

LECTURE

THE BRENDAN BROWN LECTURE* RADICAL REDUCTIONISM IN DEBTOR- CREDITOR LAW

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This Article is generally about the evolution of the state law of debtors and creditors. This "awesomely technical" law¹ serves two main purposes. It describes when and how property of a debtor is forcibly taken and applied to satisfaction of debt. Equally important, debtor-creditor law also determines the order of paying the debtor's creditors from the property.

Generally, a creditor can only seize property of the debtor that is subject to a lien of the creditor. A lien is an interest in property created for the purpose of securing a debt, and a debt backed by a lien is a secured debt. Property subject to a lien is collateral, and a creditor with a lien is a secured creditor. In recognizing a lien, the law confers on the secured creditor a legal right to have the collateral forcibly applied in satisfaction of the secured debt.

Multiple liens can attach to the same property. In this event, the law must decide the order of payment among the secured creditors if the property's value is not sufficient to pay all of the secured debts. In broad, general terms, these creditors are usually paid from collateral in the order in which

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The lecture was designed to sketch broad themes and issues for a general audience and is reprinted here with only minor, mostly stylistic, changes that were made primarily to accommodate the different form. Footnotes were added where the Law Review staff deemed them essential.

1. 1 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY xi-xii (1965).

their liens arose or were publicly recorded. The priority of liens is thereby ordinarily determined by a simple first in time rule.

Naturally, creditors are paid nothing if they hold no liens on the property, or if they hold subordinate liens that are unsupported by value; these creditors are unsecured. Accordingly, they search for other property in which to create liens, but this search often ends fruitlessly for many of them. The equity of the debtor's estate is eventually exhausted, and the creditors who remain unpaid must absorb the loss of the remaining debt. Therefore, a creditor's interests are best served by effectuating a lien as early as possible.

Debtor-creditor law does not provide for a single species of lien or even a set of homogeneous liens. Instead, the area of law creates a somewhat disorderly array of liens that are alike in essential purpose and function, but different in most procedural respects. This disorder creates uncertainty and confusion in both theory and in practice. These problems are compounded when the different liens intersect.

With respect to personal property, the single most important and most common lien is the Uniform Commercial Code's Article 9 security interest.² Article 9 is a uniform statute which is the law in every state and the District of Columbia. It provides for a lien, technically called a "security interest," that a debtor creates basically by agreeing to it: the debtor identifies property that he agrees shall serve as collateral for an obligation, any obligation, and with a minimum of formality the law thereupon subjects the property to a lien—a security interest—in the creditor's favor.

Because of the importance to a creditor of having a lien as soon as possible, and because Article 9 security interests can be easily created even at the inception of debt, the law very effectively encourages securing debt with Article 9 interests in personal property. In fact, security interests are so dominant in practice that Article 9 almost entirely occupies the practice and scholarship of debtor-creditor law with respect to personal property.

Paradoxically, "econo-legal" scholars, who judge law primarily by rules of economics, have debated the rationality of this consensually secured debt for more than a decade.³ It is a puzzle. Secured debt reduces the cost of credit to a debtor because of the protection the collateral offers the creditor. This savings is lost, however, because other creditors for whom there is no security will compensate by charging an offsetting higher amount for credit. The net result is a wash. On the whole, no economic gain or benefit exists.

2. U.C.C. Art. 9 (1987 official text and comments).

3. For an excellent summary of the debate, see Shupack, *Solving the Puzzle of Secured Transactions*, 41 RUTGERS L. REV. 1067, 1073-83 (1989).

There is an even more troubling aspect of secured debt. Unknowledgeable and unsophisticated creditors populate the imperfect market of the real world. They extend unsecured credit without getting fully compensated for the attendant risks. Professor Paul Shupack stated that, as a result, "a leveraged debtor who issues secured debt improves his position . . . by means of transferring wealth from ignorant unsecured creditors to himself and his secured creditors."⁴

The transfer is most common between a debtor's bank or other principal financier and the debtor's trade and other amateur creditors. The bank is the professional creditor to which the debtor looks for start-up funds and a continuing flow of operating credit. As the initial lender, the bank gets a lien before anyone else. This lien protects the bank, but not any more so than the bank's ability to monitor and guard its investment. The bank will watch and police the debtor closely to ensure that its loan stays fully collateralized. This policing activity is a principal activity of bankers and other professional financiers.

The trade creditors are mainly merchants who sell goods and services and only incidentally provide credit. Many trade creditors and other casual financiers are relatively amateur creditors. They devote themselves to their main roles of working and selling, not financing. Thus, casual financiers deny the attention to credit that is essential to guard against increasing risk, and they often lack the ability to assess and monitor credit risks even if they have the time to watch them.

So, when the debtor begins to slip and slide financially, the bank notices and is unlikely to provide further credit. The amateur creditors are not looking, see nothing, and continue to supply their goods and services. They keep the debtor going and thereby feed the debtor's value and thus, directly or indirectly, often support or inflate the bank's collateral. Yet, when the debtor collapses, amateur creditors cannot share in the debtor's assets until the bank's first lien is fully paid. Then, when the debtor is in bankruptcy, they share pro rata any remaining morsels. Often, nothing remains.

A good example is the trade creditor of the farmer/rancher who supplies feed on credit for the debtor's cattle. The feed costs thousands of dollars each year; the cattle eat the feed and grow. The debtor's bank, however, enjoys the feed as well. The bank has a first lien on the cattle which becomes more valuable as they get fatter on the supplier's feed. If the farmer-debtor defaults, the bank gets the cattle, and all of their value, ahead of the sup-

4. *Id.* at 1069.

plier.⁵ The bank avoids loss at the expense of the supplier who, quite literally, fattens the bank's collateral.

Trade and other amateur creditors are supposed to insure themselves against losses from unsecured credit. In theory, they charge higher prices for their goods and services or higher rates on their incidental credit. In practice, many of them are truly amateur creditors. They fail to see the need for credit risk self-insurance, or they undercharge for it. Consequently, amateur creditors often starve with the withering debtor and sometimes also financially die.

Econo-legal scholars usually respond by attempting to prove that secured debt does produce a net benefit. Their proofs, however, do not prevent the unfair imbalance of protection among creditors caused by secured debt in an imperfect market. These smart and clever theorists have enriched greatly debtor-creditor law, but they have not created the perfect world their models necessarily assume. At most, these scholars have suggested that, on the whole, secured debt brings an economic benefit that, to some degree, counterweighs the harm it unfairly causes unsecured creditors. The theorists do not decide whether the benefit or the harm is heavier. They cannot make this decision. It is a political decision that is helpfully, though incompletely, informed by their insights.

A recent proposal by Professor Alan Schwartz of the Yale Law School represents the latest development in the debate about the law and economics of secured transactions. He is an econo-legal scholar who has been a prime player in the debate about the efficiency of secured debt. His new idea, however, is not about justifying the current law; rather, it is about creating a different law of secured transactions. In his article *A Theory of Loan Priorities*,⁶ Professor Schwartz proposes to change the priority scheme of Article 9. This scheme determines the order in which creditors share in a debtor's property that is subject to an Article 9 lien. Article 9's priority scheme channels the debtor's losses to the backs of the debtor's unsecured creditors. Changing the scheme implies worsening or evening the imbalance between the unsecured and secured creditors.

5. See, e.g., *First Nat. Bank v. Boston*, 39 Colo. App. 107, 564 P.2d 964 (1977) (creditor's security interest in feed did not extend to the cattle which ate the feed or to the proceeds from their sale); *Farmers Coop. Elevator Co. v. Union State Bank*, 409 N.W.2d 178 (Iowa 1987) (feed seller who took purchase money security interest to secure price of feed did not have security interest in hogs which ate the feed). Cf. *In re McDougall*, 60 Bankr. 635 (Bankr. W.D. Pa. 1986) (creditor's security interest in growing crops did not extend to proceeds of cattle feeding on the crops).

6. Schwartz, *A Theory of Loan Priorities*, 18 J. LEGAL STUD. 209 (1989).

Professor Schwartz's new proposal, and the maturation of the debate about the efficiency of secured transactions, coincide with the formation this year of a national committee to study and consider revamping Article 9.⁷ All of these developments prompted reflection on the growth of debtor-creditor law, and also free speculation on the very different shape that the law could take in the future by projecting and extending its major evolutionary developments.

