be quite modest in bankruptcy cases. As we discuss below in part II.B., we expect the major effects of Revised Article 9 to be manifested outside of bankruptcy.

Article 9 have little significance outside of bankruptcy" is a material overstatement. Warner, *supra* note 8, at 5.

⁶³ See *supra* text accompanying note 35.

⁶⁴ See 11 U.S.C. § 545(1) (permitting avoidance of statutory liens that "first become effective" upon a bankruptcy filing, another insolvency proceeding, or insolvency).

⁶⁵ Professor Warner makes much of what he perceives is a "bifurcation" of priority rules affecting lien creditors, on the one hand, and competing secured parties and other purchasers, on the other. See Warner, *supra* note 8, at 32-40. However, he acknowledges, as he must, that this bifurcation also existed under Former Article 9. See *id.* at 32 n.161. Revised Article 9 simply recognizes some additional situations in which purchasers (including secured parties) should be afforded better protection than non-reliance lien creditors. For an explanation of why this "bifurcation" may expand the amount of credit available to debtors, see Randal C. Picker, *Perfection Hierarchies and Nontemporal Priority Rules*, 74 CHI.-KENT L. REV. 1157 (1999).

⁶⁶ See, e.g., Kenneth N. Klee, *Barbarians at the Trough: Riposte in Defense of the Warren Carve-Out Proposal*, 82 CORNELL L. REV. 1466, 1468 (1997) (stating revision project is "secured creditors' grab" reflecting "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").

⁶⁷ See, e.g., Elizabeth Warren, *Making Policy with Imperfect Information: The Article 9 Full Priority Debate*, 82 CORNELL L. REV. 1373, 1374 (positing revision process is a "headlong rush to enlarge on every scintilla of priority for secured creditors").

⁶⁸ See, e.g., Warner, *supra* note 8, at 44-45.

It is quite plausible to speculate, as has Professor Warner, that by affording enhanced certainty to the law of secured transactions Revised Article 9 may permit more easily obtainable and more "bulletproof" secured claims.⁶⁹ In a similar vein, it seems reasonable to imagine that, with the revised Article's broader scope, secured creditors' claims may reach a greater proportion of a debtor's assets than would have been the case under Former Article 9.⁷⁰ For example, imagine that under Revised Article 9 a secured creditor in bankruptcy has a perfected security interest in a commercial tort claim to secure a loan.⁷¹ Under Former Article 9, let us assume, the assignment of the tort claim for security would have been vulnerable to the trustee's "strong-arm" powers.⁷² Ought one conclude on these facts that under Revised Article 9 the secured creditor will receive the value of tort claim if the debtor enters bankruptcy, whereas under the former Article the value of the tort claim would have been available for satisfaction of administrative expenses and, perhaps, claims of the debtor's general creditors, leaving the putative secured creditor with only an unsecured claim? We doubt it.

We question whether the static analysis employed in the example produces useful insights. Proceeding under Former Article 9, we must presume it more likely than not that the secured creditor would have appreciated the risk that its interest in the tort claim would be avoided in bankruptcy and reacted accordingly. The creditor might have bargained for a security interest in other collateral of comparable value. Had it done so (and had the tort claim and other collateral each retained its value to the same extent), the bankruptcy distribution would have been the same under both the former and the revised Article. Alternatively, the loan might never have been made under Former Article 9 because no acceptable collateral was available. In that case, the tort claim would be a free asset, but, without the loan proceeds, the debtor's *other* assets might be of a *lesser* value.⁷³ Another obvious possibility also comes to mind. In the Revised Article 9 regime our hypothetical debtor may never enter bankruptcy, at least in part because of the additional financing that the secured creditor provided.⁷⁴ An analysis that holds all facts constant *except* that a secured claim under Revised Article 9 would have

⁶⁹ *See id.*

⁷⁰ *See id.* Subject to specified exceptions, whether an interest in personal property can be transferred (outright or for collateral purposes) is governed by non-Article 9 law. *See* § 9-401(a). This principle was "implicit under former Article 9." *Id.* at cmt. 4. Assuming the property in question is otherwise transferrable, nothing in Former or Revised Article 9 prohibits creation of a non-Article 9 interest that secures an obligation. However, it is generally believed that a transaction falling within the scope of Article 9 involves more certainty and predictability and less cost—conditions that are likely to result in more plausible reliance on the collateral.

⁷¹ *See* §§ 9-109(d)(12) (excluding of tort claims from scope of Revised Article 9 contains exception for commercial tort claims), 9-102(a)(13) (defining "commercial tort claim").

⁷² *See* 11 U.S.C. 544(a)(1); *supra* note 28.

⁷³ We have noticed that, somehow, discussions critical of secured credit often implicitly assume that the proceeds of secured loans quickly disappear. *See* David Gray Carlson, *Secured Lending as a Zero Sum Game*, 19 CARDOZO L. REV. 1635, 1651 (1997) (commenting on model proposed by Alan Schwartz).

⁷⁴ *See* Steven L. Schwarcz, *The Easy Case for the Priority of Secured Claims in Bankruptcy*, 47 DUKE L.J. 425, 453 (1997) (explaining that debtor often must choose between obtaining secured credit or filing under chapter 11).

been an unsecured claim under Former Article 9 fails to appreciate even the most basic dynamics of credit markets outside bankruptcy.⁷⁵

In Part I we mentioned the argument that under Revised Article 9 there may be fewer perfection-related mistakes and consequently fewer opportunities for avoidance under the trustee's "strong-arm" power.⁷⁶ Two examples will suffice.⁷⁷ First, Former Article 9 required that a financing statement "indicat[e] the types, or describ[e] the items, of collateral."⁷⁸ Although the courts were not in complete agreement on this point, the prevailing view was that an indication such as "all assets" or "all personal property" does not meet this requirement.⁷⁹ In contrast, Revised Article 9 makes clear

⁷⁵ Professor Warner appears to rely on such a static analysis. *See* Warner, *supra* note 8, at 5 ("[T]he revision greatly enhances the rights of secured creditors and transfers to them assets that currently would be available to unsecured creditors or to finance the reorganization effort."); *id.* at 79. Our experience suggests that bankruptcy professionals generally have a great appreciation for the market functions, and wealth-creation potential, of secured credit *in bankruptcy*. In a talk given to members of the bankruptcy bar a few years ago, one of us posed, as a thought experiment, repeal of the power of a debtor in possession to obtain post-petition secured credit under Bankruptcy Code § 364. Not surprisingly, objections were strong and uniform, generally based on the premise that without secured credit many debtors could not reorganize. But if secured financing generally is thought to have wealth-creation attributes in bankruptcy, we see no reason to question these generally applicable benefits when the debtor is solvent and has not entered bankruptcy. Part II.B. addresses this matter more directly.

⁷⁶ *See supra* text accompanying note 47.

