Perfection Hierarchies and Non-Temporal Priority Rules

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The most basic rule in all of Article 9 is that the earlier of first to file or perfect has priority, embodied for generations of secured transactions lawyers in U.C.C. § 9-312(5) (now in R § 9-322(a)(1)). Of course, this means that in contests between two secured creditors both of whom filed to perfect their security interests, the first to file wins. The rule also covers that rare situation where a secured creditor perfected first by possessing the collateral, say, a laptop, an intervening secured creditor filed, and then the first secured creditor filed before giving up possession. In that case, because the rule is the earlier of first to file *or* perfect wins, assuming no intervening period of neither filing nor perfection, the secured creditor who initially took possession has priority, even though its financing statement was second. In both cases, though, it is *time* that matters: the first one, where one is defined appropriately, wins. And, note that in this framework, possession of the laptop and filing against it are on par: from the secured creditor's perspective for the purpose of achieving perfection and priority, they are perfect substitutes. (Not so for the debtor, of course, who cannot write papers without her laptop, hence the rise of filing over time.) Given the substitutability of filing and possession in the rule of U.C.C. § 9-312(5), we determine priority by mapping both events to the single metric of time, giving rise to the mantra, the earlier of first to file or perfect wins.

We could run the system differently; indeed, to some extent we have always done so, but the combination of Revised Article 8 and now Revised Article 9 makes real inroads in changing the basic scheme of perfect substitutability among different methods of perfection mapped over to the single scale of time. Instead, to some extent, and perhaps less than we should have, we have embraced the idea of a *perfection hierarchy*: some methods of perfection are better than others. A secured creditor perfected first through an inferior means runs the risk of losing priority to a later secured creditor who perfects through a superior means. Method of perfection, or status,

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matters, and we must first categorize our secured creditors by method before we can assign priority. Of course, if we have more than one secured creditor using the same method, we will need a rule for assigning priority within classes, and we might reintroduce time and temporal priorities at the point. Indeed, this is exactly what Revised Article 9 has done.

This paper is divided into five sections. Section I sketches the new perfection scheme of Revised Article 9 and its reliance on the idea of *control* over collateral. Section II examines the origins of the different methods of perfection. Section III looks at the role that notice filing has played in secured transactions, while Section IV develops a role for perfection hierarchies, non-temporal priority, and the usefulness of control in that regard. Section V concludes the paper.

To preview that conclusion and the argument that leads to it, it is important to recognize that having collateral subject to Article 9 and its rules covering financing statements makes the cost of creating and perfecting a security interest the same for all creditors. Excluding collateral from Article 9—as we have traditionally done with deposit accounts—creates cost differentials among creditors. Cost differentials can help match collateral with creditors. Absent a cost, creditors may take too much collateral. Uninformed borrowers will ignore the scope of the security interest sought, while informed borrowers may be reluctant to tip their hands by negotiating over the scope of the security interest. An initial creditor may take a very broad security interest without any intent of taking the steps necessary to ensure a return on some of the collateral. At the same time, the breadth of the security interest taken by the non-reliance creditor may impair the ability of a reliance creditor to obtain a return on its investment in monitoring collateral. All of this shrinks the credit available to the debtor.

A perfection hierarchy may solve this problem. Let perfection through filing vest priority rights against one class of creditors, say unsecured creditors and lien creditors. At the same time, create a second method of perfection—say, control—that makes it possible for a second creditor to jump ahead of the filed secured creditor. If this second method of perfection is sufficiently costly, we will discourage non-reliance creditors from using it, and thereby create a way for reliance creditors to recover on their efforts by allowing them to obtain priority. This structure does a better job of matching collateral taken and reliance on it, assuming that control is a good proxy for reliance.

I. The Role of Control in Revised Article 9

Pick a seemingly obscure place to start, namely, U.C.C. § 9-308, on the purchase of chattel paper and instruments:

> A purchaser of chattel paper or an instrument who gives new value and takes possession of it in the ordinary course of his business has priority over a security interest in the chattel paper or instrument
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> > (a) which is perfected under Section 9-304 (permissive filing and temporary perfection) or under Section 9-306 (perfection as to proceeds) if he acts without knowledge that the specific paper or instrument is subject to a security interest; or
> >
> > (b) which is claimed merely as proceeds of inventory subject to a security interest (Section 9-306) even though he knows that the specific paper or instrument is subject to the security interest.

For my purposes, the key feature of this section is the different status that it gives to a secured creditor who takes possession of chattel paper from one who perfects through filing. Obviously, the rule is substantially more textured than that description suggests, but the key idea of a perfection hierarchy is clearly at work here. Secured creditors are presented with the opportunity to structure their respective priorities through the choice of the method of perfection. Taking possession of the chattel paper ensures that another secured creditor cannot jump ahead of the possessor. Filing against chattel paper just creates a perfected security interest good against lien creditors and therefore the trustee in bankruptcy asserting the status of a hypothetical lien creditor under Section 544(a) of the Bankruptcy Code, but makes it possible for another secured creditor giving new value to acquire priority against the chattel paper without negotiating with the filed secured creditor.