Part I of this Article outlines, in exceedingly general terms, the evolutionary progression of modern debtor-creditor law with respect to personal property. The path is marked by several important simplifying reductions that have made it easier for knowledgeable creditors to get wider liens on debtors' property more expediently, with the consequence that unknowledgeable creditors are more often left unsecured and holding only an empty failed risk they did not appreciate or even see.

Part II introduces Professor Schwartz's proposal and briefly explains his main idea and principal proposal. In light of Part I, the theory and practice have almost exactly overlapped: the law's evolution has stopped just short of the edge of Professor Schwartz's theory. His theory goes beyond the law only in a small matter of form that the law honors and Professor Schwartz would disregard. Significantly and ironically, disregarding the form could trigger the final, ultimate simplifying reduction in debtor-creditor law that would take the law far beyond where Professor Schwartz would like it to stop.

Part III focuses briefly on this possible next step in the evolution of debtor-creditor law, the radical reduction. It is radical in the trendy sense and also in the traditional sense of being fundamental and extreme. Part III is not designed, however, to advocate the reduction. The purposes are rather to demonstrate the potentiality of the reduction, how this reduction would neatly fit within the evolutionary history of debtor-creditor law, and to suggest that the reduction could lessen, if not entirely eliminate, the unfair imbalance between secured and unsecured creditors which Professor Schwartz's proposal would worsen, if adopted. In sum, this Article gives history in Part I, news in Part II, and opinion in Part III.

7. A Study Committee was formed in 1990 under the auspices of the Permanent Editorial Board of the Uniform Commercial Code. Telephone interview with Frederick H. Miller, Advisor to the Study Committee & Member of the Permanent Editorial Board (August 27, 1990).

I. EVOLUTION OF MODERN DEBTOR-CREDITOR LAW REGARDING PERSONAL PROPERTY

A. *Historical General Rule of Debtor-Creditor Law: Execution*

More than 100 years ago, in a classic treatise about a piece of debtor-creditor law, Henry Herman speculated that:

In a state of nature . . . a creditor might have seized on any part of his debtor's goods without ceremony or contract.

But when society became compacted and consolidated, there immediately arose a right to every man to enjoy his own, and the support and vindication of that right was one grand object of every civilized community.⁸

At common law in civilized England and America, "the principal avenue for a creditor to enforce a claim for the payment of money . . . was to reduce his claim to a judgment . . . and thereupon to resort to the appropriate remedies for its enforcement."⁹ These "appropriate remedies" involved the sheriff seizing and selling the debtor's property to satisfy the creditor's judgment. The process is appropriately called "execution."¹⁰

Today, similarly, any creditor can get a lien on a debtor's property, and thereby grab the property in satisfaction of the debt by suing the debtor and getting a judgment that recognizes the debt. Indeed, the most general rule of theory in debtor-creditor law is that a creditor cannot forcibly seize any of the debtor's property without reducing the debt to judgment and thereafter enforcing the judgment through execution process. The process gives the creditor a lien. The whole of the debtor's estate is then made available to satisfy the debt, except a typically small portion that is exempt. The debtor is not gently asked to turn over his property. Rather, a court order directs the sheriff to invade the debtor's estate and take so much of his property as is necessary to satisfy the judgment. The sheriff then sells the seized property and delivers the proceeds to the creditor.

If a deficiency remains, the sheriff returns to the estate and takes more property. If the estate is too small to satisfy the judgment, the creditor and sheriff wait until the debtor's labor or luck builds his estate to a size that will pay the judgment. They can wait as long as it takes. The debtor himself can escape them through death, but his estate cannot escape with him; it remains

8. H. HERMAN, TREATISE ON CHATTEL MORTGAGES § 14, at 23 (1879) (footnote omitted).

9. S. RIESENFELD, CREDITORS' REMEDIES AND DEBTORS' PROTECTION 2-3 (3d ed. 1979).

10. For an overview of the fundamentals of satisfying judgments through execution process, see D. EPSTEIN, J. LANDERS & S. NICKLES, DEBTORS AND CREDITORS 28-58 (3d ed. 1987).

liable for the judgment. The debtor's escape in life is bankruptcy, which discharges the judgment so far as no lien supports it when bankruptcy is filed. Liens, generally all liens, survive bankruptcy and are unaffected by the discharge.¹¹ A bankruptcy discharge affects only unsecured debt.

Under this scheme a debtor's property is safe until the state, through its courts, determines both the existence and size of the debt. Having done so, the state is willing to use its own coercive power to collect the debt, and actually does so through its enforcers. The creditor acting on his own cannot define a lien or enforce it. Having the state so involved seems quite logical and appropriate, even essential, in a society that honors both public peace and the private ownership of property.

B. Early Recognized Exceptions: Pledge and Common Law Suppliers' Liens

From a very early period the common law provided for liens apart from execution process and without the creditor even going to court. In the beginning, the most important of these exceptional, nonjudicial liens were (1) the pledge, which is a consensual lien that requires the creditor to hold the collateral,¹² and (2) a collection of common law liens that were given automatically, without the debtor's consent, to certain suppliers of certain goods and services. These nonconsensual, nonjudicial automatic liens are known as "suppliers' liens."¹³

11. Liens that are valid in bankruptcy survive the debtor's discharge. See *Estate of Lellock v. Prudential Ins. Co. of America*, 811 F.2d 186, 188-89 (3d Cir. 1987) (even though the underlying debt was discharged in bankruptcy, a lien created before bankruptcy to secure the debt, which was neither disallowed nor avoided, survived the discharge); *United States v. Marlow*, 48 Bankr. 261, 262-63 (Bankr. D. Kan. 1984) (a valid creditor's lien survives discharge in bankruptcy); *Noble v. Yingling*, 29 Bankr. 998, 1001 (Bankr. D. Del. 1983) (valid lien survives discharge of debt or ruling that a particular debt is dischargeable. More specifically, "[a] discharge has the effect of voiding and prospectively enjoining collection of a judgment as the personal liability of the debtor. This does not prevent post-discharge enforcement of a valid lien existing prior to discharge . . ." (citation omitted)); *In re Leslie*, 103 Bankr. 775, 777 (Bankr. S.D. W. Va. 1989) ("[T]he IRS correctly asserts that discharge of the . . . tax liability does not invalidate the federal tax lien which attached to the Debtors' real property A lien created before bankruptcy survives bankruptcy even though the underlying debt was discharged in bankruptcy, if the lien is not avoided."); *Matter of Brown*, 73 Bankr. 740, 745 (Bankr. W.D. Wis. 1987) ("If a creditor's lien has not been avoided . . . the debtor will not be able to exempt the encumbered property free and clear of the lien, and the lien will pass through bankruptcy unaffected."). Cf. *In re Service Decorating Co.*, 105 Bankr. 859, 862 (Bankr. N.D. Ill. 1989) ("[E]ven after confirmation . . . [which discharges prior claims, the creditor] could assert as a setoff to a prepetition liability owed to the Debtor a claim that arose prepetition.").

12. 1 G. GILMORE, *supra* note 1, at 5-7.

13. See D. EPSTEIN, J. LANDERS & S. NICKLES, *supra* note 10, at 7-8.

The pledge and suppliers' liens of early common law were originally small, exceptional creatures that separately have grown to become very large monsters. The pledge grew until it became Article 9. Modern statutes have richly supplemented the common law suppliers' liens. These statutes have widely expanded both the range of people who may obtain the liens and also the remedies for enforcing them.¹⁴

Today, in practice, getting a court judgment that is enforced through execution is not the usual means of getting a lien and forcibly satisfying debt. Indeed, postjudgment execution is a creditor's last resort. Much preferred are the "exceptional" remedies of Article 9 and modern suppliers' liens. These remedies are collectively so wide that they typically apply and, therefore, almost entirely displace postjudgment execution in practice and theory. In both dimensions they swallow execution as a general rule. The unlucky creditor who enjoys neither an Article 9 security interest nor a suppliers' lien can still resort to execution process for access to the debtor's estate; but, by the time this process is pursued, creditors, who typically already have Article 9 interests or suppliers' liens will have completely or largely exhausted the estate.