⁷⁷ In our earlier article we outlined other examples of how Revised Article 9 facilitates the creation and perfection of security interests. The examples include (i) permitting perfection of security interests in instruments by filing as well as by possession (§§ 9-312(a); 9-313(a)), (ii) clarifying what constitutes a sufficient collateral description in a security agreement (§ 9-108), (iii) expanding and clarifying what constitutes proceeds of collateral (§ 9-102(a)(64)), (iv) establishing priority rules for security interests in proceeds when security interests in original collateral are governed by non-temporal priority rules (§ 9-322(d), (e), (f), (v) enhancing the rules governing filing (Revised Article 9, Part 5), and (vi) clarifying and improving the provisions governing default and enforcement (Revised Article 9, Part 6). *See* Harris & Mooney, *How Successful*, *supra* note 43, at 1360-63.

Professor Warner considers the expansion and clarification of what constitutes proceeds of collateral and other proceeds-related revisions, arguing that the effect of these changes will be to reduce the value of free assets in bankruptcy. *See* Warner, *supra* note 8, at 54-66. He concedes, however, that the effect of the expanded definition of proceeds merely reaches collateral that generally could be subjected to a security interest under current law through the use of broad after-acquired property descriptions in a security agreement. *Id.* at 54-55. And he acknowledges that the real impact of the expanded definition may be under § 552(b)(1) of the Bankruptcy Code. *Id.* at 65-66. It is far from clear, however, that the Bankruptcy Code will be interpreted so as to incorporate the expanded definition of proceeds. *Id.* at 66. Moreover, as Professor Warner also acknowledges, courts could refuse to recognize an expansion on equitable grounds. *Id.* at 66. In addition to "proceeds," § 552(b)(1) extends protection to security interests in "product, offspring, and profits." The expanded definition of "proceeds" under Revised Article 9 merely pushes the definition toward the scope of § 552(b)(1). Although "profits" usually is associated with earnings derived from real property, there is no reason that it should be so limited for purposes of § 552(b)(1). *Cf.* Former § 9-207(2) (referring to "increase or profits" of collateral). In sum, we believe that Professor Warner's concerns are unwarranted. It is interesting, moreover, that Professor Warner bemoans the elimination of the special proceeds rule applicable in insolvency proceedings under Former § 9-306(4). The former provision was a perfect example of an insolvency-only rule to which Professor Warner generally objects!

Note further that in some cases Professor Warner may not appreciate that certain provisions of Revised Article 9 merely carry forward non-controversial provisions of Former Article 9. *See, e.g.,* Warner, *supra* note 8, at 34 n.171 (citing § 9-331, although subsection (c) follows Former § 9-309); *id.* at 49 ("free assignability provisions [§ 9-406(d)] . . . now expressly applies to payment intangibles," although Former § 9-318(4) also applied to "a general intangible for money due or to become due").

⁷⁸ Former § 9-402(1).

⁷⁹ *See* ELDON H. REILEY, GUIDEBOOK TO SECURITY INTERESTS IN PERSONAL PROPERTY § 3.09[1] (1997).

that a filed financing statement indicating the collateral as "all assets" or "all personal property" is effective.⁸⁰ As easy as it was to include an adequate indication of collateral under Former Article 9, inadequate indications provided the basis for a number of bankruptcy avoidances over the years.⁸¹ Assuming secured creditors adopt the "all assets" approach for filings and debtors are willing to authorize those filings, the number of avoidances should shrink under Revised Article 9.⁸² (Of course, not everyone is confident that "all assets" filings will be commonplace.)

Second, under Revised Article 9 a security interest in nearly all kinds of collateral can perfected by filing a financing statement in a single office. As a consequence of Revised Article 9's choice-of-law rules for perfection, in some transactions there will be fewer jurisdictions in which to file and a corresponding reduction in the potential for filing in the wrong jurisdiction or failing to file in the correct one.⁸³ However, we suspect that in the vast majority of cases there was only one jurisdiction in which to file under Former Article 9 and that this will continue to be the case under Revised Article

⁸⁰ See § 9-504(2).

⁸¹ See, e.g., *In re* I.A. Durbin, Inc., 46 B.R. 595, 600 (Bankr. S.D. Fla. 1985) (finding financing statement deficient because it did not describe assigned receivables or indicate "statutory 'type' of property, i.e. 'general intangibles'"; unperfected security interest avoided under 11 U.S.C. § 544(a)).

⁸² Under Revised Article 9 a secured party may file an effective financing statement against a debtor only if the debtor authorizes the filing. See §§ 9-509(a), 9-510(a).

⁸³ Under § 9-301(1) the jurisdiction in which the debtor is located will normally be the jurisdiction whose law governs perfection (*i.e.*, the jurisdiction in which to file). For collateral such as ordinary goods, the jurisdiction governing perfection under Former Article 9 was the location of the collateral. See Former § 9-103(1)(b). Consequently, for debtors who owned equipment and inventory located in many jurisdictions, many filings were necessary. Under Revised Article 9, only one will be necessary.

For most intangibles, Former Article 9 provided that the jurisdiction governing perfection was the location of the debtor—usually a business debtor's "chief executive office." Former § 9-103(3)(b), (d). Revised Article 9 provides greater certainty as to the location of a debtor that is a "registered organization," such as a corporation, organized under the law of a single state. Such a debtor is located in its "jurisdiction of organization" (*e.g.*, that in which it is incorporated). See §§ 9-307(e), 9-102(a)(50) (defining "jurisdiction of organization"), 9-102(a)(70) (defining "registered organization").

Professor Warner argues that the filing regime under Former Article 9, which could necessitate searches and filings in many jurisdictions, is more beneficial to creditors than the new system under Revised Article 9. See Warner, *supra*, note 8, at 40-43. He worries that searchers will not know where to search in "distant offices" and that searches may turn up "an overwhelming number" of financing statements. *Id.* at 42. This argument puzzles us, in light of Professor Warner's acknowledgment that "[f]ew unsecured creditors search the public records for lien filings." *Id.* at 7. To the extent that unsecured creditors rely on UCC filings, they typically obtain the information from credit reports. Moreover, developments in information technology and the advent of "search services" largely have rendered "distance" from a filing office unimportant.

Many searchers are likely to be prospective secured creditors who normally would need to search for all financing statements filed under the former Article. For these secured creditors the number of filings to be examined will not change, but the number of offices in which searches will be necessary may be reduced substantially. A searcher under the former Article who may be interested, for example, in one item of equipment located in one jurisdiction, might well have more financing statements to review under the Revised Article 9 filing regime. However, we expect that under Revised Article 9 the aggregate reductions in transactions costs resulting from having fewer offices to search will swamp the increased costs of reviewing additional financing statements.

Finally, we note that, by limiting the grounds upon which a filing office may reject a financing statement, see §§ 9-520(a), 9-516(b), and by requiring a filing office to respond to a search request within two business days after receipt, see § 9-523(e), Revised Article 9 increases the amount of information available from the public record.

9.⁸⁴ Revised Article 9 is also likely to reduce perfection errors by its providing for a single filing office for each jurisdiction (with the narrow exception of certain filings covering collateral relating to real property), regardless of the nature of the collateral covered by the filing.⁸⁵ Former Article 9 offered alternative provisions addressing this issue. Under the most popular alternative, the type of collateral and the use to which it was put determined the office within which to file.⁸⁶ Another alternative contemplated circumstances under which two filings in one jurisdiction were needed to perfect.⁸⁷

Certainly we hope (and expect) that errors in perfection will be reduced under Revised Article 9. Many people put in long hours over several years to that end. We find it difficult to imagine how anyone interested in improving our legal system could take a contrary position, yet Professor Warner actually laments Article 9's potential for reducing perfection errors.⁸⁸

Assuming that perfection errors will be reduced, how material will the effect in bankruptcy be? We hazard to guess that the effect will be modest. Initially one should ask, how material to bankruptcy distributions have perfection errors, or alleged errors, been under Former Article 9?⁸⁹ If a very small percentage of security interests are avoided in bankruptcy, as we hypothesize, then even were Revised Article 9 to cause a material reduction in the number of avoidances or scaled-down secured claims, the overall impact would be immaterial. A material reduction of an immaterial fraction cannot be material in the aggregate.