This is an example of a non-temporal priority, one that is tied to both to the status of the winner—new value, ordinary course of business and the absence of knowledge of the competing security interest—as well as to the method of perfection used by the winner, here possession of the chattel paper or the instrument. Article 9 has always had other non-temporal priorities as well, such as the special status given to purchase money security interests (see U.C.C. § 9-107 and U.C.C. § 9-312(3), (4)). This priority was

implemented through status alone—traced new value, coupled with an appropriately timed filing, and, in the case of inventory, advance notice.

Revised Article 9 makes few important changes to the fundamental principles of the statute. Perhaps the most important consistent change throughout Article 9 relates to be expanded role for the idea of control as a means of establishing priority and perfection. This tracks generally the way that control has been used in revised Article 8 relating to investment property. In Revised Article 9, control serves a number of important purposes in implementing key changes to the statute:

- *Deposit Accounts.* Original security interests in deposit accounts may now be taken and perfected under Article 9. Control operates as a way of policing the manner in which a security interest in a deposit account is perfected. Allowing filing to perfect the security interest in the deposit account would have made it quite easy—too easy in the eyes of many—to take a perfected security interest in a deposit account. Insisting on control over that account may mean that only genuine reliance creditors will take security interests in deposit accounts.
- *Filing Against Instruments.* A secured creditor can now perfect a security interest in an instrument through filing. Such a filing serves the purpose of providing notice of the security interest in the instrument, just as it always had for other categories of collateral. Still, there may be circumstances in which having the secured creditor take an additional step beyond filing adds value—recall the discussion of U.C.C. § 9-308—and having control serve as a superior method of perfection for instruments creates a carrot to get our secured creditor to take that additional step.
- *Support Obligations.* The explicit treatment of support obligations and property securing such obligations necessitated a decision about the appropriate method of perfecting a security interest in these rights. Again, control is a natural way to implement a two-tier perfection system based on non-temporal priorities.

R § 9-104 through R § 9-107 set forth the circumstances under which control has been established over deposit accounts (R § 9-104),[1] electronic

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[1] SECTION 9-104. CONTROL OF DEPOSIT ACCOUNT.

(a) *Requirements for control.* A secured party has control of a deposit account if:

chattel paper (R § 9-105),[2] investment property (R § 9-106),[3] and letter-of-credit rights (R § 9-107).[4] R § 9-314 legitimates control as a method of per-

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(1) the secured party is the bank with which the deposit account is maintained;

(2) the debtor, secured party, and bank have agreed in an authenticated record that the bank will comply with instructions originated by the secured party directing disposition of the funds in the account without further consent by the debtor; or

(3) the secured party becomes the bank's customer with respect to the deposit account.

(b) *Debtor's right to direct disposition.* A secured party that has satisfied subsection (a) has control, even if the debtor retains the right to direct the disposition of funds from the deposit account.

[2] SECTION 9-105. CONTROL OF ELECTRONIC CHATTEL PAPER. A secured party has control of electronic chattel paper if the record or records comprising the chattel paper are created, stored, and assigned in such a manner that:

(1) a single authoritative copy of the record or records exists which is unique, identifiable and, except as otherwise provided in paragraphs (4), (5), and (6), unalterable;

(2) the authoritative copy identifies the secured party as the assignee of the record or records;

(3) the authoritative copy is communicated to and maintained by the secured party or its designated custodian;

(4) copies or revisions that add or change an identified assignee of the authoritative copy can be made only with the participation of the secured party;

(5) each copy of the authoritative copy and any copy of a copy is readily identifiable as a copy that is not the authoritative copy; and

(6) any revision of the authoritative copy is readily identifiable as an authorized or unauthorized revision.

[3] SECTION 9-106. CONTROL OF INVESTMENT PROPERTY.

(a) *Control under Section 8-106.* A person has control of a certificated security, uncertificated security, or security entitlement as provided in Section 8-106.

(b) *Control of commodity contract.* A secured party has control of a commodity contract if:

(1) the secured party is the commodity intermediary with which the commodity contract is carried; or

(2) the commodity customer, secured party, and commodity intermedi-

fection for each of these property types and sets forth rules for the time when perfection by control takes place and how long that perfection continues.[5] We also need to know whether any other perfection method works for these collateral types. For deposit accounts, other than as proceeds, control is the exclusive acceptable perfection method (R § 9-312(b)). A se-

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ary have agreed that the commodity intermediary will apply any value distributed on account of the commodity contract as directed by the secured party without further consent by the commodity customer.

(c) *Effect of control of securities account or commodity account.* A secured party having control of all security entitlements or commodity contracts carried in a securities account or commodity account has control over the securities account or commodity account.

[4] SECTION 9-107. CONTROL OF LETTER-OF-CREDIT RIGHT. A secured party has control of a letter-of-credit right to the extent of any right to payment or performance by the issuer or any nominated person if the issuer or nominated person has consented to an assignment of proceeds of the letter of credit under Section 5-114(c) or otherwise applicable law or practice.

[5] SECTION 9-314. PERFECTION BY CONTROL.

(a) *Perfection by control.* A security interest in investment property, deposit accounts, letter-of-credit rights, or electronic chattel paper may be perfected by control of the collateral under Section 9-104, 9-105, 9-106, or 9-107.

(b) *Specified collateral: time of perfection by control; continuation of perfection.* A security interest in deposit accounts, electronic chattel paper, or letter-of-credit rights is perfected by control under Section 9-104, 9-105, or 9-107 when the secured party obtains control and remains perfected by control only while the secured party retains control.