The growth of the consensual lien from its beginning as a pledge to its present form as Article 9 is the lead and principal story in the modern development of debtor-creditor law. This law has proved extremely adaptive and pliable. It repeatedly expands and shrinks through remarkable reductionism that has continued to the point where it now threatens to swallow everything. The whole field of personal property security is set to implode into Article 9 and change it radically, in a last radical reduction of itself.

C. Growth of Consensual Liens: From the Pledge to Article 9

1. The Pledge Functionally Expanded by Broadening "Possession"

The pledge, the most basic of all consensual liens, is a simple deal: the creditor extends credit and, as security, takes hostage personal property of the debtor that the debtor agrees to surrender as collateral.¹⁵ The creditor

14. See generally *id.* at 509-53 (discussing various types of suppliers' liens arising from statutes and common law).

15. At bottom, a pledge is nothing more than "a bailment for the purpose of securing the payment of a debt or the performance of some other duty." RESTATEMENT OF SECURITY § 1 (1941).

keeps possession of the collateral during the debt,¹⁶ and applies the property to the debt if the debtor defaults.¹⁷

The pledge far predates the common law. Indeed, Professor Herman nearly argued that the pledge is a principle of natural law, an essential underpinning of civilization itself. He wrote that soon after becoming civilized, society

must soon have suggested [to] itself, that no easier method of supplying their immediate wants, could have been adopted than by resorting to a system of borrowing on loan. When men recognize the rights of property, their necessities will suggest the idea of pledging that property as the ready means of supplying their wants without departing with their absolute ownership. Their immediate personal property may be the first objects of pledge, afterwards articles of merchandize and trade, and finally land. They must frequently have been in need of temporary accommodation, and the plan of assisting each other on credit would have exhibited the readiest method of giving relief to their present necessities. In cases of magnitude, they would have required a pledge, or security for the return of the thing borrowed, and the immediate delivery of some movable article was the consequence of a compliance with that request. Hence, it should appear that the primitive idea of mortgaging ought to be referred more to the introduction of order and civilization among mankind, than to the invention of any particular set of people; for the tranquillity of every commonwealth . . . , it is absolutely requisite that recourse should be had, even in its infancy, to this system of lending on security. It is evident that

16. The creditor's taking and keeping possession of the collateral is essential: "a surrender of the collateral to the pledgor, save for a temporary and limited purpose, means the end of the pledge." Glenn, *The Chattel Mortgage as a Statutory Security*, 25 VA. L. REV. 316, 319 (1939).

17. Under the most mature common law rule the pledgee enjoys several options for enforcing his lien:

Upon default, the pledgee, in addition to his rights in respect of the enforcement of the claim secured by the pledge, can

- (a) after giving reasonable notice of the time and place of sale to the pledgor and also to the third person where the pledgor has been authorized by a third person to pledge the latter's chattels, sell the pledged chattels at a public sale where they are goods or instruments which have a market, or
- (b) exercise any special power of sale which he has been given by the pledgor, or
- (c) in the absence of a special power of sale, collect but not sell, bills and notes not having a market, or
- (d) maintain an action in a court of equity for foreclosure and sale of the pledged chattels and, if the pledgor is under a personal obligation, also obtain a deficiency judgment in the event that the proceeds of sale do not satisfy the claim which is secured by the pledge.

RESTATEMENT OF SECURITY § 48 (1941).

different nations would subject it to different regulations. . . . But the general principle must have been common to all mankind as a necessary effect of the establishment of society. The practice, then, of lending and borrowing must have existed from earliest antiquity. For, in the Laws of Moses, Deuteronomy, chapter twenty-four, we find the first regulations in regard to pledges.¹⁸

The large practical problem with the pledge is the restriction that the creditor take and keep possession of the collateral. The possession requirement was necessary at common law to protect third parties from a double-dealing debtor. It was the only reliable means of actually alerting third parties to the pledgor's lien. Any security arrangement that left the debtor in possession of the collateral was generally unenforceable against innocent third parties. The law enforced only the possessory pledge.

The creditor's possession both warned and regulated, limiting the property that could be used as collateral and limiting also the use of collateral as security by tying the property to the creditor in possession. The effects impeded financial and economic growth. The law responded with flexibility, initially provided by the courts. They creatively and expansively defined possession, so much so that a lender could take possession of a debtor's warehouse of stored goods by taking the keys to the place,¹⁹ or of a debtor's inventory of coal by placing a sign by the pile.²⁰ The courts recognized a

18. H. HERMAN, *supra* note 8, at 23-24. In the wilderness Moses told Israel:

When you make your neighbor a loan of any sort, you shall not go into his house to fetch his pledge. You shall stand outside, and the man to whom you make the loan shall bring the pledge out to you. And if he is a poor man, you shall not sleep in his pledge; when the sun goes down, you shall restore to him the pledge that he may sleep in his cloak and bless you; and it shall be righteousness to you before the Lord your God.

Deuteronomy 24:10 (Revised Standard Version).

19. See *Wilkes v. Ferris*, 5 Johns. 335 (N.Y. Sup. Ct. 1810); *Hilton v. Tucker*, [1887] 39 Ch.D. 669; L. JONES, A TREATISE ON THE LAW OF PLEDGES § 37 (1883). *But cf.* *Chappel v. Marvin*, 2 Aik. 79 (Vt. 1827) (in sale of goods, delivery of key to shop is delivery of goods stored therein); *Whitney v. Tibbits*, 17 Wis. 369 (1863) (court compares delivery of warehouse receipts covering collateral to delivery of keys to the warehouse). "Where goods are ponderous, and incapable . . . of being handed over from one to another, there need not be an actual delivery; but it may be done by that which is tantamount, such as the delivery of the key to a warehouse in which the goods are lodged . . ." *Chaplin v. Rogers*, [1800] 1 East 192, 194-95 (Lord Kenyon, C.J.). In the civil law, too, "[t]he delivery of a key, is the delivery of the possession." *Ryall v. Rolle*, [1749] 1 Atk. 165, 176.

20. Here, an authoritative example:

A offers to pledge to B a pile of steel scrap lying in an enclosure near A's factory.

B accepts the offer and posts a placard to a stake firmly affixed in the ground near the pile on which it is stated that the scrap has been pledged to B. The marking is a sufficient evidence of assumption of control to create a pledge.

RESTATEMENT OF SECURITY § 6, illustration 1 (1941); *see also* *Philadelphia Warehouse Co. v. Winchester*, 156 F. 600 (D. Del. 1907) (employee of pledgor placed and maintained signs near

wide array of exotic fictional, symbolic, or constructive means of taking "possession."

2. *Constructive Possession Collapsed Into a Filing System for Nonpossessory Consensual Liens*

Taking possession of collateral, especially doing so fictionally in various ways, had come to serve only the single, narrow end of constructively, rather than actually, notifying the public. Recording laws, as demonstrated in the real estate area, could serve this purpose without the restraints of creditor possession of the collateral. Thus, beginning in the early part of the nineteenth century, state legislatures cooptively displaced various forms of possession by enacting recording laws for personal property security. Filing the creditor's lien in a public place was deemed sufficient to make the lien effective against third parties. Possession of the collateral by the creditor was no longer required. Interestingly, this change effectively placed more of the burden of protecting third parties on the third parties themselves and less on the secured creditor.

a. *The Chattel Mortgage*

The recording laws did not simply validate a filed nonpossessory pledge. Rather, they recognized a separate security device known as the "chattel mortgage," which was essentially a nonpossessory pledge with various technical differences.²¹

The debtor's possession of the collateral under a chattel mortgage raised two questions largely unknown to the pledge. First, how does the creditor get the collateral and realize on it when the debtor defaults? Here, the law had two very distant models from which to choose: the pledge, in which enforcement is private,²² and execution upon judgment, which involves state enforcement. The law eventually opted to permit private enforcement of the

collateral indicating pledgee had a special interest therein). Similar evidence of assumption of control may also be sufficient to validate a pledge. *See, e.g., Ward v. First Nat. Bank*, 202 F. 609 (6th Cir. 1913) (lumber pledged as collateral was placed in separate piles on pledgor's lot, tagged with pledgee's initials, and designated on map as collateral for loan); *American Pig-Iron Storage-Warrant Co. v. Berman*, 126 Ala. 194, 28 So. 603 (1899) (pledged iron was placed in a separate pile on pledgor's lot and marked with pledgee's initials).