Cutting against arguments that Revised Article 9 will bring an expanded reach for secured claims in bankruptcy is the claim that the Article's size and complexity will give rise to mistakes (by counsel and creditors) that could swamp the increased compliance attributed to changes such as the new rule on "all assets" financing statements.⁹⁰ In an earlier article we expressed concern about the revised Article's complexity, addressing primarily the contexts of (i) changes in business structure,⁹¹ (ii) priorities in proceeds under non-temporal priority rules applicable to original collateral,⁹² and (iii) the new

⁸⁴ This is because we suspect that most debtors are located (whether the location be determined under Former Article 9 or under Revised Article 9) in the jurisdiction in which virtually all of their assets are located and, as to those debtors that are registered organizations, in the jurisdiction of organization as well. Those facts fit the paradigm that most debtors in secured transactions are consumers or small businesses. See Lynn M. LoPucki, *The Article 9 Filing System: Why the Debtor's State of Incorporation Should Be the Proper Place for Article 9 Filing: A Systems Analysis*, 79 MINN. L. REV. 577, 607-08 (1995) (estimating only slight increase in out-of-state filings by moving to system in which perfection is governed by debtor's state of incorporation).

⁸⁵ See § 9-501(a).

⁸⁶ See Former § 9-401(1) (2d alternative).

⁸⁷ See Former § 9-401(1) (3d alternative).

⁸⁸ See Warner, *supra* note 8, at 41-42 & nn.220-221.

⁸⁹ Actual perfection errors, of course, may result in avoidance of the security interest. Alleged errors may result in a secured party's compromising the size of its secured claim. We hope that data necessary to answer at least part of this question will be available from the ongoing study of business bankruptcy. See Elizabeth Warren & Jay Lawrence Westbrook, *Financial Characteristics of Businesses in Bankruptcy*, 73 AM. BANKR. L.J. 499 (1999).

⁹⁰ See Dam, *supra* note 39, at 21, quoting Professor G. Ray Warner.

⁹¹ See Harris & Mooney, *How Successful*, *supra* note 43, at 1390-93.

⁹² See *id.* at 1393-95.

taxonomy for various types of receivables.⁹³ But we cannot associate ourselves with predictions that Revised Article 9 will be the source of increases in malpractice claims, that its organization is counterintuitive, or that it will spawn increased litigation.⁹⁴ For example, we explained elsewhere:

When taken in the aggregate and in the abstract, the revised Article may appear forbidding. But articles of the UCC are not novels, to be read through from beginning to end. Approached in a given transactional context, Revised Article 9 should prove to be readily navigable. It has been substantially reorganized with the new user in mind. That the reorganization was wholeheartedly supported by experts whose familiarity with (and investment in) the organization of Former Article 9 vastly exceeds that of the average user gives us reason to believe that the revised Article's organization will accomplish its intended purpose.⁹⁵

Finally, in our earlier article we discussed the various attributes of Revised Article 9 that reflect the Drafting Committee's overarching commitment to achieving an appropriate balance between the interests of secured and unsecured creditors.⁹⁶ We already have noted that no efforts were made to override the basic priority rule that the interest of a lien creditor is senior to an unperfected security interest.⁹⁷ We turn now to other examples.

Although the scope of Revised Article 9 has been expanded to embrace security interests in deposit accounts, that reach is substantially tempered. The only method for perfecting of a security interest in a deposit account as original collateral is by obtaining "control" of the deposit account, a step that requires a secured party (other than the depositary bank) to obtain the agreement of the depositary bank or to become the bank's customer.⁹⁸ The objective, here, was to ensure that a secured party claiming a perfected security interest in a debtor's deposit accounts would be a "reliance" party—the necessity of making "control" arrangements with the bank maintaining the deposit account serves as a proxy for reliance. Moreover, the revised Article does not include within its scope

⁹³ See *id.* at 1395-96.

⁹⁴ See Dam, *supra* note 39, at 21, quoting Professor G. Ray Warner. Of course, any statute with the breadth of Revised Article 9 carries with it a wealth of litigation opportunities for those who behave strategically. That is a necessary cost of enacting any new or revised law. Our claim is simply that Article 9 answers many, many more legitimate questions than it raises.

⁹⁵ Harris & Mooney, *How Successful*, *supra* note 43, at 1389.

⁹⁶ See generally *id.* at 1358-67.

⁹⁷ See *supra* text accompanying notes 40-41. We note, however, that the rule was adjusted to afford priority to a secured advance if a financing statement has been filed and the debtor has authenticated a security agreement before the rights of a lien creditor arise. See § 9-317(a)(2)(A).

⁹⁸ See § 9-104(a)(1), (2). Under § 9-104(a)(1), however, the bank maintaining the deposit account has control without taking any further action.

security interests in deposit accounts (other than as proceeds) in consumer transactions.⁹⁹

Professor Warner predicts that the inclusion of deposit accounts as original collateral within the scope of Revised Article 9 will materially reduce the amount of free assets available in bankruptcy.¹⁰⁰ He also argues that this modification in scope cannot be justified on the basis of providing additional liquidity to borrowers or promoting secured party monitoring by secured parties.¹⁰¹ Presumably, Professor Warner does not have in mind deposit accounts that are "blocked" so as to deny a debtor unfettered access (i.e., access typically associated with an "operating" account). A blocked account easily could offer a secured party meaningful reliance value. In the case of an operating account maintained with a bank to which the debtor is indebted, Revised Article 9 will not produce materially different bankruptcy results than under the former Article. For example, if a debtor files under the Bankruptcy Code and maintains deposits with a bank to which it is indebted, the bank normally will have a secured claim to the extent of the lesser of the amount of the debt or the amount on deposit. This is so by virtue of the bank's right of setoff, whether or not the bank has a security interest in the account under the common law or Revised Article 9.¹⁰² In this situation, we suspect that in many cases the balances are withdrawn and placed elsewhere before the bankruptcy filing.¹⁰³

When the holder of a security interest in a deposit account is a third party, not the depository bank, we also believe that Professor Warner has exaggerated the likely bankruptcy impact. Because an operating account is "very uncertain class of collateral," as Professor Warner explains,¹⁰⁴ a secured party may find that the account has been depleted at the time of bankruptcy with the proceeds being untraceable. It is common knowledge that debtors often have little "cash" on hand at the time of a bankruptcy filing and, in chapter 11, frequently require post-petition financing.¹⁰⁵ In the case of debtors that maintain a high volume of cash flow, however, a secured party may indeed rely on a relatively steady volume of deposit balances from day to day. In many situations the secured party also will have a security interest in deposit accounts as cash proceeds of accounts or inventory, in which case Revised Article 9 will not have worked any material change from the former Article.¹⁰⁶ Finally, as Professor Warner recognizes,

⁹⁹ See § 9-109(d)(13).

