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SECURITY INTERESTS RECONSIDERED

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CODIFICATIONS that stand the test of time rest upon coherent first principles. Article 9 is no exception; its drafters began with a number of assumptions and took care to write a codification of the law of security interests that was consistent with those assumptions. These principles are set out in Grant Gilmore's treatise on security interests[1] and they are familiar to every student of secured transactions. They can be summarized in a few sentences. A security interest is not a general right to take priority over the claims of other creditors, but rather a priority right that is linked to specific collateral. A creditor who takes a nonpossessory security interest creates an ostensible ownership problem and should presumptively have a duty to cure it by making a public filing. The public filing, however, need only give notice that the secured creditor has or in the future may take an interest in particular types of collateral. There is no duty to record the details of the transaction. Finally, a creditor who acts in good faith and cures the ostensible ownership problem has the right to take a security interest in the personal property of the debtor.[2]

Nearly five decades have passed since the basic contours of Article 9 were put in place, and it is useful to revisit these principles and subject them to new scrutiny. We can take advantage of the work of scholars who have studied Article 9. Moreover, we can ask to what extent the assumptions of the drafters rest upon the technology that was available fifty years ago, and whether intervening technological changes should lead us to different first principles.

Legal rules cannot be separated from the context in which they operate. When Article 9 was first drafted in the late 1940s and early 1950s, long distance telephone calls were expensive and only

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1 See 1 Grant Gilmore, Security Interests in Personal Property (1965).

2 1 id. §§ 9.1, 15.1-.2; see Grant Gilmore, The Good Faith Purchase Idea and the Uniform Commercial Code: Confessions of a Repentant Draftsman, 15 Ga. L. Rev. 605, 605-13 (1981).

a few computers existed. Plain-paper copying machines did not exist at all. Before lawyers had personal computers, it made no sense to have a legal regime in which they might search for financing statements from their desktops. Now it does.

Financial markets have also undergone a revolution in the last two decades. Accounts receivable and many other forms of secured debt are securitized.[3] One of the most common forms of security interest in personal property, the purchase money security interest in an automobile, is now also routinely securitized.[4] A person who wants to borrow to buy a new car now has access (through intermediaries) to global capital markets. The new technologies that brought about these changes also suggest that we should think differently about the law governing security interests.

In this Article, I look at several common types of secured transactions and use them as vehicles for exploring the assumptions that underlie Article 9.[5] Part I of the Article focuses on the equipment financer and on whether equipment financing transactions create an ostensible ownership problem that we should solve through a public filing system. I also use this example as a way of asking the more fundamental question: should the law of personal property continue to draw the strong connection it does between ownership and possession?

In Parts II and III, I look at the lender who takes a security interest in all the debtor's assets. I first use this transaction to ask whether we should link the priority rights of a creditor to an interest in specific property. I then go on to ask whether it makes sense, if we are to have a filing system, to have notice filing rather than transactional filing.

Parts IV and V examine two more specialized transactions—security interests that back up insider guarantees, and factoring—to question whether we should continue to allow all secured lenders who jump through the same hoops to enjoy priority over gen-

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[3] Steven L. Schwarcz, Structured Finance: A Guide to the Principles of Asset Securitization 4 (2d ed. 1993).

[4] See Tamar Frankel, Securitization: Structured Financing, Financial Assets Pools, and Asset-Backed Securities § 2.4.4, at 38 n.13 (1991).

[5] For another analysis of the different roles that secured credit plays, see Randal C. Picker, Security Interests, Misbehavior, and Common Pools, 59 U. Chi. L. Rev. 645, 649-53 (1992).

eral creditors. I argue that both the lender who insists upon a secured guarantee from the owner-manager of the firm and the factor who purchases accounts receivable impose costs on third parties that other creditors do not.

I conclude that Article 9 may not give proper weight to the costs that some secured transactions impose. It may rely too heavily on the idea that all security interests are presumptively the same and that those who take security interests in good faith and give notice should be entitled to priority over general creditors.

I. Equipment Financing and the Problem of Ostensible Ownership

Those who finance the purchase of machine tools and other large capital assets resemble real estate lenders and equipment lessors. In all of these transactions, tax considerations often drive the way a firm finances its acquisition of assets. Moreover, in each of these transactions the collateral at stake has a readily ascertainable liquidation value that can be realized in the event the debtor defaults. For example, there is a dramatic difference between the ability of a creditor to realize the value of an oil-drilling rig after a firm fails and the ability of that same creditor to realize on the firm's accounts receivable. The oil-drilling rig has a ready market value, while accounts receivable typically plunge in value when the firm liquidates. To be sure, the equipment financer, like the real estate lender or the equipment lessor, is at risk for a general change in market conditions: the demand for oil drilling rigs can collapse, as it did in the early 1980s. But this is a market risk a lender faces; it is not connected to a particular debtor.

In other contexts, the primary purpose of a security interest may be to give a secured creditor a priority over a firm's other creditors in the event that the firm encounters financial distress and cannot meet its fixed obligations. In the case of the equipment financer, however, the security interest may serve a different purpose. A lender may lend because it is confident that the procedures available to it in the event of default will allow it to realize much of the amount of the loan in the event of default. Thus, the lender may take a security interest in large part because its rights upon default against the debtor are greater than they would be if it did not take security. Given its rights as a secured creditor, the equipment financer faces comparatively few obstacles in seizing the goods and selling them to someone else. Security interests may therefore be valuable to equipment financers in large part because the debt collection procedures available to an unsecured lender are much more onerous,[6] but these differences do not seem connected to the special characteristics of the secured lender. Hence, one question a law reformer should ask in this context is not whether Article 9 should be changed, but whether the debt collection procedures available to the general creditor make sense.