(c) *Investment property: time of perfection by control; continuation of perfection.* A security interest in investment property is perfected by control under Section 9-106 from the time the secured party obtains control and remains perfected by control until:

(1) the secured party does not have control; and

(2) one of the following occurs:

(A) if the collateral is a certificated security, the debtor has or acquires possession of the security certificate;

(B) if the collateral is an uncertificated security, the issuer has registered or registers the debtor as the registered owner; or

(C) if the collateral is a security entitlement, the debtor is or becomes the entitlement holder.

curity interest in investment property or chattel paper (including electronic chattel paper) may be perfected through filing (R § 9-312(a)). A security interest in a letter-of-credit right may be perfected only through control, except that a security interest in any supporting obligation for collateral (including a letter-of-credit right (see R § 9-102(a)(77)) arises through perfection of a security interest in the collateral itself (see R § 9-308(d)) (R § 9-312(b)(2)).

With the perfection rules in hand, we can then turn to priority. R § 9-327 through R § 9-330 set forth the priority rules relating to deposit accounts (R § 9-327),[6] investment property (R § 9-328),[7] letter-of-credit rights (R § 9-

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[6] SECTION 9-327. PRIORITY OF SECURITY INTERESTS IN DEPOSIT ACCOUNT. The following rules govern priority among conflicting security interests in the same deposit account:

> (1) A security interest held by a secured party having control of the deposit account under Section 9-104 has priority over a conflicting security interest held by a secured party that does not have control.
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> (2) Except as otherwise provided in paragraphs (3) and (4), security interests perfected by control under Section 9-314 rank according to priority in time of obtaining control.
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> (3) Except as otherwise provided in paragraph (4), a security interest held by the bank with which the deposit account is maintained has priority over a conflicting security interest held by another secured party.
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> (4) A security interest perfected by control under Section 9-104(a)(3) has priority over a security interest held by the bank with which the deposit account is maintained.

[7] SECTION 9-328. PRIORITY OF SECURITY INTERESTS IN INVESTMENT PROPERTY. The following rules govern priority among conflicting security interests in the same investment property:

> (1) A security interest held by a secured party having control of investment property under Section 9-106 has priority over a security interest held by a secured party that does not have control of the investment property.
>
> (2) Except as otherwise provided in paragraphs (3) and (4), conflicting security interests held by secured parties each of which has control under Section 9-106 rank according to priority in time of:
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> > (A) if the collateral is a security, obtaining control;
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> > (B) if the collateral is a security entitlement carried in a securities account and:
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> > > (i) if the secured party obtained control under Section

329),[8] and of a purchaser of chattel paper or an instrument (R § 9-330).[9] We also need to take account of rules outside of Article 9 that may effect

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8-106(d)(1), the secured party's becoming the person for which the securities account is maintained;

(ii) if the secured party obtained control under Section 8-106(d)(2), the securities intermediary's agreement to comply with the secured party's entitlement orders with respect to security entitlements carried or to be carried in the securities account; or

(iii) if the secured party obtained control through another person under Section 8-106(d)(3), the time on which priority would be based under this paragraph if the other person were the secured party; or

(C) if the collateral is a commodity contract carried with a commodity intermediary, the satisfaction of the requirement for control specified in Section 9-106(b)(2) with respect to commodity contracts carried or to be carried with the commodity intermediary.

(3) A security interest held by a securities intermediary in a security entitlement or a securities account maintained with the securities intermediary has priority over a conflicting security interest held by another secured party.

(4) A security interest held by a commodity intermediary in a commodity contract or a commodity account maintained with the commodity intermediary has priority over a conflicting security interest held by another secured party.

(5) A security interest in a certificated security in registered form which is perfected by taking delivery under Section 9-313(a) and not by control under Section 9-314 has priority over a conflicting security interest perfected by a method other than control.

(6) Conflicting security interests created by a broker, securities intermediary, or commodity intermediary which are perfected without control under Section 9-106 rank equally.

(7) In all other cases, priority among conflicting security interests in investment property is governed by Sections 9-322 and 9-323.

[8] SECTION 9-329. PRIORITY OF SECURITY INTERESTS IN LETTER-OF-CREDIT RIGHT. The following rules govern priority among conflicting security interests in the same letter-of-credit right:

(1) A security interest held by a secured party having control of the letter-of-credit right under Section 9-107 has priority to the extent of its control over a conflicting security interest held by a secured party that does not have control.

(2) Security interests perfected by control under Section 9-314 rank according to

priority, such as status as a holder in due course (U.C.C. § 9-309 and R § 9-331), as well as setoff rights against deposit accounts (R § 9-340).

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priority in time of obtaining control.

[9] SECTION 9-330. PRIORITY OF PURCHASER OF CHATTEL PAPER OR INSTRUMENT.

(a) *Purchaser's priority: security interest claimed merely as proceeds.* A purchaser of chattel paper has priority over a security interest in the chattel paper which is claimed merely as proceeds of inventory subject to a security interest if:

(1) in good faith and in the ordinary course of the purchaser's business, the purchaser gives new value and takes possession of the chattel paper or obtains control of the chattel paper under Section 9-105; and

(2) the chattel paper does not indicate that it has been assigned to an identified assignee other than the purchaser.