¹⁰⁰ See Warner, *supra* note 8, at 47-48, 75-78.

¹⁰¹ See *id.* at 47-48. For an argument to the contrary, see Picker, *supra* note 65.

¹⁰² See 11 U.S.C. §§ 553(a) (stating that Bankruptcy Code generally does not affect right of setoff under non-bankruptcy law), 506(a) (providing that amount subject to creditor's right of setoff is secured claim).

¹⁰³ It is fair to question, then, why the scope of Revised Article 9 was expanded to include all (non-consumer) operating accounts and was not limited to "blocked" accounts on which meaningful reliance might be expected. One answer is that the Drafting Committee could not settle on a straightforward and non-controversial definition of what constitutes a "blocked" deposit account.

¹⁰⁴ Warner, *supra* note 8, at 48.

¹⁰⁵ See 11 U.S.C. § 364 (providing for post-petition financing).

¹⁰⁶ Holding a security interest in a deposit account under Revised Article 9, however, would eliminate the secured party's burden to trace proceeds of antecedent collateral to that account. The significance of eliminating the tracing requirement depends on whether, under Former Article 9, application of tracing rules generally provides accounts financiers with materially less than the entire deposit account. Consider also that eliminating tracing also reduces

several states enacted non-uniform amendments to their versions of Former Article 9 that expanded the scope to embrace deposit accounts as original collateral.¹⁰⁷ As far as we are aware, these non-uniform amendments have not resulted in any material impact on operating accounts in bankruptcy.

Recall also that the expanded scope of the revised Article covers security interests in commercial tort claims.¹⁰⁸ As to them, however, Revised Article 9 provides that a security agreement must describe a commercial tort claim with specificity (*i.e.*, not merely by "type") and is ineffective to cover after-acquired commercial tort claims.¹⁰⁹

The revised Article imposes new requirements for perfection by possession of collateral that is in the hands of one other than the debtor or the secured party. Former Article 9 provided that perfection could be achieved in this setting by the third-party bailee's receipt of a notification of a security interest; no attornment was necessary.¹¹⁰ Under Revised Article 9, perfection is achieved only if the third party "authenticates a record acknowledging that it holds [or will hold] possession of the collateral for the secured party's benefit."¹¹¹

Revised Article 9 also addresses directly foreclosure sales that fetch unreasonably low prices. It resolves a debate under former section 9-504(3), which imposed on a secured party that disposes of collateral after default the duty to do so in a "commercially reasonable manner." Is the price obtained in a disposition a "term" of the disposition which must be commercially reasonable? Or, is it sufficient that the disposition be commercially reasonable as a procedural matter (*e.g.*, reasonable advertising, etc.)? Revised Article 9 resolves this debate not by dictating that the price be a term that must be commercially reasonable, but by a special provision that directly addresses certain low-price sales. The special formula is contained in section 9-615(f).

Revised Article 9 provides a special method for calculating a deficiency if a complying disposition of collateral to a secured party, a person related to the secured party, or a secondary obligor yields proceeds that are "significantly below the range of proceeds that a complying disposition to a person other than the secured party, a person related to the secured party, or a secondary obligor would have brought." In these situations there is reason to suspect that the enforcing secured party may have inadequate incentives to obtain a higher price. Consequently, instead of calculating a deficiency (or surplus) based on the actual net proceeds of the disposition, the deficiency (or surplus) is calculated based on the proceeds that would

transactions costs attendant to enforcement, with concomitant benefits to debtors.

¹⁰⁷ See Warner, *supra* note 8, at 45 n.238.

¹⁰⁸ See *supra* note 71.

¹⁰⁹ See §§ 9-108(e)(1), 9-204(b)(2).

¹¹⁰ See Former § 9-305; *id.* at cmt. 2.

¹¹¹ § 9-313(c)(1).

have been received in a disposition to a person other than the secured party, a person related to the secured party, or a secondary obligor.¹¹²

Section 9-615(f) works directly for the benefit of debtors and indirectly for the benefit of their general creditors.

Revised Article 9 paves the way for substantial improvements in the filing systems of adopting jurisdictions.¹¹³ The clarification and modernization of the filing regime may ease the way for perfection of security interests. On the other hand, a modern, easy-to-use filing system also benefits unsecured creditors and others who wish to know whether a debtor's personal property may be encumbered.¹¹⁴ One fundamental attribute of the Revised Article 9 filing system is the increased burden on a secured party to *get the debtor's name right* on a financing statement.¹¹⁵ Under this approach, searchers are safe in searching only against the debtor's correct name; they need not discover and search under other names that the debtor might use.¹¹⁶ A collateral consequence—one that was not lost on the Drafting Committee—is that some financing statements that would have been sufficient to perfect under Former Article 9 will be insufficient under the revised Article.¹¹⁷

¹¹² See Steven L. Harris & Charles W. Mooney, Jr., *Filing and Enforcement Under Revised Article 9*, 54 BUS. LAW. 1965, 1978 (1999) (footnotes omitted). Section 9-102(a)(62) and (63) defines "person related to" with respect to an individual secured party and a secured party that is an organization, respectively. Section 9-615(f) applies only if the disposition generating the low price is conducted in a commercially reasonable manner. If the disposition is not commercially reasonable, then § 9-625 governs the secured party's liability. It necessarily follows that price is not a "term" that must be commercially reasonable under § 9-610.

¹¹³ See Harris & Mooney, *Property-Based Theory*, *supra* note 5, at 1969-1974.

¹¹⁴ Professor Warner claims that the "relaxed perfection requirements of revised Article 9 make the filing system virtually useless as a means of providing actual notice of security interests." Warner, *supra* note 8, at 18. A financing statement that covers "all assets or all personal property" sufficiently indicates the collateral. See § 9-504(2). Such an "all assets" financing statement clearly provides notice that whatever collateral (if any) actually may be covered by a security agreement, the searcher must assume that "all assets" are or will be encumbered. Professor Warner further argues that under the revision the "filing system will provide little in the way of precise information." Warner, *supra* note 8, at 18. Of course, Former Article 9 does not require that a financing statement contain precise information; an indication of the "types" of collateral is sufficient. See former § 9-402(1). In some cases, a broad "all assets" financing statement may prompt a searcher to undertake further investigation, whereas a financing statement covering, say, "inventory and accounts" may not. But we would not expect debtors to routinely authorize the filing of "all assets" financing statements when a security agreement covers a substantially more narrow class of collateral.

¹¹⁵ Among the required information that a sufficient financing statement must contain is "the name of the debtor." § 9-502(a)(1). Section 9-503(a) contains specific rules for determining a debtor's name. Under § 9-506 a financing statement that provides an incorrect name for the debtor is seriously misleading, and therefore insufficient, unless "a search of the records of the filing office under the debtor's correct name, using the filing office's standard search logic, if any, would disclose" the financing statement. § 9-506(c).

¹¹⁶ We do not diminish the problems of determining the "correct" name, especially in the case of natural persons. But the clarifications in § 9-503(a) will be of much help with respect to registered organizations, in particular.