21. The chattel mortgage existed before the advent of recording laws, but it was unenforceable against third parties unless the mortgagee took possession of the collateral. Thus, the distinction between this form of the chattel mortgage and the pledge "was metaphysical at best." Gilmore & Axelrod, *Chattel Security: I*, 57 YALE L.J. 517, 529 n.28 (1948). As a truly distinct financing device, and certainly as a fully enforceable nonconsensual lien, the chattel mortgage is dependent on recording laws and, in this sense, is a nineteenth century invention.

22. *See supra* note 13 and accompanying text.

chattel mortgage if the collateral could be peacefully seized.²³ Second, because the lien of a chattel mortgage did not depend on creditor possession, the likelihood increased that more than one creditor at a time would claim a lien on the collateral. How then should multiple liens rank? The answer was that the lien first filed got priority.²⁴ This priority rule is based fundamentally on the property principle of derivative title which, in this setting, is keyed to the order in which interests are filed to protect against secret liens.²⁵

These answers to the questions of enforcement and priority have never been widely rethought. Private enforcement and first in time priority are standard characteristics of consensual liens that recur without debate.

b. Functional Clones: Alternative and Supplemental Liens That Extended the Use of Consensual Liens

The recordable chattel mortgage was truly a momentous, primal event in personal property security law. Courts stunted its growth, however, by overemphasizing technicalities and form, and analogizing to restrictive principles of real estate mortgage law. For instance, creating a chattel mortgage was complicated work. The governing law was marked "by a fastidious,

23. The courts recognized private enforcement by validating agreements giving mortgagees the right of peaceable self-help repossession and the right to foreclose privately under a power-of-sale clause. See 2 L. JONES, *THE LAW OF CHATTEL MORTGAGES AND CONDITIONAL SALES* §§ 705, 789-822 (R. Bowers ed. 1933); see also 2 G. GILMORE, *supra* note 1, § 44.1, at 1212 ("The right to take possession without applying to a court for permission was a concomitant of the mortgagee's right to conduct his own foreclosure under a power of sale clause, whose validity came to be recognized during the nineteenth century."). As Henry Herman explained:

A mortgage being made as security for debt, and being a conveyance which vests the title in the mortgagee, after condition broken, for the purpose of subjecting the property to the satisfaction of such debt, the mortgagee is considered the true owner for that purpose, and has a right to the actual possession and control of the property in the event of the non-payment of the debt due him from the mortgagor. An agreement between the parties, in reference to the temporary possession of the goods, does not alter the rights of the mortgagee; and for this purpose he may enter upon the premises of the mortgagor in the night and seize the mortgaged property, if he can do so without violating the criminal law.

H. HERMAN, *supra* note 8, § 96, at 209-10 (citation omitted). Herman also recognized that the mortgagee could foreclose by power of sale, but observed that this remedy was not exclusive: "such a power is merely cumulative, and will not prevent a resort to a court of equity for foreclosure of the mortgage, nor will it prevent an action on the note and sale of the property on execution to satisfy the judgment." *Id.* § 213 at 506.

24. See 2 L. JONES, *supra* note 23, §§ 484, 491a-500.

25. As explained in a classic treatise: "A subsequent mortgage conveys only an equitable title in the property; and it conveys a title subject to all the existing rights and equities of the prior mortgagee." 2 L. JONES, *supra* note 23, § 492, at 267.

cranky, at times almost insane insistence on documentary formalities.”²⁶ The courts followed this law to the letter, but mitigated against it by enforcing a malformed chattel mortgage, in equity, as an equitable lien.²⁷

More important, because of the fine points of the law, the theoretical doctrine that powered early chattel mortgages also restrained their use. Initially, the chattel mortgage was transactionally inflexible and unadaptable to satisfy fully the needs of business and finance. For example, the courts interpreted chattel mortgage recording laws to limit them to tangible chattels and to exclude intangibles such as accounts and other receivables. Moreover, the chattel mortgage could not easily and reliably cover inventory because a previously agreed upon lien would not reach later, newly acquired stock without a fresh agreement. The lien that the parties created would attach only to property the debtor then owned. It would not reach property the debtor later acquired.²⁸ Thus, the chattel mortgage did not work well in financing many common businesses. Here too, however, the equitable lien sometimes filled the gap, providing a basis in equity for stretching a chattel mortgage beyond its legal limits.²⁹

At law, specialized security devices were developed to cover situations and property that were beyond the reach of the chattel mortgage. Two good examples were the trust receipt, which banks used as a reliable way to finance a debtor's purchase of inventory, and the factor's lien, which effectively permitted manufacturers and distributors to easily discount their receivables. State legislatures enacted statutes that defined and regulated these devices and provided systems for recording them. The Uniform Trust Receipts Act, an early and important precursor to Article 9, “expressly rejected the insistence on formalities of . . . [creation] which characterized chattel mortgage law, and . . . insisted that a basic policy of the act was to do

26. 1 G. GILMORE, *supra* note 1, § 2.7, at 52.

27. For discussion and citation to authorities, see R. HILLMAN, J. McDONNELL & S. NICKLES, *COMMON LAW AND EQUITY UNDER THE UNIFORM COMMERCIAL CODE* ¶ 19.03[2][a] (1985).

28. The general rule was that:

At common law, a mortgage can operate only on property actually in existence at the time of giving the mortgage, and then actually belonging to the mortgagor, or potentially belonging to him as an incident of other property then in existence and belonging to him. A mortgage of goods which the mortgagor does not own at the time of making the mortgage, though he may afterwards acquire them, is void in respect to such goods as against subsequent purchasers or attaching creditors. Thus, if a mortgage be made of a stock in trade, it will not at law cover additions afterwards made to the stock, though it be expressly framed to cover additions to the stock intended to be made to replace such as should be sold.

1 L. JONES, *supra* note 23, § 138, at 228-29 (citations omitted).

29. *Id.* §§ 170-175 (mortgages of after-acquired property in equity).

away with red tape and needless formalities . . . [to promote] business convenience, flexibility and expedition."³⁰

Each device grew beyond its original purpose. At the same time, use of the chattel mortgage widened as it gained freedom from its original doctrinal base. Also, receivables financing on a wide scale was officially regularized in the 1940's when most states enacted special recording laws permitting and regulating the use of accounts as security.³¹

Sellers of goods, wishing to finance their own sales, used an entirely different device: the conditional sales contract. The buyer took possession of the goods at the time of sale, but the parties agreed that the buyer would get title to the property only if he paid the price when due. If the buyer defaulted, the seller's retained title would permit reclamation of the goods.³² In some states, this arrangement met the same fate as the nonpossessory pledge and the unfiled chattel mortgage or other nonpossessory lien; it was unenforceable against third parties because the buyer's possession masked the creditor's secret claim.³³

The law's response was yet another statute. Conditional sales acts everywhere validated the seller's retention of a lien, technically referred to as a "title," as long as the seller publicly recorded his interest.³⁴

Through the middle of this century, the courts constantly refined distinctions between security devices because so many existed that were formally and technically different and carried their own peculiar details. In each case, the lawyers had to decide in which security pigeonhole the transaction properly fit. Choosing the wrong device, or missing the many formalities of any device, could mean that the creditor-client was without security. Enforcing the device against the debtor and third parties also involved gambling that the parties had chosen, and properly complied with, the right device. A mistake could mean loss of the security and the debt or, worse, that the creditor was subject to tort liability. The confusion was expensive and repressive.

30. 1 G. GILMORE, *supra* note 1, § 4.11, at 124 (citing 9C U.L.A. 225 (1957)).

31. See, e.g., G. GILMORE, *supra* note 1, § 8.7, at 275; Note, *Policing Accounts Receivable and Inventory Under Modern Factor's Legislation*, 104 U. PA. L. REV. 393, 397-400 (1952-1953); Comment, *Multistate Accounts Receivable Financing: Conflicts in Context*, 67 YALE L.J. 402, 410-17 (1957-58).