(b) *Purchaser's priority: other security interests.* A purchaser of chattel paper has priority over a security interest in the chattel paper which is claimed other than merely as proceeds of inventory subject to a security interest if the purchaser gives new value and takes possession of the chattel paper or obtains control of the chattel paper under Section 9-105 in good faith, in the ordinary course of the purchaser's business, and without knowledge that the purchase violates the rights of the secured party.

(c) *Chattel paper purchaser's priority in proceeds.* Except as otherwise provided in Section 9-327, a purchaser having priority in chattel paper under subsection (a) or (b) also has priority in proceeds of the chattel paper to the extent that:

(1) Section 9-322 provides for priority in the proceeds; or

(2) the proceeds consist of the specific goods covered by the chattel paper or cash proceeds of the specific goods, even if the purchaser's security interest in the proceeds is unperfected.

(d) *Instrument purchaser's priority.* Except as otherwise provided in Section 9-331(a), a purchaser of an instrument has priority over a security interest in the instrument perfected by a method other than possession if the purchaser gives value and takes possession of the instrument in good faith and without knowledge that the purchase violates the rights of the secured party.

(e) *Holder of purchase-money security interest gives new value.* For purposes of subsections (a) and (b), the holder of a purchase-money security interest in inventory gives new value for chattel paper constituting proceeds of the inventory.

(f) *Indication of assignment gives knowledge.* For purposes of subsections (b) and (d), if chattel paper or an instrument indicates that it has been assigned to an identified secured party other than the purchaser, a purchaser of the chattel paper or instrument has knowledge that the purchase violates the rights of the secured party.

For my purposes, the most salient feature of this priority scheme is that perfection through control is superior to perfection through another manner, such as through filing. Put differently, we have created a perfection hierarchy, and we no longer seek to map over all of our methods of perfection to a single, temporal metric. A secured creditor who takes control over a deposit account will have priority over one who merely claims it as proceeds, who will typically rely on a filed financing statement to perfect its interest.[10] Again, a secured creditor with control over a letter-of-credit-right has priority over another secured creditor perfecting under another method.[11] The same is true for investment property[12] and, in a more complicated fashion, for electronic chattel paper.[13] This is not to say that time has become irrelevant, for even here, if two parties perfect through control, the first to achieve control usually has priority.[14] Nonetheless, the broader use of control coupled with the perfection hierarchy just described means that we have stepped away importantly from our temporal, earlier-of-first-to-file-or-perfect priority scheme.

II. Why Perfection and Why through these Means?

As the prior section makes clear, Revised Article 9 now has three basic perfection methods, ignoring for these purposes cases of automatic, statutory perfection.[15] Perfection through possession is the traditional pledge; perfection through filing is perhaps the defining item of modern secured transactions law. Perfection through control is the new kid on the block, though it obviously has roots in perfection through possession. Given these three basic devices for perfecting a number of questions should be considered. Start with the most basic: why perfection at all?

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[10] R § 9-327(1).

[11] R § 9-329(1).

[12] R § 9-328(1).

[13] R § 9-330(a).

[14] For deposit accounts, see R§ 9-327(2); for investment property, see R§ 9-328(2); and for letter-of-credit rights, see R § 9-329(2).

[15] R § 9-309.

A. Perfection and Priority

Perfection is just one of Article 9's instruments for describing a legal status and keying consequences to that status. Perfection is often described as being related to priority, but there is no simple relationship between perfection and priority. Priority may exist even without perfection. In other cases, priority is tied directly to perfection, and is both necessary and sufficient for priority. In yet other cases, perfection is necessary but not sufficient for priority.

To be more concrete, for example, consider a contest between a secured creditor and an unsecured creditor. An unperfected secured creditor is senior to an unsecured creditor, so perfection is not necessary for priority, as the secured creditor will be senior without being perfected. Perfection, though, is sufficient for priority, as the perfected secured creditor is senior to the unsecured creditor. R § 9-201. In contrast, in a competition between a secured creditor and a lien creditor, an unperfected secured creditor is junior to a lien creditor, R § 9-317(a)(2), while a perfected secured creditor has priority over a lien creditor as to all funds advanced at the time the previously unsecured creditor becomes a lien creditor. Perfection is both necessary and sufficient for priority against the lien creditor. In a third case, perfection is necessary but not sufficient to establish priority. An unperfected secured creditor loses to another perfected secured creditor. R § 9-322(a)(2). Being perfected is necessary for the first secured creditor to have superior rights as against the second perfected secured creditor, but is insufficient standing alone to establish priority. For two perfected secured creditors, priority is generally dated by the earlier of first to file or perfect. R § 9-322(a)(1). As this should make clear, perfection says nothing necessarily about priority against a given competing creditor: either way, perfected or unperfected, the secured creditor can win or lose, depending on the competitor.

That said, it would be a mistake to lose sight of how important perfection is for the secured creditor. Although the unperfected secured creditor would triumph in a competition with an unsecured creditor, it is unlikely that the contest will be so framed. The unsecured creditor can—and will—take steps to improve its position by becoming a lien creditor. As a lien creditor has priority over an unperfected secured creditor, an unsecured creditor always has a route available that will enable it to change the momentary priority of the unperfected secured creditor. Perfection is the way that the secured creditor ensures that it maintains any priority that it en-

joys against an unsecured creditor. First and foremost, to say that a secured creditor is perfected is to say that an unsecured creditor cannot jump ahead of the secured creditor. Perfection is also essential for the secured creditor to compete successfully with other secured creditors. Again, this is not literally true: R § 9-322(a)(3) provides a rule of priority based on the time of attachment to resolve priority disputes between attached but unperfected secured creditors. Nonetheless, it is highly unlikely that a dispute would arise in that context; one or both of the creditors would try to perfect, and R § 9-322(a)(3) would cease to apply.