¹¹⁷ For example, most cases that have held trade names to be sufficient under Former Article 9 would come out differently under the revised Article, as would cases like *In re Mines Tire Co., Inc.*, 194 B.R. 23 (Bankr. W.D.N.Y. 1996). In *Mines Tire*, the bankruptcy court held that a financing statement was not seriously misleading and was effective to perfect a security interest, even though it omitted the word "Tire" in the name of the debtor, "Mines Tire Company, Inc." Although a computer search by the trustee against the debtor's full and correct corporate name failed to discover the financing statement, a manual search by trustee was successful. The court noted that the

A thorough evaluation of every material revision contained in Revised Article 9 is not feasible for present purposes. But the foregoing illustrates that the revised Article reflects a substantial effort to achieve balance among the various interests affected by secured transactions and a process that featured much give-and-take.

B. Impact of Revised Article 9 Outside Bankruptcy

This part assumes, contrary to our intuitions just expressed, that under Revised Article 9 secured creditors will materially expand the reach of their secured claims in bankruptcy to the end that there will be a material reduction in free assets in bankruptcy cases.¹¹⁸ However, this assumption about free assets in bankruptcy does not suggest that Revised Article 9 necessarily would adversely affect the fortunes of unsecured creditors more generally. We have little doubt that there are many more unsecured claims against debtors that are not in bankruptcy than against those that are in bankruptcy. It follows that the institution of secured credit, even as (according to some) materially expanded under Revised Article 9, is not necessarily detrimental to unsecured creditors outside of bankruptcy. In an earlier article we observed:

In the absence of empirical data it is also impossible to conclude whether giving security generally transfers wealth from unsecured creditors to secured creditors. Research that focuses only on creditors of debtors that actually become insolvent cannot possibly answer the question; everyone knows that collateral provides a comparative advantage to the secured creditor in that situation. But once one acknowledges that in the real world a substantial amount of credit would not be extended without collateral and that most recipients of secured credit do not become insolvent, benefits of secured credit appear—benefits that accrue to unsecured creditors and must be weighed against the costs imposed on those creditors in the comparatively few cases of insolvency.

Secured transactions are neutral. Like many types of transactions in property (and human behavior generally), security interests can foster both the good and the bad for debtors and third parties. Even if it cannot be proved that secured transactions necessarily have beneficial results, secured transactions can and sometimes do promote efficiency and social welfare. To the extent that secured transactions bear a tarnished reputation from inferences about the general effects of

proper test should be based on what is discovered in a manual search. Under Revised Article 9, the results of a manual search would be irrelevant. In all likelihood, the relevant computer search, conducted under "Mines Tire Company, Inc.," would not reveal the financing statement filed against "Mines Company, Inc.," and the security interest would be unperfected and thus avoidable.

¹¹⁸ This working assumption is analytically useful in the following discussion. Moreover, our intuitions just might be wrong.

secured transactions, drawn solely from observing the effects in insolvencies, their good name should be cleared.¹¹⁹

In our argument we made two basic and quite plausible assumptions. First, we assumed that our legal landscape would continue to feature Article 9 or something like it. Second, we assumed that, in the absence of an effective security interest in collateral, there are many situations in which credit would not be available, would be available in a lesser amount, or would be available only at a higher price.¹²⁰

Several features of Revised Article 9 provide concrete examples of how the revision may enhance social welfare outside of bankruptcy, in particular when compared to Former Article 9. To the extent that it provides more certainty and predictability, Revised Article 9 should lower costs for both debtors and secured financiers, with at least some of the cost savings being applied to the payment of unsecured debts. For example, we would anticipate that Revised Article 9 will make possible more certain legal opinions, with fewer qualifications, rendered more quickly, and at a lower cost.¹²¹ The expanded scope of Revised Article 9 also may facilitate transactions that would be too risky under sometimes unknown and uncertain common law rules¹²² or too costly under the rules of Former Article 9.¹²³ As explained above,¹²⁴ other changes permit the

¹¹⁹ Harris & Mooney, *Property-Based Theory*, *supra* note 5, at 2036-37 (footnotes omitted).

¹²⁰ *Id.* at 2030-31, 2035, 2065, 2072; *see also* Schwarcz, *supra* note 74, at 426, 430-33, 452-58 (arguing that solvent debtors suffering liquidity crises often need new financing that is available only on a secured basis). As we later explained:

Article 9 embraces the goal of facilitating the extension of secured credit. The revised Article rejects the assumption, prevailing in some circles, that secured credit somehow primarily benefits secured creditors and is necessarily detrimental to unsecured creditors. Instead, it reflects the increasing awareness that the principal beneficiaries of secured credit are the borrowers to whom credit is extended and others who have commercial or other relationships with those borrowers.

Harris & Mooney, *How Successful*, *supra* note 43, at 1359 (footnote omitted). Professor Warner continues to believe that the primary beneficiaries of secured credit are secured creditors. *See* Warner, *supra* note 8, at 17-18. Professor Warner's analysis may be based in part on his belief that a creditor that refuses to extend unsecured credit at a higher interest rate acts "irrationally." *Id.* at 13 n.50. In other words credit always will be extended if a high enough rate is charged. This argument has long been discredited. *See* Paul M. Shupack, *Solving the Puzzle of Secured Transactions*, 41 RUTGERS L.REV 1067, 1096-97 (1989).

¹²¹ *See, e.g.*, § 9-318(a) (providing that "[a] debtor that has sold an account, chattel paper, payment intangible, or promissory note does not retain a legal or equitable interest in the collateral sold.") This clarifies what should be the result under Former Article 9 and corrects the problems created by *Octagon Gas Systems, Inc. v. Rimmer*, 995 F.2d 948 (10th Cir. 1993). In *Octagon Gas* the court "erroneously stated that '[t]he impact of applying Article 9 to [the buyer's] account is that Article 9's treatment of accounts sold as collateral would place [the buyer's] account within [the seller's] bankruptcy estate.'" PEB Commentary No. 14, "Section 9-102(1)(b)" (1994). Section 9-318(a) rejects *Octagon Gas* insofar as the opinion interpreted Article 9. Overriding the wrongly-decided *Octagon Gas* is important for asset securitization transactions. Professor Warner also criticizes asset securitizations, and therefore their facilitation by Revised Article 9, as contrary to bankruptcy policy. *See* Warner, *supra* note 8, at 78-83. His critique fails to appreciate, however, that in every cash sale of every asset, the seller incurs no debt (although it receives cash). Moreover, implicit in his critique is a static analysis that assumes that if an asset securitization did not occur a secured loan in the same amount and on equivalent terms would have taken place.

¹²² *See, e.g.*, § 9-109(a)(3) (extending scope of Revised Article 9 to cover sales of payment intangibles and promissory notes).