32. For general discussion of this security device and its relation to the chattel mortgage, see Glenn, *The Conditional Sale at Common Law and as a Statutory Security*, 25 VA. L. REV. 559 (1939); Starr, *Conditional Sales and Chattel Mortgages*, 9 WASH. L. REV. 143, 183 (1934).

33. A leading proponent of this view was the Pennsylvania Supreme Court, which held in *Martin v. Mathiot*, 14 Serg. & Rawle 214 (Pa. 1826), that a seller secretly retaining title to goods apparently owned by the buyer is "an injury to society, by giving the [debtor] a false credit, which might induce others to trust him with their property." *Id.* at 215.

34. Many states adopted the Uniform Conditional Sales Act (act withdrawn 1943).

3. *The Implosion and Resulting Article 9*

Following the confusion that surrounded the extended use of consensual liens, a great reduction occurred. The legal structure for personal property security law imploded: All the different security devices were collapsed together and combined within one statute, Article 9. It provided for a single, unitary, streamlined lien, known as a "security interest,"³⁵ based mainly on a few essential principles that were common denominators of the old pre-Code security devices.

Article 9 applies to *any* transaction, regardless of its form, in which any creditor and any debtor intend by agreement to create any kind of interest that is designed to secure any kind of obligation with any kind of personal property.³⁶ Thus, Article 9 governs whenever a creditor and debtor wish to create a consensual lien on personal property; it explains how the interest is created,³⁷ how the interest is enforced against the debtor,³⁸ and how the interest ranks in relation to third parties' claims to the collateral. This wide scope thereby embraces and subsumes every past and future lien that is "created by contract including pledge, assignment, chattel mortgage, chattel trust, trust deed, factor's lien, equipment trust, conditional sale, trust receipt, other lien or title retention contract and lease or consignment intended as security."³⁹ Article 9 repealed all of these pre-Code security devices and assumed their functions.

Thus, when a bank makes a car loan to an individual, or a bank or another financier makes operating or other commercial loans to a business and secures the loan with any of the company's personal property, whether goods or intangibles, the lien that the parties create is an Article 9 security interest. Also, when a retailer sells goods to an individual on credit, or a manufacturer finances the sale of its products to the retailer, the interest in the goods that secures both sellers is an Article 9 security interest.

In place of all the pre-Code security devices is a single, simple lien that serves every occasion. It is always created by an agreement known as a "security agreement," which is nothing more than minimal evidence of an understanding between the parties that particular property of the debtor shall serve as security for the debt owed the creditor.⁴⁰ The only formalities re-

35. The official short-form definition is "an interest in personal property or fixtures which secures payment or performance of any obligation." U.C.C. § 1-201(37) (1977).

36. U.C.C. §§ 9-102(1)(a), 1-201(37) (1977).

37. *See id.* § 9-203(1).

38. *Id.* §§ 9-503, 9-504.

39. *Id.* § 9-102(2).

40. The official definition is "an agreement which creates or provides for a security interest." *Id.* § 9-105(1)(l).

quired are that this agreement describe the collateral in writing and that the debtor sign the agreement.⁴¹ Even these minimal requirements are dropped if the creditor takes possession of the collateral.⁴²

This security agreement encumbers the collateral with a lien in the amount of the debt that the debtor owes the creditor. The agreement is usually made at the inception of the parties' deal, so that the creditor enjoys a lien at the birth of the debt and throughout the debt's life.⁴³ If and when the debtor defaults, the creditor can grab the collateral.⁴⁴ Neither the courts nor any other arm of the state is involved in creating or enforcing the lien. The creditor is free to determine default and also free, personally or through an agent, to realize on the collateral: to seize the property, sell it, and apply the proceeds to the secured debt.⁴⁵ Therefore, it is possible to enforce the interest completely and exclusively through private action.

Third parties can obtain their own liens on the property⁴⁶ by acquiring their own Article 9 interests in it, by postjudgment execution process, by force of a suppliers' lien law, or in other ways that are of minor importance. Generally, however, an Article 9 security interest outranks subsequent claims if the interest was filed earlier, that is, publicly recorded or otherwise perfected. Article 9 provides the complete structure for the filing system,⁴⁷ and provides that a filed or otherwise perfected interest generally outranks subsequent liens and other claims.⁴⁸ First in time has survived as the major principle of priority.

To perfect by filing, Article 9 provides for recording only a notice of the creditor's security interest,⁴⁹ not the actual security agreement that created the lien. In practice, however, a reduction has occurred here. Lawyers have combined the two forms into a single document, commonly called a UCC-3 form, that serves both purposes.⁵⁰

41. *Id.* § 9-203(1).

42. *Id.*

43. This manner of structuring the deal is not required, however, because an Article 9 lien is created any time that a debt is outstanding.

44. U.C.C. § 9-503.

45. *Id.* § 9-504.

46. A debtor's rights in collateral, that is, property already subject to a security interest, may be voluntarily or involuntarily transferred, creating further encumbrances on the property. *Id.* § 9-311.

47. U.C.C. Art. 9, Part IV.

48. This rule of priority is repeated throughout Article 9. *See, e.g.*, U.C.C. §§ 9-301, 9-312(5)(a).

49. *Id.* § 9-402.

50. *Cf. id.* (a copy of the security agreement is sufficient as a financing statement if it satisfies the requirements of a financing statement and is signed by debtor).

More important, Article 9 reduces process by expressly expanding the utility and potency of the security agreement. It renders enforceable any provision in the agreement stipulating that the collateral will secure future debts to the creditor.⁵¹ Article 9 also approves a provision which states that all debts acquired by the debtor in the future, which are covered by the agreement, will be secured by collateral of the kind described in the agreement.⁵² Standard form security agreements always contain both kinds of provisions, respectively referred to as "future-advance" and "after-acquired property" clauses. These insure that all debts owed to the creditor, now and in the future, will be secured by all property described in the agreement that the debtor owns, now and in the future. No fresh agreements are necessary, as was often true with pre-Code security law. The cross-collateralization occurs automatically by force of the two clauses in the security agreement.

Moreover, by force of law, a security interest attaching to any property for any debt also continues in any proceeds of the property.⁵³ This reach of the interest to after-acquired property and proceeds of the property occurs automatically, without the debtor's consent or knowledge.⁵⁴

The notion that a lien can float over a debtor's estate and automatically attach to newly acquired property is not new or unusual. Judicial liens float and, in theory, cover an even broader range of interests than Article 9 liens. The former, such as judgment and execution liens, effectively hang over the debtor's entire estate. The latter, an Article 9 security interest covering after-acquired property, is limited to the kinds of property described in the security agreement.

In practice, however, this difference largely disappears. An Article 9 security agreement can cover all of a debtor's personal property. This comprehensive coverage is easily accomplished because of the existence of simplifying reductions in debtor-creditor law down to, and especially including, Article 9. In the beginning, chattel mortgages were difficult to create because of the required formalities, including specificity in describing the collateral. Equity answered by enforcing failed mortgages as equitable liens, especially when the failure resulted from a formally defective description of collateral. The Uniform Trust Receipts Act codified this simplified approach to creating consensual liens.

Article 9 follows suit: it reduces "formal requisites to a minimum" to the extent of displacing the need for the equitable liens theory,⁵⁵ and it rejects

51. *Id.* § 9-204(3).

52. *Id.* § 9-204(1).

53. *Id.* § 9-306(2).

54. *Id.* § 9-203(3).

55. *Id.* § 9-203 comment 5.

any requirement of "exact" or "detailed" descriptions of collateral.⁵⁶ A description that reasonably identifies what is described, regardless of specificity, is sufficient.⁵⁷

Because of this laxness, the courts have approved increasingly broad descriptions of collateral under Article 9. Generic descriptions that merely identify the collateral in terms of its broad type, nature or use are now commonly used and enforced. Examples include "equipment" or "inventory" in the case of goods, and "accounts" or "receivables" in the case of intangibles. A combination of these and a few other generic labels describing the collateral in a security agreement will easily and reliably cover everything.

Despite this high degree of simplification, the push for further reduction continues. The Minnesota Supreme Court has approved descriptions as broad as "all goods"⁵⁸ and even "all of the debtor's personal property,"⁵⁹ on the theory that formality should not stand in the way of the debtor encumbering all of her property.