We must also address the distinct issues concerning the equipment financer's rights against third parties. A security interest protects the equipment financer from different kinds of debtor misbehavior, the most obvious of which is the fraudulent sale of the asset to a third party. Other kinds of misbehavior include allowing a tax lien to be formed on the property or using the property as collateral in some other secured transaction.[7]

Article 9 requires an equipment financer to make a public filing if it wants to protect itself against a subsequently perfected secured creditor or against a good-faith buyer who takes possession of the property without knowledge of the security interest.[8] In this context, we should ask whether a filing requirement makes sense. Third parties, secured parties, and levying creditors cannot draw the inference of ownership from possession in Article 9. It has no doctrine analogous to the holder-in-due-course concept. Instead, ownership of assets is firmly rooted in the derivation principle: the rights of a purchaser of an asset turn in the first instance on the rights of its transferor.[9] The rule that secured creditors must give notice of their property interest is an exception to this principle.

It might seem that creditors and purchasers of machinery cannot rely on the Article 9 filing system to establish a debtor's title to the asset. A failure to find a filing does not, by itself, assure creditors

[6] Most conspicuously, an unsecured creditor cannot conduct the sale of property seized to satisfy the debt. This task typically falls to a state official such as a sheriff.

[7] The equipment financer is protected from subsequent tax liens under 26 U.S.C. § 6323(a) (Supp. V 1993), and from preexisting and subsequent secured creditors under U.C.C. § 9-312(4) (1990).

[8] U.C.C. § 9-301(4).

[9] Douglas G. Baird & Thomas H. Jackson, Cases, Problems, and Materials on Security Interests in Personal Property 3-8 (2d ed. 1987).

or purchasers that the debtor owns the machine. To ensure that the debtor owns the machine, they must find out how the debtor acquired the machine. That is, they must ensure that the debtor did not lease the machine from a third-party or acquire it from someone else subject to a security interest.

The status quo, however, may not place undue burdens on either equipment financers or those who want to find out whether the debtor owns its equipment. The equipment financer must incur only the costs of an Article 9 filing, whereas a potential purchaser need only search the files and then ask the buyer for a bill of sale. Third parties can infer ownership from the debtor's possession of the machine, the existence of a bill of sale, and the absence of an Article 9 filing. Even though no single source of information about ownership exists, this may not matter much if going to these three sources is relatively straightforward. This is the logic that justifies the absence of a filing requirement for leases.[10] Because anyone who wants to find out about the debtor's title must demand a bill of sale, the debtor who is merely a lessee cannot mislead potential creditors even when lessors have no filing requirement.

When one attacks the problem from this perspective, the law reform issue that we face for this sort of secured transactions problem is straightforward: how can we make the Article 9 filing system simpler? The contours of such a filing system would take advantage of the revolution in data processing that has taken place over the last 50 years. For instance, as many commentators have noted, there is no longer any justification for local filing systems or the requirement that a filing be done under the debtor's name when a debtor's social security number or taxpayer identification number could be used instead.[11] Nor is there a continuing need for an offi-

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[10] For a careful study of the relationship between secured transactions and leases and the justifications for filing requirements, see Charles W. Mooney, Jr., The Mystery and Myth of "Ostensible Ownership" and Article 9 Filing: A Critique of Proposals To Extend Filing Requirements to Leases, 39 Ala. L. Rev. 683 (1988).

[11] For a paper advocating that the law of secured transactions should be federalized and that the filing system should be a national one, see David M. Phillips, Secured Credit and Bankruptcy: A Call for the Federalization of Personal Property Security Law, Law & Contemp. Probs., Spring 1987, at 53. For a discussion of the need to take account of technological changes in reforming Article 9's filing system, see Lynn M. LoPucki, Computerization of the Article 9 Filing System: Thoughts on Building the Electronic Highway, Law & Contemp. Probs., Summer 1992, at 5. For a report of an ABA Task Force

cial to record the filing. Instead, the debtor itself could record the filing on an electronic bulletin board accessible to everyone. This would permit filing searches to be done for a fraction of their current cost.[12] In addition, because the system could be national (and eventually international) in its scope, there would be no need for the complexities that now arise when a debtor changes residence or the collateral moves from one jurisdiction to another.

It is worth emphasizing that having a national filing system does not itself require the federalization of these provisions in Article 9. Article 9 could be drafted in a way such that each state recognized the same self-funding organization as the instrumentality responsible for posting filings on an electronic bulletin board available to everyone on Internet or other national electronic networks.[13] Filing systems could also be entirely private. For example, state incorporation laws could require the debtor to state on its corporate charter the agent with whom any security interests would be filed. These agents would be required to provide on-line access to their files. Those who wanted to file against the debtor and those who sought information about the debtor could then go to this agent.

In the electronic world in which we already live, filing a financing statement or searching any agent's file should prove to be easy. After the point at which a secured creditor files, the filing system already is privatized.[14] Databases such as Lexis transfer the information in the public files onto their own systems. The initial chances of error, the delays inherent in transferring the files from state indexes to private filing systems, and the costs of making these transfers might all be largely avoided if we moved further in this direction.