¹²³ As already described, a security interest in an instrument may be perfected under Revised Article 9 by filing

consummation of effective secured transactions that could not have been effected under Former Article 9 because of an effective legal or contractual restriction on assignment.¹²⁵ Under Revised Article 9, however, formerly non-assignable rights may be the subject of attached and perfected security interests, thereby facilitating credit.¹²⁶

We acknowledge an apparent tension between our hypotheses that Revised Article 9 is not likely to materially reduce free assets in bankruptcies and that the effects of the revised Article outside of bankruptcy are likely to facilitate extensions of secured credit by lowering costs and reducing errors.¹²⁷ But we believe this tension is superficial. First, the vast majority of debtors affected by the marginal benefits provided by Revised Article 9 are likely to be those who would not become subject to bankruptcy proceedings, regardless of whether Former Article 9 or Revised Article 9 were applicable. Stated otherwise, the greatest benefits to debtors and their unsecured creditors are likely to appear outside of bankruptcy, inasmuch as most debtors do not file for bankruptcy.¹²⁸ Second, the facilitation of credit and cost reductions may, at the margin, assist debtors in avoiding bankruptcy.¹²⁹

Building on our explanation in *Property-Based Theory* of how secured credit may benefit unsecured creditors generally, in a subsequent article we addressed efficiency-based proposals, made by a few legal academics, that security interests should be subordinated in bankruptcy, fully or partially, to some or all unsecured creditors (or the trustee in bankruptcy).¹³⁰ In that article we outlined an agenda for research that would investigate the quantification of the social costs of adopting these subordination proposals. We considered, in particular, the costs imposed on debtors and their

a financing statement or by the secured party's taking possession of the instrument. See §§ 9-312(a), 9-313(a). Under Former Article 9, possession was the only method of long-term (as opposed to temporary) perfection. See Former § 9-304(1); *supra* note 53.

¹²⁴ See *supra* note 62 and accompanying text.

¹²⁵ See § 9-408(a), (c).

¹²⁶ See § 9-408 cmt. 8, quoted at *supra* note 62. As noted elsewhere, at the margin, this facilitation of credit may serve to keep debtors out of bankruptcy. See *supra* text accompanying note 62. Professor Warner doubts that the intended facilitation of secured credit will transpire. See Warner, *supra* note 8, at 50-54. He also believes that § 9-408 "perverts" Bankruptcy Code § 365, which permits a debtor to assume and assign some otherwise non-assignable executory contracts. See *id.* at 66-71. We disagree. For example, it is plausible that, outside bankruptcy, the relevant other party might consent to the debtor's sale of its assets (or even a particular intangible, such as a permit or franchise) to a successor that is satisfactory to the other party. Although a fuller analysis of his critique is not feasible here, a central response is addressed in the paragraph that follows in the text. Even if the actual transactions that give rise to proceeds, in this context, were to occur only in a debtor's bankruptcy, we continue to believe that the major impact would be outside bankruptcy. Secured credit is facilitated in transactions with the many debtors who never enter bankruptcy (compared with the relative few that do) because of the protection it affords against the contingency of bankruptcy.

¹²⁷ See *supra* text accompanying notes 118-26.

¹²⁸ See *supra* note 126.

¹²⁹ See *supra* note 62 and accompanying text.

¹³⁰ See Steven L. Harris & Charles W. Mooney, Jr., *Measuring the Social Costs and Benefits and Identifying the Victims of Subordinating Security Interests in Bankruptcy*, 82 CORNELL L. REV. 1349 (1997) [hereinafter Harris & Mooney, *Social Costs*]. The subordination proposals that we considered included those set forth in Lynn M. LoPucki, *supra* note 8, and Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857 (1996).

unsecured creditors that would result from the contraction of credit, and the higher cost of credit, that we hypothesized would follow from subordination.¹³¹ We also criticized and evaluated the claim that tinkering with bankruptcy priority rules for secured claims could materially reduce the perceived negative externalities resulting from the priority of secured claims.¹³² In that connection, we expressed doubt that subordination of security interests would materially increase levels of precaution by the management of a firm or monitoring by a firm's creditors, as claimed by subordination proponents.¹³³

In another article appearing in the 1997 symposium issue in which we published *Social Costs*, Dean Robert Scott aptly summarized the state of the security interest debate:

The debate over the social value of secured credit (and the appropriate priority for secured claims in bankruptcy) is entering its nineteenth year. Yet the continuing publication of succeeding generations of articles exploring the topic have yielded precious little in the way of an emerging scholarly consensus about the nature and function of secured credit. Put simply, we still do not have a theory of finance that explains why firms sometimes (but not always) issue secured debt rather than unsecured debt or equity. Moreover (and perhaps because of the lack of any plausible general theory), we lack any persuasive empirical data to predict whether, in any particular case, a later security-financed project will generate sufficient returns to offset any reduction in the value (i.e., the bankruptcy share) of prior unsecured claims.¹³⁴

In considering of our analysis in *Property-Based Theory*, Scott acknowledged our claim that "given a world with secured credit . . . some positive-value projects can be financed only with security."¹³⁵ Scott explained that our approach employed a "discontinuity assumption," because it assumed that "there is a discontinuity in the financing alternatives that are typically available to solvent debtors with positive-value projects."¹³⁶ Scott noted that our claim does not prove that positive-value projects would *not* be financed in a world *without* security.¹³⁷ We agree, but do not apologize for our quite plausible assumption that Article 9 or something like it will remain a part of the world. Scott's bottom line on the prevailing theoretical and empirical impasse is instructive:

¹³¹ See Harris & Mooney, *Social Costs*, *supra* note 130, at 1356-64.

¹³² *Id.* at 1364-70.

¹³³ *Id.*

¹³⁴ Scott, *Truth*, *supra* note 7, at 1436.

¹³⁵ *Id.* at 1461.

¹³⁶ *Id.* at 1460.

¹³⁷ *Id.* at 1461.

If, as seems plausible, some (or many) of these other [unsecured] creditors do not adjust to this reduction in bankruptcy share, there is a redistributive benefit to the creditor that the debtor does not fully internalize in assessing its total interest bill. This, then, would lead to some inefficient uses of security (as well as raise problems of distributive fairness). The question, in short, is simple: What are the relative values of these two offsetting effects? At this point we do not have a clue.¹³⁸

Although Scott may have overstated the point, we agree with his sentiments. We, too, doubt that future scholarship is likely to nail down both theory and facts with sufficient certainty to forge a strong consensus among scholars and practitioners.¹³⁹

This state of affairs raises questions for scholarship and law reform alike. Scott's answer for both efforts is a call for scholars to study more intensely "the institutional processes which produce the relevant legal rules," including the "private lawmaking process."¹⁴⁰ Scott suspects that the bright-line rules typical of Article 9 (both versions) reflect the strong influence of a "dominant interest group."¹⁴¹ We applaud initiatives to study the private law making process. Not surprisingly, our years in the trenches revealed flaws and inspired insights for improvement. But we question whether these

¹³⁸ *Id.*

¹³⁹ In assessing the scholarly debates concerning bankruptcy theory, Professor Baird questioned whether the intellectual gap between the bankruptcy traditionalists and proceduralists could be bridged. See Baird, *supra* note 6, at 574, 599. We suspect that the same could be said of the security interest debate.

¹⁴⁰ Scott, *Truth, supra* note 7, at 1465.

¹⁴¹ The private legislative process that produces Article 9 may be more susceptible to interest group influence than ordinary legislatures for two reasons. First, ordinary legislatures have mechanisms for reaching agreement (log-rolling) that permit normative debate to reach a resolution—a resolution more clearly reflected in the legislative product. Second, ordinary legislatures have mechanisms for finding facts (hearings) that are unavailable to private legislative groups, and are exposed to many more sources of information concerning the effects of the proposals which they consider. Information, in turn, is a corrective to statutory products that the process itself skews.