Thus, in just a few words on a form that the debtor signs without negotiating or even reading the terms, a creditor can acquire an Article 9 security interest in all of the personal property of a debtor's business. Indeed, it is standard practice for banks and other primary lenders to do so. Thus, at the beginning of the debtor-creditor relationship, as soon as even a penny is loaned, the initial lender has a lien on all of the debtor's personal property estate, however it may grow or change. This lien floats over the estate and is generally superior to all subsequent claims. The lender's lien is first in priority because it is first in time. Any and every piece of the estate, presently owned and later-acquired, is affected by the lien which clings to everything in the estate for as long as anything, even a penny, is owed the secured party.

Only a few kinds of subsequent claims escape subordination. In a practical sense, the most important unsubordinated claim is the purchase-money security interest. A purchase-money security interest is an Article 9 security interest of a subsequent creditor in later-acquired property that the debtor received because this subsequent creditor supplied the purchase-money financing.⁶⁰ A purchase-money creditor gets first claim to property that she

56. *Id.* § 9-110 comment.

57. *Id.* § 9-110.

58. *James Talcott, Inc. v. Franklin Nat. Bank*, 292 Minn. 277, 194 N.W.2d 775 (1972).

59. *World Wide Tracers, Inc. v. Metropolitan Protection, Inc.*, 384 N.W.2d 442 (Minn. 1986).

60. A purchase-money security interest is officially defined as a security interest:

- (a) taken or retained by the seller of the collateral to secure all or part of its price; or
- (b) taken by a person who by making advances or incurring an obligation gives value to enable the debtor to acquire rights in or the use of collateral if such value is in fact so used.

enables the debtor to buy, notwithstanding that an earlier recorded floating lien also attaches to it.⁶¹ Under a routine application of Article 9's first in time rule, the earlier floating lien would outrank the purchase-money interest. In this situation, however, Article 9 applies exceptional priority rules that permit the purchase-money lien holder to prevail.

This super-priority for purchase-money interests is not new. It echoes a theme running throughout debtor-creditor law, applying even to nonconsensual judicial liens, that enabling liens for new value outrank floating claims for preexisting debt.⁶² Article 9 adopts this theme not only with respect to purchase-money security interests, but also with respect to other interests and liens of creditors who enabled the debtor to acquire value other than by purchase.⁶³

D. *The Survival and Statutory Modernization of Common Law Suppliers' Liens*

The tremendous growth in consensual liens could have stunted or entirely smothered the development of suppliers' liens, the other early exception to execution. The law gives these liens to certain suppliers of certain property and services.⁶⁴ The liens secure the price of whatever the creditor supplies, and arise automatically, without judicial proceedings or the debtor's consent, as soon as the creditor delivers the property or services.

Common law suppliers' liens were narrow in terms of the classes of suppliers covered and the availability of remedies for enforcement. The best known of the common law liens is the artisan's lien, which applies in favor of a worker who, by his skill and labor, enhances the value of chattels.⁶⁵ The artisan's lien, like all common law liens, is dependent on the creditor having possession of the property and detaining it as security for the price of his services.⁶⁶ This detention is the enforcement mechanism. In effect, a common law suppliers' lien is a forced or nonconsensual pledge in which the

U.C.C. § 9-107 (1977).

61. See, e.g., *id.* §§ 9-312(3)-(4), 9-313(4)(a).

62. See Nickles, *Setting Farmers Free: Righting the Unintended Anomaly of UCC Section 9-312(2)*, 71 MINN. L. REV. 1135, 1150-74 (1987).

63. See, e.g., U.C.C. §§ 9-310 (1977) (security interest subordinate to lien of artisan for improving collateral); *id.* § 9-314 (security interest in accession added to collateral superior to preexisting interest in the collateral); *id.* § 9-315 (security interests components of product or mass rank equally). For explanations of these exceptions to the usual principle of first-to-file rule, see Nickles, *supra* note 62, at 1164-71.

64. The classic work on common law liens, which also covers equitable and statutory liens, is L. JONES, A TREATISE ON THE LAW OF LIENS (2d ed. 1894).

65. *Id.* § 731.

66. *Id.* § 20.

creditor, who got the property as a bailee for a special and limited purpose, keeps it as hostage for the debt owed him.

Now, mainly as a result of legislative action, suppliers' liens have substantially enlarged in every sense. Statutes have codified and widened the common law liens, and new statutory suppliers' liens that were unknown at common law have been created.⁶⁷ Today's suppliers' liens are also enlarged in that they no longer always depend on possession for attachment of the lien or enforcement. For example, in most states an artisan's lien survives and is enforceable against the debtor, and also against third parties, despite return of the goods to the debtor. The requirement of publicly filing a lien notice replaces possession.

To a large extent, therefore, modern suppliers' liens are now the functional equivalent of nonconsensual Article 9 security interests, and many of the most modern suppliers' liens prescribe their own priority in relation to true Article 9 interests. This equivalency is increasing. The latest twist in the development of suppliers' liens is to provide for filing and enforcing the lien as if it were an Article 9 security interest.⁶⁸ This incestuous hybridity is a clear sign of an impending reduction in debtor-creditor law that, minimally, would collapse suppliers' liens into Article 9.

II. PROFESSOR SCHWARTZ'S THEORY OF LOAN PRIORITIES AND WHERE IT FITS IN THE LAW'S EVOLUTION

A. Professor Schwartz's Main Proposal

In his recent piece, *A Theory of Loan Priorities*,⁶⁹ Professor Alan Schwartz worries and theorizes about the priority of initial lenders, that is, banks and other primary financiers, who hold substantial amounts of a borrower's long-term debt, debt expected to be outstanding for a considerable time.⁷⁰ He begins with the proposition "that the law regulating priorities should reflect the priority contract that a debtor and its initial financier would negotiate."⁷¹ He reasons that, if initial financiers and their debtors dislike the law's usual or default priority scheme, they will achieve by contract the scheme they

67. A typical state's list of suppliers' liens could include liens for: agisters who feed and board cattle, blacksmiths who shoe animals, attorneys, warehousemen, landlords, farm and common laborers, suppliers of goods to farmers, hotelkeepers, carriers, craftspeople, fishers, health care providers, jewelers, launderers, cleaners, loggers, and miners.

68. See, e.g., MINN. STAT. § 514.92 (1988) (veterinarian's lien); *id.* §§ 514.950-514.959 (agricultural production input lien).

69. Schwartz, *supra* note 6.

70. At one place Schwartz defines "financier" to mean "the first creditor that made a substantial loan that would be outstanding for a nontrivial time period." *Id.* at 247. The definition excludes trade creditors.

71. *Id.* at 210.

prefer. Thus, it is more efficient for the law to codify the scheme the parties, as a class, typically create rather than to require them to change the law's default setting each time a new agreement is reached.

Professor Schwartz claims that "[p]ractice varies sharply from the legal priority scheme" of Article 9, and that "commercial parties typically contract out of the . . . scheme."⁷² Initial financiers do so, he writes, primarily by including in security agreements covenants restricting or eliminating the debtor's right to incur debt, especially secured debt, elsewhere.⁷³ A breach of such a covenant is an event of default under the security agreement that permits the financier to pull the plug on the debtor.

Professor Schwartz explains that these restrictions:

commonly require the debtor to maintain a 'cushion' between the value of the collateral subject to the earlier security interest and the amount still due on the loan. This provision is then policed by requiring the debtor who wishes to borrow further to supply independent appraisals of the collateral's value. *Initial secured parties say they regulate later security to avoid being pressured by junior lienors to foreclose when the debtor is in difficulty.* Rather, the seniors want the power themselves to decide whether the debtor should be allowed to continue in business or not.⁷⁴

Professor Schwartz states that these covenants "suggest that initial financiers and debtors commonly prefer to give the initial financier senior rank,"⁷⁵ and therefore that "the law should adopt such a contract as its default rule and make it fully effective."⁷⁶ Thus, he would give first priority to the initial financier, whether secured or not. Essentially, Professor Schwartz argues that the initial financier should acquire, by force of law, a prior claim to all of the debtor's personal property estate that is subordinate only to the claims of purchase-money creditors: creditors claiming specific assets the debtor purchased with their financing.