Even such dramatic changes in the filing system, however, may assume too much about the status quo. The bold question is not

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chairperson on reform of the filing system, and the potential costs and benefits of filing by taxpayer identification number, see Peter A. Alces & Robert M. Lloyd, An Agenda for Reform of the Article 9 Filing System, 44 Okla. L. Rev. 99, 112-13 (1991).

12 See LoPucki, supra note 11, at 16-19.

13 Alternatively, common protocols could be adopted so that files could be maintained in different computers that were linked on a network. A single search request might examine all the relevant files. See id. at 17-19.

14 See id. at 17.

whether the existing system can be rationalized and improved upon, but whether its initial premises are sound. The common-law derivation rule emerged in an earlier era, and today it is no longer followed when negotiable instruments, land, and large moveable assets such as airplanes and automobiles are involved. Thus, we should consider whether the rules governing the transfer of ownership of private property should be substantially changed to accommodate large capital assets such as plant machinery.[15]

Perhaps the principal problem is simply that of creating a way to identify a piece of personal property uniquely.[16] Once there is a standard that everyone can easily adopt (such as attaching an indelible serial number to each asset), it is possible to create a public filing system that would govern the transfer of all assets. Along these lines, recent advances in cryptography now allow us to create a mechanism to ensure that only the registered owner of an asset has the power to make a filing and thus possesses the power to transfer ownership of the asset.[17] If everyone were to use this mechanism, we would be able to trace the ownership of every asset and only the rightful owner of the asset would have the ability to transfer it or to encumber it.

But creating a unique way to identify an asset is difficult in a world in which capital assets do not have discrete sizes. Just as a large computer has a number of discrete components, a large machine tool can similarly be broken down into its many different parts. It is worth emphasizing, however, the role that law plays in this environment. A unique system of identification works only if there is a convention that everyone recognizes; it does little good for me to devise one unique way of identifying an asset and for you to devise another. The role of the law is to establish a standard,[18] and it is more important in this context that the law establish *some*

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15 See id. at 33-34.

16 See Douglas Baird & Thomas Jackson, Information, Uncertainty, and the Transfer of Property, 13 J. Legal Stud. 299, 306-07 (1984).

17 Modern cipher systems rest on the idea that computers are unable to factor the product of very large prime numbers. The power of these systems itself has generated concerns about privacy and law enforcement. For a discussion of cryptography and computer networks, see Stephen T. Kent, Internet Privacy Enhanced Mail, Comm. ACM, Aug. 1993, at 48, 50.

18 For an economic analysis of the process of standardization, see Joseph Farrell, Standardization and Intellectual Property, 30 Jurimetrics J. 35 (1989); Joseph Farrell &

standard, rather than the optimal one. The essence of the law of property is that it binds those who are not parties to the transaction; therefore, a title registration system can work only if it has the imprimatur of the state.

Even if we are to retain the current system, in which only secured creditors must file, and in which we require them only to give notice that they have or may take a security interest in property of the debtor, we must still take changes in technology into account. It makes sense to index the filing system by the debtor's taxpayer identification number. Given that the filing system will be searched electronically, we should rethink what it should contain. For example, it may not be cost effective to build a system that requires the financing statement to have any description of the collateral.[19] We may also want to impose greater duties on the secured party to ensure that the filing has been made correctly.[20]

In confronting these questions of how to reform the filing system, we must keep in mind the relative importance of the problem. For instance, confusion as to ownership may not be important to trade creditors and others who rely on the cash-flow of the firm in order to be paid, rather than on the firm's assets. Because trade creditors know that they will be paid only if the firm survives as an ongoing concern, it is a matter of indifference to them whether the firm leases capital equipment or buys it and finances the purchase with a security interest. The firm may fail if the debtor cannot make payments to the equipment financer, but the firm will also fail if the firm cannot make payments to its lessor. Moreover, trade creditors are indifferent as to whether multiple creditors claim security interests in the asset. In a world in which trade creditors receive only a few cents on the dollar in the event of a firm's reorganization, what may matter the most may be the total debt obligations of the firm relative to its cash flow.

Garth Saloner, Standardization, Compatibility, and Innovation, 16 Rand J. Econ. 70 (1985).

19 See Morris G. Shanker, A Proposal for a Simplified All-Embracing Security Interest, 14 UCC L.J. 23, 26-27 (1981).

20 Under current law, the secured party is not responsible for mistakes that the filing officer makes in filing the financing statement. U.C.C. § 9-403(1); see also In re Royal Electrotype Corp., 485 F.2d 394 (3d Cir. 1973) (construing Pennsylvania law in accordance with U.C.C. § 9-403(1)).

As this country's economy changes, the capital assets of a firm may become less important. In service industries, a firm's value may be locked up in the firm-specific human capital of its employees. Alternatively, the value of the firm may rest in customer lists, patents, computer software, or some other intellectual property that is neither created nor transferred in the same way as a tangible asset. The lender who wants to finance the acquisition of such assets and ensure that it has a priority with respect to these assets, however, does not need a security interest. Such a lender could require the debtor to set up a separate corporation for the new project, write covenants that ensure that the subsidiary would not take on other debt, and then lend on an unsecured basis to the subsidiary. The investor could, of course, obtain additional confidence of its priority by taking a security interest in all the assets of the subsidiary and taking a security interest in all of the stock of the subsidiary held by the parent company, but its priority is ensured in the first instance by creating a separate corporate vehicle.