Id. at 1464. We have gently raised questions about Scott's thesis.

Dean Scott hails the benefits of "log-rolling" and hearings before state legislators to afford lawmakers better information, and he laments the "poor quality of information the voters in the private legislature possess." . . . [Scott, *Truth, supra* note 7,] at 1464. Does it seem likely to you that the members of 50 state legislatures would possess a better quality of information about secured credit than that presented to The American Law Institute and the National Conference of Commissioners on Uniform State Laws during the process of drafting and revising Article 9? As a thought experiment, consider whether a typical state legislator would be likely to grasp the analysis of secured financing presented in Dean Scott's article.

JOHN O. HONNOLD, STEVEN L. HARRIS & CHARLES W. MOONEY, JR., SECURITY INTERESTS IN PERSONAL PROPERTY 560-61 (3d ed. 2001). For a stronger critique, see George G. Triantis, *Private Law-Making and the Uniform Commercial Code*, in 3 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 117, 118-20 (1998) (arguing not only that there are limited incentives for special interest groups to lobby for inefficient terms, but that there are persuasive efficiency justifications for the sections of Article 9 that Scott believes resulted from special interest lobbying).

research efforts should proceed at the expense of continuing research on security interests and bankruptcy.

As to the future for law reform and scholarship, we predict confidently that neither the private lawmaking process nor the ongoing theoretical, empirical, and normative debates about secured financing and bankruptcy will subside while all adjourn to study private lawmaking. We submit this symposium issue as strong support for our prediction.

While we share Scott's assessment of the indeterminacy of the social welfare claims made in the security interest debate,¹⁴² law reform does not await the blessing of scholars. The remarkable success of Revised Article 9 in the state legislatures sends strong signals about the widespread support for the goals of the revision effort and the influence of NCCUSL and the ALI.¹⁴³ Moreover, recent years have witnessed worldwide efforts to reform domestic laws and forge international conventions along the lines of Article 9, and these efforts are continuing.¹⁴⁴ The train may have left the station, but we hope that scholars will keep it in their sights as it moves along on its journey.

III. REPRISÉ: BANKRUPTCY POLICIES

Part II.B. proceeded on the assumption that one effect of Revised Article 9 would be to materially reduce the free assets (i.e., those not subject to security interests) in bankruptcy. It then explored the possibility that Revised Article 9 might have an aggregate beneficial effect on unsecured creditors generally, when the effects on unsecured creditors outside of bankruptcy were taken into account. In this part we raise the possibility that, even under the assumption of reduced free assets in bankruptcy, Revised Article 9 may, nonetheless, benefit unsecured creditors *in bankruptcy*. We focus primarily on chapter 11 reorganization cases.

A large and diverse literature, most based on efficiency grounds and supported by empirical studies, argues that chapter 11 proceedings often do not necessarily result in optimal recoveries by unsecured (or any other) creditors.¹⁴⁵ There is an inherent tension between preserving (or even increasing) a firm's going concern value and maximizing the satisfaction of non-bankruptcy entitlements.¹⁴⁶ And scholars have found much to

¹⁴² We should note, however, that notwithstanding imperfect information, certainly we hypothesize that the institution of secured credit, on balance, promotes social welfare. See generally Harris & Mooney, *Social Costs*, *supra* note 130.

¹⁴³ See *supra* text accompanying notes 3-4.

¹⁴⁴ See generally Charles W. Mooney, Jr., *Assignments Under the UNIDROIT and UNCITRAL Draft Conventions on Mobile Equipment and Receivables Financing*, 20 U. PENN. J. INT'L ECON. L. 443 (1999); Jane K. Winn, *Symposium on Globalization of Secured Lending*, 34 INT'L LAW. 1089 (2000).

¹⁴⁵ See, e.g., Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043 (1992). Traditionalists, of course, strongly disagree with this claim. See, e.g., Donald R. Korobkin, *The Unwarranted Case Against Corporate Reorganization: A Reply to Bradley and Rosenzweig*, 78 IOWA L. REV. 669 (1993).

¹⁴⁶ See Kevin A. Kordana & Eric A. Posner, *A Positive Theory of Chapter 11*, 74 N.Y.U. L. REV. 161, 182 (1999).

criticize concerning the operation and effects of chapter 11 on reorganization value as well as the division of that value in chapter 11.¹⁴⁷

Chapter 11's bargaining model, which affords a debtor corporation's shareholders considerable opportunity to delay or frustrate confirmation of a plan, often results in the shareholders' retention of an interest in a reorganized firm—notwithstanding the absolute priority rule¹⁴⁸ and the fact that the firm's creditors are not paid in full.¹⁴⁹ When management of the debtor sees its interest allied with those of shareholders, the debtor's exclusivity period for filing a plan of reorganization also can work to the benefit of shareholders.¹⁵⁰

Our concern in this part lies chiefly with the potential for the dissipation of a debtor's assets while operating under chapter 11.¹⁵¹ The pool of free unencumbered assets are available to the debtor's management for the payment of salaries and other administrative expenses, such as attorneys' and other professional fees. These administrative claims have priority in distribution over general creditors and normally are paid during the pendency of a case.¹⁵² Consider also the fact that a substantial portion of chapter 11 cases are unsuccessful and result in a liquidation, either through a conversion to chapter 7 or a liquidation in chapter 11 itself.¹⁵³

It seems clear that the chapter 11 environment may foster the continued operation of businesses that may be destined to liquidate, not reorganize.¹⁵⁴ We may hypothesize that in many situations an early liquidation would be in the general creditors' interests.

During the continued operations, assets may be dissipated by transfers of wealth to managers, employees, and professionals. How typical in fact is this vision of chapter 11 as a device for the systematic depletion of wealth available for distribution to general creditors, even in circumstances in which ultimate liquidation is likely or even certain? This is not the place to explore a definitive empirical answer to this question. But if we

¹⁴⁷ Much of the scholarly debate has focused on alternatives to the "bargaining" approach embraced by chapter 11 with respect to both realizing reorganization value and allocating that value to the various claims and interests. The two most prominent alternatives are the "auctions" approach and the "options" approach. For an overview of the literature, see Lucian Arye Bebchuk, *Chapter 11*, in 1 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 219, 221-222 (1998).

¹⁴⁸ See 11 U.S.C. § 1129(b)(2)(B).

¹⁴⁹ See, e.g., Allan C. Eberhart et al., *Security Pricing and Deviations from the Absolute Priority Rule in Bankruptcy Proceedings*, 45 J. FIN. 1457, 1468 (1990); Lynn M. LoPucki & William C. Whitford, *Bargaining Over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 139 U. PA. L. REV. 125, 133 (1990).

¹⁵⁰ There is an exclusivity period of 120 days, which is frequently extended, during which "only the debtor may file a plan." 11 U.S.C. § 1121(b).

¹⁵¹ We leave for another day more comprehensive criticisms of chapter 11 and the arguments of its many supporters and detractors.

¹⁵² See 11 U.S.C. §§ 507(a)(1), 503.