B. *Surprising Aspects of the Proposal*

The philosophy of this reasoning is troublesome. Professor Schwartz sees a very tiny role for the law. He would codify the power of the economically strong initial lenders on the theory that these people, in any event, will get their own way. The law should then serve the strong by saving them time and transaction costs in exercising their power. The law is wasted in this

72. *Id.* at 216.

73. *Id.* at 217.

74. *Id.* (emphasis added).

75. *Id.* at 218.

76. *Id.* at 219.

role of describing the inevitable. The law is most useful as a counterweight to transactional and economic strength, reducing practical, transactional power when there is a legitimate public policy reason for doing so.

Beyond this endless fundamental debate, Professor Schwartz's reasoning is surprising in several technical respects. First, initial lenders do not spend time or money to negotiate the terms of security agreements. These are standard or word processed forms that are beyond negotiations.

Second, Professor Schwartz argues that financiers are dissatisfied with the current regime because subordinate creditors can foreclose against the wishes of an initial financier. Yet, because the initial financier always retains a prior, senior security interest in the debtor's property, subordinate creditors cannot themselves foreclose without risking conversion liability or otherwise accounting to the financier.⁷⁷ Moreover, any buyer of the collateral at a sale conducted by subordinate creditors would take subject to the financier's senior interest.⁷⁸ Current law, therefore, empowers the financier to dictate the timing of foreclosure and control it. Having to yield to the pressure of subordinate creditors results not from the law, but from the financier's thin skin and weak will.

Third, initial lenders do not contract around Article 9's current priority rules using anti-debt covenants. These covenants cannot stop the debtor from borrowing from third persons and securing the loans and other credit with property in which the initial lender also claims an interest. Moreover, the very fact that initial lenders complain about subordinate creditors makes clear that debtors actually do get additional credit from other sources, and that initial lenders do not enforce the anti-debt covenants. So the anti-debt covenants do not displace Article 9's rules even in the gross sense of preventing conflicting claims.

Fourth, in any event, Professor Schwartz's priority rule would not cure the ill that supposedly prompts it. The rule does not prohibit subordinate creditors, nor does it prevent them from exerting whatever pressure they can muster.

Finally, the most significant criticism is obvious from Part I of this Article: the rule that Professor Schwartz proposes is, in practice, already the law. By honoring tiny form requirements, that is, by getting a debtor to sign

77. See generally Byrne, Murphy & Vukowich, *Junior Creditors' Realization on Debtors' Equity Under U.C.C. Section 9-311: An Appraisal and a Proposal*, 77 GEO. L.J. 1905 (1989); Nickles, *Rights and Remedies Between U.C.C. Article 9 Secured Parties with Conflicting Security Interests in Goods*, 68 IOWA L. REV. 217 (1983).

78. See U.C.C. § 9-504(4) (1977) (sale "discharges the security interest under which it is made and any security interest or lien subordinate thereto," not any senior interest) (emphasis added).

a standard form security agreement that describes the collateral as all of the debtor's personal property, an initial lender currently gets, at the loan's inception, a lien on all of the debtor's personal property estate. Under current law, this creditor is already entitled to priority over all subsequent creditors except purchase-money secured parties.

The primacy of initial lenders and the significance of their priority is well-known and widely understood even by nonlawyers. For instance, in a recent book by Sol Stein, *A Feast for Lawyers*, the author, who is not a lawyer, chronicles the bankruptcy of the publishing company that he and his wife owned. His book is a rare view of the process, from the vantage point of the debtor. The book, from beginning to end, is a condemnation of Chapter 11 and bankruptcy lawyers. In many parts the book is accurate, including the author's description of the priority among the debtor's creditors as they compete in claiming the debtor's property:

When the creditors vie for ranking, it is for a very real objective — who gets paid back first. Secured creditors come first, with the mass of unsecured creditors following. But if there is more than one secured creditor, they vie with each other for position. . . . [I]f there's a bank involved and its loan was secured, the bank usually comes first.⁷⁹

Professor Schwartz's only innovation, therefore, is dispensing with the form eliminating the security agreement. Ironically, initial lenders are the most sophisticated and knowledgeable creditors. They are least bothered or hindered by form. It affects them only fortuitously when they inadvertently neglect to follow it. Significantly, this fortuity is a source of equity for unsecured creditors. As Stein learned in the bankruptcy of his company:

But a bank's papers may be faulty, it may have filed a UCC [financing statement] (to perfect a security agreement) in the wrong jurisdiction, or it may have failed to file in a county where important collateral is kept. I've personally observed instances of all of these things, so there must be a fair amount of sloppy bank work around. And any weakness in a bank's position will be exploited by others. For instance, if no one has filed a UCC in a place where some collateral is housed, the unsecured creditors may lay claim to it at once.⁸⁰

Thus, abolishing the form for initial lenders, as Professor Schwartz proposes, would worsen the position of all other creditors because fortuitous equity for them would dry up.

79. S. STEIN, *A FEAST FOR LAWYERS* 65 (1989).

80. *Id.* (footnote omitted).

Abolishing the form for all creditors would somewhat compensate, but Professor Schwartz's proposal is not so generous. Everyone other than initial lenders must continue to satisfy the law's formalities to acquire security under Article 9.⁸¹ Moreover, details of his proposal would reduce Article 9's new value, purchase-money exceptions to the first-in-time priority, giving additional protection to initial lenders who are the creditors least in need of the law's protection.

Professor Schwartz does not worry that the position of later creditors could be worsened. They will, in his words, "exact compensation for their worsened status in the interest rate they charge."⁸² This reasoning is the same as that which powered the now deflated junk bond market. Quoting a recent news story: "Milken's magic was to transform investors' view of these bonds, persuading insurance companies, pension funds and thrifts that the higher interest rate that junk bonds paid offset the higher risk of default."⁸³ The truth, however, in both high finance and ordinary commercial credit, is that the higher interest rate which, in the beginning, justifies taking a risk, is entirely worthless if in the end the investment collapses. It is hardest on the unknowledgeable creditor whose investments, in the form of credit, are too often uninformed and not closely watched or widely diversified. Additionally, the risk-taking and accompanying strategies that the higher rate encourages may produce consequences whose whole effects are socially offensive.

Ironically, in proposing to eliminate the form requirement of a security agreement for initial lenders, Professor Schwartz unknowingly prophesies another simplifying reduction in debtor-creditor law — the ultimate, final reduction — which he would likely oppose.

III. THE EVOLUTIONARY END: A LAST, RADICAL REDUCTION

If debtor-creditor law continues to reduce and simplify itself, the next major round that is theoretically possible will be the last. It will shrink the law to its irreducible core in a final, radical reduction. Suppliers' liens and execution will collapse into Article 9 in much the same fashion as pre-Code consensual liens combined to form Article 9. The result of this "big un-bang" or "colossal collapse" is a hybrid, democratic security interest which balances the power of initial lenders.

In the beginning, suppliers' liens are folded into Article 9. They are not materially different from Article 9 security interests except that many of the

81. Schwartz, *supra* note 6, at 214-15.

82. *Id.* at 210.

83. *The Downfall of Drexel*, Newsweek, Feb. 26, 1990, at 50, 51.

liens, by their own terms, currently enjoy priority over earlier encumbrances, including earlier filed, floating security interests. This priority would not necessarily be lost if the liens were collapsed into Article 9 and then recast as security interests. The liens are mostly liens for new value that the suppliers give the debtor. A theme that already runs throughout Article 9 is priority for new value security interests. It would be a consistent and natural reduction in the law to broaden this new-value priority in Article 9 so that it covers suppliers' liens turned nonconsensual security interests.

Suppliers' liens do differ in form from security interests in that the former are created by force of law when the debt is established, and the latter depend on the debtor signing a security agreement. This formality, however, serves no meaningful purpose. Security is not negotiated today. Debtors expect to provide collateral and never bargain over having to do so. Moreover, the form of a security agreement is so brief that no cautionary function is served by the ritual of signing it.

Thus, spurred by the folding of suppliers' liens into Article 9, the law in the final reduction abolishes the security agreement as a requirement for creating collateral under Article 9. All Article 9 security interests become in theory, as they are in practice, nonconsensual liens.