II. Property and Priority

Security interests under Anglo-American law have always been tied to particular assets. A creditor acquired an interest in a particular piece of real and personal property and looked to it first to obtain repayment.[21] The history of secured credit is one in which a debtor's assets have become increasingly available to creditors to use in satisfying the debtor's obligations.[22] As the modern corporation emerged, investors became more likely to try to take priority over others with respect to all of a debtor's assets.[23] The reasons for this are not hard to divine. The capital structures of the railroads of the late nineteenth century, for example, were often a patchwork of different mergers and different financings. One lender might have a security interest in the rolling stock, another a security interest in a terminal, another in the main line, and still others in various branch lines. Such a fragmented capital structure

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21 1 Gilmore, supra note 1, § 9.1, at 288.

22 See id.

23 See generally Gilmore, supra note 2 (describing the evolution of the good faith purchase idea in commercial law).

made it hard to restructure debt when, as often proved the case, the firm did not have enough revenues to meet its fixed obligations.

Over the last century, firms have gravitated toward capital structures that are strictly hierarchical—that is, a single creditor will have a security interest in all the assets of a firm and other creditors will all take a position that is junior to this single creditor's position.[24] When the firm encounters financial distress, the amount owed this creditor may exceed the value of the firm. Thus, the financial restructuring problem is not one involving the debtor and many creditors, but one involving the debtor and a single creditor.

If we assume that investors as a group are better off with strictly hierarchical capital structures,[25] we can identify another weakness that flows from connecting security interests to particular assets. To create strictly hierarchical capital structures, no connection need exist between security interests and particular assets. Even though bankruptcy is designed to solve collective action problems, a perfected secured creditor that is owed more than the assets are worth may prefer that the debtor file a bankruptcy petition under the current system because nonbankruptcy rules do not work as a coherent whole and do not make it easy to reach all the debtor's assets. Moreover, the debtor may have real and personal property in multiple jurisdictions. Seizing the property, and at the same time preserving the value of the firm as a going concern, may be possible only in bankruptcy because the current set of rules does not allow a creditor to levy on the assets of the entire firm outside of bankruptcy.

The all-asset financer can be viewed as an investor who bargains for priority over all other investors in the event that the firm's capital structure needs to be overhauled. If we adopt this view, however, two different kinds of questions arise. First, we want to know

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24 For a discussion of the important role that this large secured creditor plays in the firm, see Robert E. Scott, A Relational Theory of Secured Financing, 86 Colum. L. Rev. 901 (1986).

25 The question of why firms possess the capital structures that they do remains a puzzle, given the Modigliani and Miller Irrelevance Proposition. Franco Modigliani & Merton H. Miller, The Cost of Capital, Corporation Finance and the Theory of Investment, 48 Amer. Econ. Rev. 261, 288 (1958). For a review of the literature, see Milton Harris & Artur Raviv, The Theory of Capital Structure, 46 J. Fin. 297 (1991).

if in fact strictly hierarchical structures are likely to be desirable when investors bargain for them. Second, if they are, we want to know exactly how the law should respond to them.

Existing law does not seem to allow investors to opt out of bankruptcy law. Moreover, investors in firms are often trade creditors who typically offer a standard set of terms that do not vary for individual customers. The terms are set based on conditions in the industry as a whole, and not the characteristics of a particular debtor; thus, it may not be plausible to think that each firm could, by private contracting or provisions in its charter, create the capital structure that was in everyone's best interest because the transaction costs may simply be too high. In addition, strictly hierarchical capital structures are not self-evidently desirable: one can make arguments about why various departures from the absolute priority rule might be efficient, and indeed a number of scholars have.[26] It is also arguable that, as a normative matter, absolute priority should not be recognized even if such arrangements were to emerge through private bargaining.[27]

In the end, however, not much can be done to avoid strictly hierarchical capital structures if in fact the principal investors want them.[28] Once we view secured debt as simply one kind of investment instrument in a firm, it becomes hard to do much to alter the capital structures for which the parties bargain. Secured debt, ordinary debt, subordinated debt, preferred stock, common stock, and everything in between are different kinds of investment contracts. The emergence of derivatives in the last decade underscores the

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26 See Lucian A. Bebchuk & Randal C. Picker, Bankruptcy Rules, Managerial Entrenchment, and Firm-Specific Human Capital (Chicago Law & Economics Working Paper No. 16, 1992) (supporting rule allowing ex post violations of absolute priority); Thomas H. Jackson & Robert E. Scott, On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain, 75 Va. L. Rev. 155 (1989) (supporting rules that favor ex ante bargains).

27 See, e.g., Elizabeth Warren, The Untenable Case for the Repeal of Chapter 11, 102 Yale L.J. 437, 472-74 (1992) (arguing that a contract-based priority system would disadvantage nonparties to the transaction).

28 See Douglas G. Baird, The Reorganization of Closely Held Firms and the "Opt Out" Problem, 72 Wash. U. L. Rev. (forthcoming 1994).

idea that every financial instrument can be rewritten in any number of different ways.[29]

Moreover, the ability to create parent and subsidiary firms, and the ability to write covenants governing the obligations such firms can incur, in principle allows investors to insulate themselves from the workings of bankruptcy law altogether. As a result, a subsidiary can engage in the actual business enterprise and the parent corporation can write a series of contracts with investors that give them different rights to the cash flows. Such a structure could have whatever risk-sharing investors wanted to have and operate completely free of bankruptcy law.