B. Origins of the Ostensible Ownership Problem

So step back and ask again: why do we require an additional act for the security interest to be effective against third parties? The traditional explanation focuses on the problem of ostensible ownership. Consider the analysis in *Clow v. Woods*,[16] a Pennsylvania case decided in 1819. Hancock and Poe had formed a partnership. At some point thereafter Hancock granted a mortgage on property to Clow, who had guaranteed certain of Hancock's debts. The mortgage covered "all those good and chattelf now in [Hancock's] tan-yard in Liberty street, in the Northern Liberties of Pittsburg, to wit: all the bark and tools and implements of trade of the party of the first part, all his cafe-skins and bark, and all his sides of leather and bark, with the appurtenances." We are told nothing about whether this property was related to Hancock's partnership with Poe, or wholly separate. That partnership dissolved, and was settled through an "amicable suit" for the adjustment of their accounts. Sheriff Woods levied on the material in Hancock's tanyard to enforce the judgment obtained from the suit. Clow sought to divert the proceeds of that levy away from Poe to Clow based on the mortgage, and sued the sheriff to force that result. Poe had no notice of the mortgage until the levy was made and Sheriff Wood received notice of it only after he had arrived on Hancock's premises. The mortgage had not been recorded. The legal issue presented was whether the mortgage was good against Poe notwithstanding that failure.

The court held that the mortgage transaction was a per se fraud against creditors and was void under the statute of 13 Elizabeth.[17] That statute

[16] 5 Sergeant & Rawle 275 (Pa. 1819).

[17] need citation

rendered void any conveyance made to the end, purpose and intent of defrauding creditors. Both judges, Gibson and Duncan, issued opinions. The opinion of Gibson cut to the heart of the problem quickly:

> The law will not and ought not to permit the owner of personal property to create an interest in another either by mortgage or absolute sale, and still continue to be the ostensible owner; and where the creating of such an interest is the sole object, the conveyance will be fraudulent, whether it contain a stipulation for retention of possession or not; for to indulge the motive that led to the arrangement, would be against true policy.[18]

Which policy? The clear concern was the ability of the borrower to cheat subsequent creditors:

> But where, from the nature of the transaction, possession cannot be given, the parties ought in lieu, to do everything in their power to secure the public from that deception which the possession of the property, without the ownership, always enables a person to practice.[19]

Duncan's opinion emphasizes the same issues and forecasts the death of credit were a contrary outcome to obtain:

> In chattels, possession is the strongest evidence of ownership. That a secret mortgage to secure a creditor, without any change of possession, the debtor in the daily and constant occupation of the goods, without valuation, or inventory, or specification, accompanying the instrument, should be valid, and bind the property against creditors, or sales made by the debtor without notice, would be a reproach to the law. It ought not, it cannot be so. If it were so, it would put an end to all credit. Credit is given on the faith, that the man who was once the owner of goods, continued the owner, until he parts with the possession.[20]

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[18] Pin cite.

[19] Pin cite.

[20] Pin cite.

Note what this says before turning to whether it is right. The vision presented is that prospective creditors rely on the appearance of ownership of property in making lending decisions. Unlike the real estate system, where the public records provide a chain of title to establish ownership, evidence of ownership of personal property is tied directly to possession of that property. An unrecorded mortgage is therefore a secret lien, and it purports to divide the ownership of the property in a way that is incompatible with the possession of the property.

C. Problems with the Ostensible Ownership Problem Analysis

Now step back to see if this analysis holds up. There is a certain internal incoherence to this system: the problem of mistaken inferences from possession is to be solved by requiring that an effective security interest be created by turning over possession of the property to the secured creditor. This, of course, was the pledge system, where the secured creditor took possession of the property, but did not become the owner of the property. This is the separation of ownership and possession that *Clow* decries, and that the pledge system is defined by.

We should also question the informational assumptions made in *Clow*. The public record is hardly the only source of information about a debtor. Even if Dun & Bradstreet did not have an online service available in 1819, there was probably much "public" information known in small, closely-knit communities. And, we should not discount too quickly the possibility of learning valuable information from the debtor itself. A prospective trade creditor meets with the debtor and inquires about whether the debtor has any outstanding security interests. The assumption in *Clow* must be that the debtor will deny such interests in an effort to lure the trade creditor into providing credit at a lower interest rate than would otherwise be available were the security interest made known. While this may seem obviously right, closer examination suggests that the analysis is less straightforward. First, we should consider the possibility of explicit contractual provisions addressing preexisting security interests, with penalties attached to the breach of such a provision. Many creditors will require an affirmative covenant about the existence of security interests ("Debtor hereby covenants that, as of this date, there are no outstanding security interests against its property"). Although a penalty provision may be of little solace if the debtor is indeed insolvent, we students of failure should not lose

sight of the fact that some businesses actually succeed. The unsecured creditor may learn of the breach eventually—by happenstance or, more systematically, by searching periodically for new financing statements against the debtor—and stick the debtor with the penalty when it has the wherewithal to pay. A sufficiently large penalty—paid when the debtor is solvent—may be enough to induce the debtor to act truthfully.