Defining the collateral without a security agreement is not a problem. After the big unbang, the law formalizes Professor Schwartz's theory but rejects his stinginess. All creditors get the privilege previously enjoyed by knowledgeable creditors operating, through standard forms, under Article 9. In other words, every creditor's interest automatically, nonconsensually extends to all of the debtor's personal property estate. This interest arises as soon as the creditor gives value, automatically attaching at the instance credit is extended and spreading by force of law, as now by boilerplate, to everything.

The substance of standard form security agreements also defines, by law, the important incidents of the security interest. For example, the security interest operates as though the parties had agreed to an after-acquired property clause, so that the creditor's broad interest floats over the personal property estate however it grows and otherwise changes. Additionally, default occurs under the circumstances always described in standard forms: whenever the debtor fails to pay or the creditor otherwise feels insecure. The remedies already described by Article 9, predominantly including private enforcement, remain unchanged. In sum, the law in the future gives all creditors the advantages of a floating lien that standard forms now give initial lenders.

The law has always enabled a creditor to get a lien that covers all of the debtor's personal property. Indeed, the original postjudgment execution rule for liens effectively creates such a lien. Execution limits only the procedures for getting and enforcing the lien, not the size of it. Because the law has permitted consensual liens to grow to the same all-embracing size, and because these consensual liens are privately enforced, the significance of execution has steadily diminished through the years and is entirely eroded in the final reduction. Execution process, like suppliers' liens, is no longer needed or useful and entirely collapses with respect to personal property.

All that remains after the final reduction is the nonconsensual, Article 9 security interest that attaches to everything as soon as debt is incurred. It is a lien on the whole personal property estate that continues in the whole estate, however the estate changes, until the debt is paid.

Filing remains a requirement for enforcing a security interest against third parties, but the process is greatly simplified. A creditor files a notice of credit electronically, using his own personal computer to access the public records. The entry is short, including the fact and amount of credit given the debtor and the identity of the creditor providing it. Filing requires only a few minutes.

In an equally brief time any of the debtor's creditors can check the entire collection of filings against a debtor by monitoring, through their computers, the electronic Article 9 records. This innovation is not farfetched or far off. Some states are already providing, or experimenting with, computer access to Article 9 filings and other public records.⁸⁴

Most important, this new world evens the imbalance between initial lenders and other creditors. The position of amateur creditors improves. To begin with, their ignorance and inexperience with the law's formalities for creating a lien cannot leave them unsecured. After the final reduction every creditor gets a lien on everything automatically.

Their liens make them no better off, however, if the value of the debtor's estate is deficient and priority is determined by the usual first in time rule. In this case the initial lender, as usual, will get first claim to everything because it is first. A disproportionate share of the loss, as usual, is borne by the

84. Minnesota's Secretary of State has recently announced a "project to provide private parties direct computer access to information on file" in her office. "The project will provide for direct electronic access via phone lines and modems to all of the computerized records of the Secretary of State as well as the Uniform Commercial Code records of the county recorders . . ." The Secretary expects "that this service will be available 24 hours a day, 365 days per year and will allow customers throughout the State access to about five million records on an on-line basis." Memorandum from Minnesota Secretary of State to Interested Parties (January 1990) (regarding direct computer access project survey) (on file at the Catholic University Law Review office).

amateur creditors, who lacked the knowledge and sophistication to protect themselves.

After the colossal collapse, however, first in time priority is not necessarily the general rule of priority. In the new regime, where the whole estate is collateral for all creditors, every creditor is a new value, enabling party; the credit that each one gives adds to the value of the whole and enables the debtor to acquire that value.

The law has never agreed on a uniform rule for deciding the priority of new value, enabling interests among themselves. There is, rather, a nonuniform assortment of different rules for ranking enabling liens *inter se*. The range of these priority rules is very wide. At one extreme is the familiar first in time principle, but at the other extreme is a rule that ranks enabling liens ahead of earlier ones so that last in time is first in right.⁸⁵

When everyone's collateral is the debtor's whole estate, applying the last in time rule is consistent with the broad theme of debtor-creditor law which protects new-value creditors from the first in time rule. Also, while the last in time rule would obviously enhance the position of amateur creditors relative to an initial lender, the rule would not necessarily materially increase the risks to the initial lender. Because of its monitoring activities, the initial lender will know the level of debt to third persons. If this debt level increases to the point of threatening the initial lender's secured position, it can stop third party credit, or completely withdraw.

This monitoring by initial lenders does not reliably and adequately protect amateur creditors under the first in time regime for the very reason that the first in time rule abuses these creditors. The initial lender's priority argues against foreclosure as long as the other creditors continue to extend credit that could enhance the value of the debtor's estate. A second in time rule would give initial lenders an incentive to monitor the situation more closely, which would benefit everyone.

85. This rule generally applies to conflicting enabling liens on vessels, that is, maritime liens:

[T]he general principle has always been that liens . . . take precedence in the inverse order of their time of accrual, the later liens prevailing over the earlier . . . [because] the earlier lienors, having a proprietary interest in the ship, have been benefited by the services rendered to all interests in her by the later lienors.

BENEDICT ON ADMIRALTY § 51, at 4-4 (7th ed. 1989) (footnote omitted); see also *The St. Jago de Cuba*, 22 U.S. (9 Wheat.) 409, 416 (1824) ("[T]he last lien given will supersede the preceding . . . [because] [t]he vessel must get on."). See generally G. GILMORE & C. BLACK, *THE LAW OF ADMIRALTY* 743 (2d ed. 1975). The middle position is a relatively common rule that ranks enabling liens equally *inter se*, in which case the lien holders share ratably in the proceeds of the collateral. Finally, and least commonly, the order among conflicting enabling liens is occasionally determined with reference to the nature of the underlying claims, without regard to the order in which the liens arose.

The monitoring process could be made more reliable by requiring creditors to file within 24 hours after, or even 24 hours before, they extend credit in order to achieve priority over initial lenders and other prior parties. In this manner the initial lender, by acting promptly to foreclose, could avoid any prejudicial dilution of the estate and, in the process, protect other creditors as well as itself. There is no reason the filing system could not be made to serve this double duty of protecting both prior and subsequent creditors, especially when the system is electronic and thus easily and quickly accessed.

Under this scheme, the risk to amateur creditors would decrease, and so should the price of their goods, services, and credit. On the other hand, there is no compensating material increase in risk to initial lenders; they already police debtors. The only change is that errors in monitoring and policing activities cannot be paid out of the value invested by trade and other amateur creditors. The cost of mistakes would come from the initial lender's share of the estate.

In the end, therefore, a fairer balance exists between initial lenders and amateur creditors. Also, as an added bonus, a solution is suggested to the puzzle of secured credit: the system becomes efficient when the risks and protections are more evenly distributed. The initial lenders have superior knowledge and control of the debtor because of the financing role they play, and are thereby amply positioned to protect themselves and, incidentally, other creditors. The amateurs, who cannot protect themselves as well, benefit from the initial lenders' vigilance and, when that is lacking, get priority that protects them by law.

IV. CONCLUSION

Changing Article 9's priority scheme to last in time is first in right is a political impossibility. Debtor-creditor law will continue to reduce itself, eventually to the point of officially ratifying Professor Schwartz's proposal. The process will cease when it seriously threatens the preferential position of the politically dominant initial lenders. This point is certainly reached when reductionism begins to weaken the first in time rule of priority. This rule institutionalizes the lenders' dominance. They will not permit replacing it with a rule recommended mainly for balance and fairness.

The imbalance between initial lenders and amateur creditors will be evened, if at all, only by decisional rule in the courts where political and economic power sometimes yields to fairness. The process has begun there. A few narrow decisions have been made that are the possible embryos of principles that would even the relationship between an initial lender and the

debtor's amateur creditors. The judicial process, however, is very slow and uncertain. Fairness will not come quickly there.

In any event, initial lenders are not villains. They are, quite simply, American capitalists who understandably define fairness in terms of their own bottom line. This perspective is the problem for fairness everywhere in the law: fairness costs. Some people must pay for it rather than spend the money on themselves or their stockholders. A lawyer's main job is convincing people that fairness is worth the price.