Even if we write bankruptcy laws or laws governing security interests that try to redistribute the assets of a firm ex post, parties may be able to opt out of these laws through private contractual arrangements. The effect of laws that attempt to alter contractual distributions may largely be to increase transactions costs. Thus, if one either accepts the results of private ordering or recognizes its inevitability, it may make sense to alter the law of secured transactions in a way that facilitates the creation of strictly hierarchical capital structures. A law that gives investors priority rights to particular assets may not be the best approach.

There are several ways in which the rights of the lender who takes priority over others might change. Unlike the equipment financer, this lender is not necessarily looking to particular hard assets and might not, for example, insist on limiting the ability of the debtor to sell assets beyond what all creditors would provide in their loan agreements.[30] With this in mind, we might provide that an investor could obtain a priority over other investors in the event that the firm needed a new capital structure without necessarily giving the creditor a right to reach specific assets.

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29 For a discussion of derivatives and the challenge they pose for tax laws, see Alvin C. Warren, Jr., Financial Contract Innovation and Income Tax Policy, 107 Harv. L. Rev. 460 (1993).

30 Marcel Kahan & Bruce Tuckman, Private vs. Public Lending: Evidence from Covenants 9 tbl. 2, 10 (June 1994) (unpublished manuscript, on file with the Virginia Law Review Association).

III. Transactional Filing in an Electronic Era

To the extent that investors want to know about the capital structure of a firm, the problem we face is much more an issue of corporate law than one ordinarily associated with secured transactions. To the extent that we want a secured creditor to give public notice, the information in the Article 9 filing system may not be enough.[31]

The revolution brought about by the Uniform Trust Receipts Act and confirmed by Article 9 was notice filing. The filing system provides only limited information because the burdens of transactional filing were enormous in a world before photocopying machines, long-distance telephone lines, or personal computers. Those burdens, however, are no longer with us. Indeed, one could now argue that the filing obligation should be extended to general creditors as well as secured creditors. One could also argue for requiring all investors in a firm to record the amount of their investment and the priority rights they claim in a firm's assets, and requiring them to update that information continuously.

Of course, we might limit the system to exclude creditors of small amounts or creditors of a particular type. But even some creditors, such as employees, who initially seem to belong outside the system, might readily be placed inside it. Just as a firm has an obligation (backed up by criminal penalties) to pay withholding taxes, a firm could have a similar obligation to record the amount owed to each of its employees.

Under a reformed filing system, the filing of the bankruptcy petition could be accompanied by a printout of the public record of the firm's capital structure. In the past, such a system was technically infeasible; the burdens of filing this information would have been enormous and retrieving it would be so hard that the filing would be able to provide only limited information to others. But with technological change and new standards, extracting the needed

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[31] This idea that technological change may make a return to a more transaction-based filing system feasible is discussed in LoPucki, supra note 11, at 34-36. The idea that the law of security interests in personal property should return to a system of transactional filing is one that has resurfaced a number of times. See, e.g., Peter F. Coogan, Article 9 of the Uniform Commercial Code: Priorities Among Secured Creditors and the "Floating Lien," 72 Harv. L. Rev. 838, 879-80 (1959); Thomas H. Jackson & Anthony T. Kronman, Secured Financing and Priorities Among Creditors, 88 Yale L.J. 1143, 1178-82 (1979).

information from loan agreements or commercial invoices might be straightforward and possible with small attendant costs.

Yet another problem associated with transactional filing is the increased possibility that, as more information is required to be kept in a file, the more likely it is that a file will contain information that a firm might legitimately want to keep out of the hands of competitors. Existing technology, however, makes it possible to have a public file that contains private information.[32] With advances in cryptography, it may be possible to limit access to information in any number of different ways. For instance, the information could be stored so that the debtor could at all times control who had access to it. Thus, a trade creditor could learn what assets the debtor had available, what rights others enjoyed in the firm, and where its claim would fit in the hierarchy if, but only if, the debtor was willing to provide that information.

IV. The Unitary Security Interest

Article 9 provides a set of terms that applies to all secured transactions, regardless of their form, and is designed to create a security interest in personal property.[33] The same rules presumptively apply to all secured transactions. Chattel paper financers and retailers of consumer goods presumptively raise the same set of problems for the lawmaker, but we impose different filing obligations on these lenders and we grant them different priority rights. Nevertheless, the starting assumption is that they are the same because they both have security interests in personal property.

By starting with this presumption, we create the risk that we make a Procrustean bed, one that may be as confining as the one from which the drafters of Article 9 escaped when they abolished the distinctions between the many different legal forms that governed economically identical transactions. Instead of beginning with the idea that there are artificial legal forms that are part of the landscape, we should begin with the idea that the world of secured transactions is one that is flat and that has discrete boundaries. This assumption has its own dangers. As debt markets change, we need to be sensitive to them.

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32 See Kent, supra note 17.

33 See 1 Gilmore, supra note 1, § 10.1.

The closely held firm typically has one institutional lender.[34] Its other creditors consist of insiders (these include, for example, relatives of the owner-manager) and trade creditors. The amount of trade credit typically expands as the firm encounters financial distress and the trade creditors typically receive nothing if the firm liquidates. Because the firm does business in limited liability form, the creditors have no recourse against the owner-manager. In many instances, however, the institutional lender has obtained a guarantee from the owner-manager. This guarantee is often secured by all the assets of the owner-manager, including all of her personal property.