Penalty clauses have been notoriously difficult to get enforced in the courts,[21] notwithstanding the substantial benefits that might flow from doing so.[22] We should instead ask whether there are other ways to get the debtor to report its situation honestly. We could, for example, as was once contemplated—apparently briefly—impose a duty on the secured creditor to take care to ensure that the debtor tells creditors of the secured creditor's interest.[23] A breach of that duty would give rise to an action for damages against the secured creditor to the extent of the harm suffered and caused by the breach. The existence of the duty should cause the secured creditor to act aggressively to ensure that the other creditors of the debtor learn of its security interest. Implementing this, though, would force litigation over the ever slippery questions of what did the debtor tell to the suing creditor, what did the creditor otherwise know, and what would the creditor have done had the required knowledge been created. These are not questions one could litigate with any confidence, and a legal system should be reluctant to tie outcomes to questions it cannot answer well.

So speak not of duties but incentives. It is possible that creditors would derive substantial comfort from the knowledge that a secured creditor was paying close attention to the debtor. As Gilmore puts it, the other creditors might "benefit[] from the fact that a professional with a substantial stake

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[21] See E. Allan Farnsworth, Contracts §12.18 at 895 (1982).

[22] That said, we shouldn't overstate. Analysis of liquidated damage clauses is quite complex and turns on a group of tricky factors. See Lars A. Stole, The Economics of Liquidated Damage Clauses in Contractual Environments with Private Information, 8 J.L. Econ. & Org. 582 (1992); Alan Schwartz, The Myth that Promisees Prefer Supra-compensatory Remedies: An Analysis of Contracting for Damage Measures, 100 Yale L.J. 369 (1990).

[23] See Gilmore's account of the quick death of the proposal he raised while serving as Reporter for Article 9. I Gilmore, Security Interests in Personal Property, § 15.1, at 464.

in the enterprise was acting as their policeman."[24] Other creditors can reduce their efforts to police the debtor's behavior if they can piggyback on the steps taken by the secured creditor.[25] This means that we can eliminate many steps taken in parallel by trade creditors, for example, and replace them with the efforts of the secured creditor. In this story, the savvy debtor *wants* to disclose that it has a secured creditor, as a way of ensuring other creditors that the debtor will be policed. Debtors, in the fashion of modern homeowners, should post signs stating "[t]hese premises protected by Secured Creditor Co."

D. Inferences and Information Revelation

We have focused so far on whether a debtor with a preexisting security interest would disclose that interest when faced with the inevitable request for a disclosure of all such interests. Another possibility has been put forward, namely, that debtors without preexisting security interests will be eager to show prospective lenders that they have no such interests, and that the activities of these debtors will sufficiently distinguish security-interest free debtors from debtors with encumbered property so as to reveal the latter.[26] Imagine a world with two types of borrowers, those with encumbered property and those without. The assumption here—and this is the same assumption that we saw in *Clow*—is that debtors would like to be seen as unencumbered so as to borrow at lower rates. These unencumbered debtors will make every effort to demonstrate that they have no outstanding security interests. They will open their books, give copies of their correspondence, do anything necessary to convince the prospective lender that there is no prior security interest in place. Debtors with preexisting security interests, goes the story, will not be eager to open their books for inquiry, and in so doing, will signal to the lender that they indeed do have outstanding security interests. Here, silence speaks volumes.

The problem with this, though, is that the borrower with a security interest may not remain silent, but may instead aggressively misrepresent the

[24] I Gilmore, § 8.3 at 261.

[25] See Randal C. Picker, Security Interests, Misbehavior, and Common Pools, 59 U. Chi. L. Rev. 645 (1992).

[26] See Alan Schwartz, A Theory of Loan Priorities, 18 J. Legal Stud. 209, 220-22 (1989).

facts. For the lender to be able to learn who does and does not have an outstanding security interest, the lender must be able to separate borrowers who actually have no outstanding security interests from those who claim to have no outstanding security interests. This is very much in the nature of trying to prove a negative. The lying borrower will have taken steps to hide evidence that would otherwise exist, and, as we have discussed above, penalties tied to a misrepresentation may or may not work. Beyond this, as noted before, the debtor may *want* to disclose its secured creditors as part of a bonding effort to assure its other creditors that they are protected. Of course, you might think, if this story is true, that debtors would be in the business of lying about the existence of a preexisting security interest rather than its nonexistence. (We switch from the horror of the secret lien to the problem of the trumped-up secured creditor.) An answer is that a trade creditor can verify the secured creditor's existence, once it has been disclosed, and only if the secured creditor is colluding with the debtor will we have the problem of fake secured creditors.