¹⁵³ See James W. Bowers, *Rehabilitation, Redistribution or Dissipation: The Evidence for Choosing Among Bankruptcy Hypotheses*, 72 WASH. U. L.Q. 955, 962-64 (1994) (explaining that chapter 11 does not rehabilitate debtors effectively). We make no effort here to address the various hypotheses for the reasons that chapter 11 often fails. Obviously, poor investment decisions by management, both before and during bankruptcy, must share some of the blame.

¹⁵⁴ See Warren & Westbrook, *supra* note 89, at 523 ("The data make clear that most businesses of any size file in chapter 11 even though some may not have a prayer of reorganizing.").

assume that this pattern reflects a nontrivial portion of chapter 11 cases, it leads to a new insight concerning the effect of secured claims in chapter 11. If under Revised Article 9 security interests in fact will cast a materially wider net, as some critics claim, this power gain for secured creditors well might shorten chapter 11 proceedings that are destined to fail. This could work to the substantial benefit of unsecured creditors. For example, if debtor's economic or financial distress is such that it cannot continue to operate while also providing adequate protection for a larger slice (presumed, under Revised Article 9) of secured claims, then the unsecured creditors could benefit from an earlier, rather than later, liquidation.¹⁵⁵ Under this view, it would be the bankruptcy professionals, not general creditors, who would face the greatest threat from a shrinkage of free assets under Revised Article 9.

Our goal here is not to demonstrate that this asset-depletion story accurately reflects a substantial part of the chapter 11 world, although there is some evidence that it does.¹⁵⁶ Instead, we need argue only that the story is plausible. If it is, then making the case that material shrinkage of free assets in bankruptcy under Revised Article 9 works against the interests of general creditors in chapter 11 takes on an enormous empirical challenge.¹⁵⁷ Simple ("symple"?) reasoning that fewer free assets in chapter 11

¹⁵⁵ See *supra* notes 18-21. Under the current *application* of adequate protection doctrine, of course, to some extent wealth is being transferred from secured claims to those holding other (e.g., administrative or unsecured) claims because secured creditors are not compensated for the delay they incur in recovering on their collateral. See *United Sav. Ass'n v. Timbers of Inwood Forest Assocs., Ltd.*, 484 U.S. 365, 371 (1988) (stating that "interest in property" protected by that 11 U.S.C. § 362(d)(1) does not include secured party's right to foreclose on collateral; "value of such entity's interest" in 11 U.S.C. § 361 means dollar value of collateral, not present value of secured party's right to obtain collateral for satisfaction of its claim).

¹⁵⁶ See Bowers, *supra* note 153, at 971-72, 976-77. A recent draft report issued for comment by a panel of largely mainstream bankruptcy practitioners and judges provides strong evidence of the need to shorten the length and reduce the costs of chapter 11 cases. See REPORT OF THE SELECT ADVISORY COMMITTEE ON BUSINESS REORGANIZATION ("SABRE") (January 15, 2001 Draft). SABRE is a special committee of the Business Bankruptcy Committee of the American Bar Association Section of Business Law. It was charged "to consider the perception that chapter 11 business reorganizations take too long and cost too much and, if appropriate, to develop legislative solutions to reduce the time and cost." *Id.* at 7. Apparently SABRE concluded that the length and cost of chapter 11 cases do present problems, inasmuch as the report makes three specific legislative proposals to address them. The first would establish a "federal workout proceeding," intended to foster non-bankruptcy workouts. *Id.* at 11, 14-18. The second would provide for the appointment of a "plan facilitator," who would work for consensus on a plan in a chapter 11 case. *Id.* at 18-23. The third proposal calls for the sharing of financial information in chapter 11 and would permit the bankruptcy court to appoint neutral business experts to conduct financial analyses. *Id.* at 24-27.

¹⁵⁷ Professor Warner may believe that he has met that burden. See Warner, *supra* note 8, at 72-75. He posits a single example in which there is a positive (60%) chance of a successful reorganization (presumably in chapter 11) of a firm (assuming sufficient free assets to finance the reorganization) and he then illustrates how a security interest that extends to all of the firm's assets could (on his numbers) result in an inefficient liquidation. See *id.* at 73. This misses the point of our hypothetical. We are not suggesting that a wider swath of collateral *necessarily* would benefit unsecured creditors in every case. Given the priority afforded secured claims, that argument would make no sense. Our point is that it is an empirical question as to whether early liquidations would, more often than not and to a greater extent than attempted reorganizations, benefit unsecured creditors generally. Stated otherwise, chapter 11's bias in favor of reorganization may result in inefficient attempts to reorganize non-viable debtors, to the detriment of those debtors' unsecured creditors. For a critique and analysis of chapter 11's bias in favor of the continuation of the business of debtors, as opposed to liquidation, see Barry E. Adler, *A Theory of Corporate Insolvency*, 72 N.Y.U. L. REV. 343 (1997).

necessarily will redound to the detriment of general creditors is unpersuasive and incomplete.

CONCLUSION

We have explained that Revised Article 9 is fully consistent with the policies that underlie the Bankruptcy Code. Our focus has been on bankruptcy policies that are immanent in the Bankruptcy Code and on which there is substantial consensus, not on the normative debate about what bankruptcy policies should be and how bankruptcy law should be reformed. While that debate is important and interesting, defending Revised Article 9 as positive law does not necessitate a defense against proposals for reforms of bankruptcy law on which no consensus appears to have emerged or to be emerging.

We also argued that Revised Article 9 may well increase the returns to unsecured creditors. We suggested that, in the aggregate, the application of Revised Article 9 is not likely to materially reduce the amount of unencumbered assets available for distribution (or application) to unsecured claims in bankruptcy. And we explained that, even if our prediction is wrong and the operation of the revised Article does materially reduce the amount of unencumbered assets available for unsecured creditors in bankruptcy, Revised Article 9 nevertheless may afford benefits to unsecured creditors *outside* of bankruptcy that more than offset any reductions in free assets in bankruptcy.

Finally, we explored the possibility that, even if Revised Article 9 reduces the amount of free assets in bankruptcy, on balance Revised Article 9 nonetheless may benefit unsecured creditors *in* bankruptcy.

We join Professor Baird in doubting that the normative debates about bankruptcy policy will be resolved and replaced by a strong consensus among bankruptcy scholars, practitioners, and judges.¹⁵⁸ Nor do we expect that the future holds the emergence of both convincing theories and data adequate to resolve the normative debate about the general economic effects of secured financing. On the other hand, it is entirely plausible that both reliable anecdotal observations and the collection of data over the next several years will offer accurate and widely-shared insights as to whether Revised Article 9 has worked any fundamental changes in the bankruptcy distributions available for unsecured creditors or the prospects for efficient reorganization of debtors in bankruptcy. Unlike most academic debates, the prospect is not unrealistic that winners and losers of this debate actually will emerge. We expect that the experience of the next decade will prove wrong the predictions of doom and gloom for unsecured creditors and reorganizations. These predictions, we suspect, will be seen more appropriately and accurately as supplements to political arguments for basic normative changes in the bankruptcy policies now embodied in the Bankruptcy Code.

¹⁵⁸ See Baird, *supra* note 6, at 575, 599.