When the owner-manager has substantial assets, the guarantee is a device to ensure that the owner-manager, from the perspective of the institutional lender, is not doing business in limited liability form. In some cases, however, the owner-manager does not have substantial nonencumbered assets. The owner-manager's wealth is tied up in the business and the house is already subject to a first mortgage. The other assets of the owner-manager (such as the car and household furnishings) are small relative to the size of the debt. If the firm fails, the owner-manager likely files a bankruptcy petition as well, and the institutional lender may in fact receive little or nothing on its guarantee.

In this case, the institutional lender does not use the guarantee as a means of recovering what it is owed. The security interest is best seen as a hostage-taking device.[35] The institutional lender wants to ensure that the owner-manager pays attention to its interests in times of financial distress. The ability to call on the assets of the owner-manager, even if these assets are not themselves valuable to the lender, may be a great value to the owner-manager.

How are we to think about this use of security interests as a general matter, before we confront the question of how or where legal rules should respond to this device? First, we can observe that the assets of the owner-manager are themselves ideal hostages. The point is one that Robert Scott has made looking at the use of

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34 See Mitchell A. Petersen & Raghuram G. Rajan, The Benefits of Firm-Creditor Relationships: Evidence from Small Business Data 8-9 (May 1993) (unpublished manuscript, on file with the Virginia Law Review Association).

35 See Robert E. Scott, Rethinking the Regulation of Coercive Creditor Remedies, 89 Colum. L. Rev. 730, 746-48 (1989).

secured debt in consumer loans.[36] The assets are analogous to a puny prince. They have value to the hostage-giver but little value to the hostage-taker, especially when the owner-manager's equity in the house is small relative to the value of the loan that the creditor has made to the owner-manager's firm.

The owner-manager can give this security confident that the institutional lender will not declare a default merely to reach these assets or to exercise control over them. The institutional lender will exercise control over the assets only to hold the owner-manager to her bargain and to ensure her cooperation in complying with the terms of the loan to the firm. The security in this case thus has a low risk of opportunistic behavior. The lender will use the threat of calling on the guarantee and asserting its rights as a secured creditor to enforce the rights it bargained for under the security agreement.

There are several points to make about this transaction. First, the device is not one in which the collateral ensures that the lender will be repaid, because the debtor may have no other creditors (other than the bank with a first mortgage on the debtor's home). Second, even if the debtor has other creditors, the lender often does not care about priority. If the owner-manager is solvent, all the creditors of the owner-manager will be paid. If, as is often the case, the owner-manager's assets are worth far less than the debt owed the institutional lender, the priority that the lender enjoys with respect to the owner-manager's personal assets does little to ensure that it will be repaid.

The advantages that the institutional lender enjoys in this context are ones that are largely independent of whether the lender's security interest in the owner-manager's own assets is perfected. It may be desirable to require the institutional lender to make a filing that puts the other creditors (of the owner-manager) on notice, but this issue is not likely to matter. The owner-manager likely does not have other creditors and in any event, priority over these creditors is not likely to matter much. What matters are the effects that the guarantee has on the relationship between the institutional lender and the owner-manager's firm.

36 Id.

When the owner-manager has few assets and the insider-guarantee is largely a hostage-giving device, it is not obvious that we should allow this transaction to go forward at all. To be sure, this case may be hard to separate from the case in which the owner-manager has assets and the guarantee with the security interest is simply a device to opt out of limited liability. In an environment in which all the debt of the firm is consensual, there seems to be no reason to prevent parties from opting in or out of limited liability if they choose to do so. The only qualification rests on the different transaction costs that the different creditors face. The mechanics of signing such guarantees and making the requisite filings, especially in the real estate records, may be too burdensome for the trade creditors, each of whom has less at stake (at least initially) than an institutional lender.

When the owner-manager has few assets, however, this kind of secured transaction may impose costs on third parties. The guarantee (reinforced by the security interest) serves two purposes. First, it reduces the chance of debtor misbehavior. The owner-manager is much less likely to act in a way that puts the creditors as a whole at risk. The lender with the guarantee has the ability to seize assets that, although not valuable to the lender, are valuable to the owner-manager and that the owner-manager will not want to put at risk. From this perspective, the guarantee favors all the creditors.

Second, the owner-manager may tend to favor the lender with this security interest at the expense of other creditors of the firm. This is problematic if the other creditors are nonconsensual or if the transaction costs of entering into such a guarantee keep others from doing so. If they all had this right, this problem would disappear, but the high transaction costs may keep this from happening. Viewed from this perspective, the institutional lender is in a position analogous to that of the IRS. The IRS likely has the ability to pursue the owner-manager personally if the tax obligations of the firm are not met.[37] This power gives the owner-manager

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[37] See 26 U.S.C. § 6672(a) (1988), establishing that

> [a]ny person required to collect, truthfully account for, and pay over any tax imposed by this title who willfully fails to collect such tax, or truthfully account for and pay over such tax . . . shall . . . be liable to a penalty equal to the total amount of the tax evaded, or not collected, or not accounted for and paid over.