We have been considering whether the ostensible ownership problem identified in *Clow* is a substantial as that case suggests and whether its solution—continued reliance on the pledge—makes sense given the problem. The pledge creates an ostensible ownership problem, though one that might be surmounted by widespread knowledge of the customs of secured creditors. We have also looked at the informational assumptions embedded in the ostensible ownership problem analysis. There are certainly ways that contracts might shrink the problem through penalty clauses, thought the law itself has rendered this an ineffective approach. In addition, the debtor may be a source of information, either voluntarily through verifiable disclosures, or involuntarily by comparison with the acts of other debtors in like circumstances. Taken together, this suggests that there may not be a central, unalterable information vacuum about the debtor and that we may not need to be able to infer ownership from possession in the way envisioned by the judges in *Clow*. All of that would support greater reliance on a system of security interests without a separate act of public notice.

II. The Rise of Notice Filing

That is not where we are today. The historical—and current—alternative to all of this, and the direct response to the ostensible ownership problem

described in *Clow*, is to require a security interest to be recorded in the public files. It is understandable why we needed an alternative to the pledge and its requirement of delivery of possession of the collateral. It is foolish to insist on possession of property to create and perfect a security interest if doing so would remove the property from its highest use. Only paper property—instruments or chattel paper perhaps—can be transferred without a substantial loss of use. So some alternative was required.

A. Filing as Public Notice

Filing makes it possible for other creditors to learn of a security interest by creating a way to verify whether property in the debtor's possession is subject to divided ownership, fee simple in the debtor subject to the lien of the secured creditor. Understanding the circumstances where filing actually matters, though, takes some work. It is far from obvious, for example, that public filing addresses the concerns identified in *Clow*, namely that creditors would lend money to the debtor and be deceived as to their rights against the debtor's property. To see this, imagine a system where public recordation of a mortgage makes it effective against both prior and subsequent unsecured creditors. That is a conventional system; indeed, it is Article 9's. Should an unsecured creditor rely on the absence of a recorded mortgage in extending credit? No, of course not. The debtor could grant a mortgage today, the creditor could record tomorrow, and the unsecured creditor would be junior. The yet-to-be-granted mortgage is the ultimate secret lien, and yet nothing prevents a subsequent grant. The requirement of recordation does permit the unsecured creditor to confirm that no creditor enjoys priority at the time the unsecured creditor extends credit, but no assurance of subsequent priority is created. The unsecured creditor is in no position to rely on the state of the record. This was almost certainly the situation in *Clow*. Poe's judgment arose out of his partnership with Hancock, which existed long before the mortgage was granted. As a result, Poe's credit arrangements with Hancock were not influenced in any way by the subsequent mortgage to Clow. Whether the mortgage was recorded or unrecorded has few direct decision-making consequences for Poe, given that the mortgage arose subsequent to the creation of the underlying contingent debt from Hancock.

B. Unsecured Creditors and Record Notice

This substantially undercuts the idea that public filing is an adequate response to the ostensible ownership problem. The unsecured creditor simply cannot rely on the record as it exists at the time of lending to ensure priority. Priority can be lost—legitimately—through subsequent events. Now ask whether we substantially change the risks faced by an unsecured creditor if we allow priority not only for security interests granted and recorded after the fact—and of course for security interests granted and recorded before the unsecured debt arises—but also for unrecorded security interests, both subsequent and earlier. Again, a subsequent security interest does not effect the unsecured creditor's lending decision, and how we split the assets between an unsecured creditor and a subsequent unrecorded secured creditor is just a question of distribution. So consider the best case for the unsecured creditor: a contest between the unsecured creditor and a secured creditor asserting priority based on an earlier unrecorded security interest. The unsecured creditor might contend that had it known of the earlier security interest, it would not have lent money to the debtor. The unsecured creditor has behaved foolishly if that is true. Nothing would prevent the debtor from granting a mortgage after the unsecured creditor had lent money, and that would have the same distributional consequences for the unsecured creditor as recognizing a prior unrecorded security interest.[27]

The point of this is that recordation of security interests should be relatively unimportant for decisions by unsecured creditors to extend credit.[28] Filing, therefore, does not appear to be a meaningful response to the heart of the ostensible ownership theory, which is that unsecured creditors extend credit based on the appearance of ownership. We thus need some other basis for why perfection is important. Unsecured creditors make other decisions, though, and we should determine whether public recordation of security interests might influence those decisions in a useful way. Consider, for example, how an unsecured creditor goes about getting paid

[27] Assuming, of course, that the new mortgage would not be overturned as a preference under Section 547 of the Bankruptcy Code in a subsequent bankruptcy.

[28] Indeed, it has been suggested that unsecured creditors rarely check the public records when they make their lending decisions. See Douglas G. Baird, Notice Filing and the Problem of Ostensible Ownership, 12 J. Legal Stud. 53 (1983)

when a debtor has refused to pay. The unsecured creditor must decide whether to undertake the costly steps required under state law to turn a debt due into a judgment, with the ultimate goal of executing on that judgment.

What does the creditor accomplish in running this process? The private benefit to the creditor, of course, is that the creditor increases the likelihood that it will get paid. The broader public benefit is that, in theory at least, lien creditors provide a public service to their fellow creditors by levying on property. The levy will become known to the debtor's creditors quickly and will let them know in no uncertain terms that the debtor's business is in financial difficulty. Creditors can piggyback on the monitoring efforts of their fellows creditors by reacting after the levy. The levy will trigger a substantial contraction of the credit available to the debtor: suppliers will seek to collect and may not extend new credit, other creditors may pursue levies of their own. This is a familiar dynamic, and it will often lead to a bankruptcy filing.