Id.

an incentive to favor the IRS when encountering financial distress.[38]

In terms of law reform, we confront two issues. First, we confront the bankruptcy question of the reach of the law of voidable preferences.[39] Second, and less well appreciated, we face a nonbankruptcy question about the reach of fraudulent conveyance law and the ability it gives other creditors of a firm to reach transfers made to a creditor when that transfer also benefits an insider because of the guarantee. To be sure, such transfers seem to be made for "reasonably equivalent value" if one characterizes the transaction as a transfer to the lender, but one can characterize the transaction quite differently, and the idea of the fraudulent preference has deep roots in the law of fraudulent conveyances.[40]

This view of secured credit and the potential problems that secured credit presents for other creditors is fundamentally different from the problem that arises when the collateral is an asset of the debtor instead of a third party. Collateral that can be levied upon by other creditors and that will be levied upon is not a hostage. The debtor will not get to keep it anyway and hence has no reason to favor the secured creditor over others.

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38 Such tax payments on the eve of bankruptcy are not voidable preferences under § 547 of the Bankruptcy Code. 11 U.S.C. § 547(b) (1988); see Begier v. IRS, 496 U.S. 53 (1990) (holding that tax fund payments were transfers of property held in trust, and therefore not avoidable as preferences).

39 Under the existing law, transfers to a creditor with an insider guarantee are subject to preference attack for a year, rather than the usual 90 days. See, e.g., Levit v. Ingersoll Rand Fin. Corp., 874 F.2d 1186, 1194-1201 (7th Cir. 1989) (holding that the preference-recovery period for outside creditors is one year when payment produces a benefit for an inside creditor, including a guarantor). As currently written, however, the one-year preference window applies not only to insiders like the owner-manager, but also to guarantees among related corporations, see id., which present a different problem. In addition, lenders may be able to avoid the preference attack but otherwise enjoy all the same benefits by having the owner-manager waive her rights of reimbursement and equitable subrogation.

40 See Unif. Fraudulent Transfer Act § 5(b), 7A U.L.A. 643, 657 (1985); see also Bullard v. Aluminum Co. of Am., 468 F.2d 11 (7th Cir. 1972) (holding that relationship of parties in settlement agreement made transfer fraudulent under Bankruptcy Act); Andrew J. Nussbaum, Comment, Insider Preferences and the Problem of Self-Dealing Under the Bankruptcy Code, 57 U. Chi. L. Rev. 603 (1990) (arguing that transfers made by or for the benefit of insiders should be scrutinized under both the fraudulent conveyance provision and the fraudulent preference provision of the Bankruptcy Code).

V. Security Interests, Asymmetric Information, and Standards

It is common in some industries (notably the textile industry) for a firm to sell its accounts to a third party on a nonrecourse basis.[41] The third party has no ability to sue the debtor if the value of the accounts proves to be less than expected, nor does the third party have to return anything to the firm if more is received than expected. We can think of this transaction as the sale of an intangible asset. The transaction takes place because the factor places a higher value on the asset than the firm. The asset, of course, is a promise to pay a stream of money, and cash is fungible, but someone who purchases accounts has expertise that the firm does not. A factor may have a better sense of the risks associated with this income stream and may be better diversified to absorb the risks. In addition, the factor may know more about the creditworthiness of various account debtors and may also be better able to collect debts and keep track of what is owing. In this sense, the factor may be the higher-valued user of the asset.

The last ten years has seen a revolution in financial markets. Debt is now securitized to the extent that it has never been before. (The amount has risen from 45% of the $3.8 trillion debt market in 1980 to 65% of the $15 trillion debt market today.) The value of a firm's accounts receivable turns, like the value of any other asset, on the firm's ability to sell it. Creating a law that facilitates the sale of an asset is, others things being equal, a good thing.[42]

Legal rules confront two different problems in dealing with factoring. First, legal rules can establish a set of norms and conventions that make it easier for the parties themselves to enter into the transaction. A set of rules that makes it easy for the account debtors to know whom they are supposed to pay works to everyone's advantage. Legal rules, however, must also confront the third-

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41 For a discussion of the practice of factoring, see 1 Gilmore, supra note 1, §§ 5.1, 5.2.

42 Decisions such as Octagon Gas Sys. v. Rimmer (In re Meridian Reserve), 995 F.2d 948 (10th Cir. 1993), which make it harder to insulate accounts that are sold from the effects of a debtor's bankruptcy proceeding, id. at 955-58, are subject to criticism on these grounds. For a discussion of the importance of the idea of a true sale in this context, see Steven L. Schwarcz, The Parts Are Greater than the Whole: How Securitization of Divisible Interests Can Revolutionize Structured Finance and Open the Capital Markets to Middle-Market Companies, 1993 Colum. Bus. L. Rev. 139, 143-49.

party effects of such a transaction. Because the debtor has no control over these accounts after it sells them to the factor, none of the potential for manipulation that we saw in the case of the security interest supporting the insider guarantor exists. Because the assets are intangible, we do not have the problem of a debtor who appears to be the owner because of possession,[43] and we also do not have the ostensible ownership problem that we encountered in the case of the equipment lessor.

Moreover, there are reasons to think that the general creditors are not likely to be misled. Trade creditors typically receive nothing when firms liquidate. They extend credit knowing that their ability to be repaid turns on the firm's ability to generate new accounts, so it should not matter to them whether the debtor pays them as it is paid by its account debtors or pays them from the proceeds it realizes when it sells the accounts to a factor.

There are, however, two problems that are worth considering. First, we may want to worry about the factoring of accounts that takes place when the debtor is already in financial distress. This factoring is not itself a preference, because the factor gives new value, but there is a sudden change in the condition of the debtor that is not readily apparent to the other creditors. Trade creditors rely upon such things as the debtor's ability to pay them regularly to draw inferences about the debtor's financial health and whether they should continue to ship goods and extend credit. The debtor's ability to reach sources of credit that are invisible to them clouds this signal and is therefore a source of potential mischief. In this respect, the factoring of accounts while in financial distress, like the ability of the IRS to enjoy priority over trade creditors when the debtor diverts FICA funds, is a source of legitimate concern.

Second, the filing requirements we impose on factors help trade creditors only if they regularly check the filings. The cost of a search is large if a trade creditor must do it each time it ships goods to each one of its debtors. (The $5 cost is modest in any large transaction, but it is a substantial cost if it must be done twelve times a year for all of a firm's customers.) Looked at through this lens, the question to ask is whether the trustee should be able to avoid such sales of accounts if they are done on the eve of bank-

43 See Benedict v. Ratner, 268 U.S. 353, 362-63 (1925).

ruptcy. One can argue that a statute similar to the bulk sales law should apply in such cases. A factor should be obliged to give actual notice to creditors and risk that the transfer of accounts to it will be avoided if the debtor fails within ninety days or some other prebankruptcy window.

Article 6, however, has not been a conspicuous success.[44] One can argue that such a legal regime would make it hard for debtors facing a cash crunch to weather the storm and might, in the long term, make trade creditors themselves worse off because more debtors would fail. Alternatively, one can imagine variations on the notification rules that would be more effective. We could, for example, create a filing system in which trade creditors could file. The factor could insulate the sale of the accounts from a voidable preference attack if it sent notice to all trade creditors who filed under the debtor's name or taxpayer identification number.

One could, of course, conclude that this game was not worth the candle. But we risk missing a potential problem that secured credit may pose to third parties if we treat a factor or an accounts receivable financer as being the same sort of animal as the purchase-money lender. The purchase-money lender who extends credit when the debtor is in financial distress does not distort the signal the trade creditors receive about changes in the financial condition of the debtor.

The sale of accounts raises another problem as well. There is always the risk that a debtor can make multiple and necessarily fraudulent transfers of the same asset. The rule that we can infer ownership from possession serves to ameliorate this problem in the case of tangible assets, but does no good in the event of intangible assets such as accounts. One of the virtues of the filing system is that it allows one to sort out ownership rights in a way that makes it easy to know where one stands. A factor who purchases accounts wants to be sure that no one has already purchased them. A filing system serves this purpose. But if we have a filing system for this reason, other characteristics of the law become suspect.

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44 Revised Article 6 gives states the option to repeal bulk sales altogether. U.C.C. art. 6, Alternative A. A number of jurisdictions have already done this. See, e.g., 1993 Fla. Laws ch. 93-77, § 3; 1991 Ill. Laws P.A. 87-308, § 1; 1993 Tex. Gen. Laws ch. 570, § 16.

For example, it is not clear that a lien creditor should be able to prime the factor who fails to file or fails to file correctly.

VI. Conclusion

In this Article, I have looked at some basic transactions that are now covered under Article 9 and have used them to reexamine some of its basic assumptions. The drafters built Article 9 around several basic propositions. First, they believed that the idea of the secured transaction was a useful legal construct. The transactions that fell within its scope were presumptively of the same type, for which the same legal rules were appropriate. Second, the drafters believed there were sound reasons for protecting the bona fide purchaser in all guises. Third, the link between possession and ownership was the foundation of the law of secured transactions. Finally, the third-party problems that security interests created were best solved through a system of notice filing. After so long a time, notwithstanding its great success, these basic assumptions should be subject to closer scrutiny.

Quite apart from the boundary problems that inevitably arise, there is little that a security interest that secures the guarantee of a corporate insider has in common with the equipment lessor or the factor or the asset-based lender who takes a security interest in all the assets of a debtor. Second, in a world in which information is imperfect, one may not want to rest with the idea that a lender who gives value should be entitled to a security interest. There is no reason to assume that protecting the bona fide purchaser for value in all guises is in the joint interests of all the investors in a firm.[45] A factor that lends to a firm in financial distress may make it harder for other investors in the firm to learn about the debtor's financial condition.

Third, the common-law idea of ownership based on derivation and possession may not make sense in a world in which it may be much easier to create a registration system for all assets of any value. Finally, notice filing may not make sense in an electronic world in which information can be encrypted and it is possible to require all investors in a debtor to register their interests so that

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[45] See Gilmore, supra note 2.

anyone who needs to know can, at any moment, accurately learn the capital structure of the firm.

One cannot expect radical change in Article 9, given how well it has served us for so long. Radical change that is desirable in theory may not be desirable in practice, because of the uncertainties inherent in implementing new ideas. Even if we desired such change, the political forces that are in place may prevent even the most sensible reforms in such things as the filing system. In contemplating reform, however, it is worth reexamining first principles. The legacy of Dunham, Gilmore, Llewellyn, and Mentschikoff is not merely a great commercial code, but also a legacy that recognizes that commercial law scholarship should be neither tradition bound nor mechanical. It should be done in the Grand Style.[46]

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46 See Karl N. Llewellyn, The Common Law Tradition: Deciding Appeals 35-45 (1960). For a discussion of the Grand Style, see William Twining, Karl Llewellyn and the Realist Movement 203-69 (1973). For one view of the Grand Style and the Uniform Commercial Code, see Richard Danzig, A Comment on the Jurisprudence of the Uniform Commercial Code, 27 Stan. L. Rev. 621, 632 n.39 (1975).