We should pause to consider whether this is a good thing. The conventional wisdom is that debtors on average file for bankruptcy too late. If that is right, we should look for ways to get debtors to file for bankruptcy at the right time.[29] A contraction of credit may be socially useful; the debtor is denied additional dollars that it might otherwise dissipate and value already in the debtor's hands is preserved. Providing information about the debtor could serve an important function along this road. A reason to proceed cautiously here, though, goes to the question of how disparate information is aggregated in small situations such as this one. It is possible that creditors will attach too much weight to the new information, will discount their own information, and that, lemming like, all the creditors will rush in to dismember the debtor. This "herd behavior" might happen as part of a chain of individually rational inferences, even though were the totality of information available to the creditors aggregated appropriately, they might conclude that the debtor should not be in bankruptcy.[30] This tells us that encouraging a public step such as a levy is not necessarily the

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[29] See Randal C. Picker, Voluntary Petitions and the Creditors' Bargain, 61 U. Cinn. L. Rev. 519 (1992).

[30] See Douglas G. Baird, Robert H. Gertner and Randal C. Picker, Game Theory and the Law 213-17 (Harvard Univ. Press, 1994) for discussion and additional citations.

right thing to do. Nonetheless, you have to make a call sometime, and my guess is that doing so is useful.

C. Priority and Marginal Incentives

Were we to eliminate the priority that lien creditors enjoy over unperfected secured creditors, would they have the incentive to provide the information that the levy conveys? The monitoring and other actions that lead to the levy are costly, of course, and must be compensated, or they will not be undertaken. If we eliminated the lien creditor priority of R § 9-317, the lien creditor's filing would always be junior to the priority of the preexisting unperfected secured creditor. That is offset in part by the fact that the lien creditor's interest becomes senior to the rights of unsecured creditors. The empirical question presented is whether unsecured creditors need the extra incentive provided by the ability to achieve priority over an unperfected secured creditor to induce them to provide the information that the levy provides. I don't know the answer, but it is certainly the case that one effect of the priority given to judgment lien creditors over unperfected secured creditors is to give them a means of recovering the costs they undertake in making the levy. If the secured creditor is always senior, even if unperfected, we have reduced the probability that the lien creditor will be able to recover its enforcement costs and get any benefit from its newly-earned priority over unsecured creditors.[31] Even under the current rules, lien creditors will often levy only to discover that the prior claim of a secured creditor exhausts the value of the property. This problem would be exacerbated if we allowed the unperfected security interest to have priority as well. Therefore, a possible justification for the rule that a secured creditor must file to perfect to have priority over unsecured creditors is that it makes it more likely that an unsecured creditor will recover the costs of levying, and will therefore take that step, to the benefit of all creditors.[32]

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[31] Of course, Section 547 of the Bankruptcy Code may be the most severe limit on this incentive, as it may allow the trustee to avoid many prepetition levies.

[32] Note that this suggests that we should be careful about carrying over this rule into bankruptcy, as we currently do through the hypothetical lien creditor power created in section 544(a) of the Bankruptcy Code. The dominant view of bankruptcy argues that nonbankruptcy entitlements should be mapped into bankruptcy and justifies allowing the trustee in bankruptcy to avoid unperfected security interests on those grounds. See Thomas H. Jackson, The Logic and Limits of Bankruptcy Law 70-75 (Harvard Univ.

D. Structuring Competition Among Creditors

So far we have focused on the consequences of perfection—or its absence—for *unsecured* creditors. Perhaps we should be looking in another direction, namely, to what perfection means for other *secured* creditors. We argued earlier that perfection had no necessary relationship to priority. What then does perfection say? Perfection is about notice—easily evidenced, or verified, notice—which in turn is about how we organize the competition that takes place among creditors. Focus on perfection through filing a financing statement. For the competition between secured creditors in creating a security interest, a new secured creditor need only check the public records to see which secured creditors may be prior to its new interest. The act of perfecting is fused with the act of determining priority, and all of this can be done in a single, simple transaction. Filing the financing statement draws relatively bright lines of demarcation for secured creditors and allows them to stake out their rights against the debtor.[33]

This is an important and more general notion. The rules of secured transactions play a part in structuring, or organizing, the resulting competition that occurs among creditors, both initially when security interests are created, and, perhaps more importantly, when the firm fails and its assets are at risk.[34] The easiest way to think about this is to recall the childhood game, musical chairs. As you will recall, the game involves children walking around a circle of chairs while music plays. The music stops, and the children scramble to find a seat. Round by round, one chair is removed, so that one child is left standing. That child exits the game, the remaining children stand, the music restarts and another chair is removed from the game. The game continues until we are left with two players, one chair and a final fight over the last chair to determine the winner.

Press, 1986). The analysis in the text suggests that R§ 9-317(a)(2)'s importance is in the pre-bankruptcy period when we are concerned about creating public information about the debtor so as to induce appropriate decisions about filing for bankruptcy. That need vanishes once the bankruptcy has been initiated. Nonbankruptcy rules designed to get us to the collective proceeding in the right fashion and at the right time need not be carried over into bankruptcy.

33 See Baird, supra note xx,.

34 See Picker, supra note, xx.

Musical chairs is about scarcity, a very structured scarcity to be sure, but scarcity nonetheless. Ask how the play of the game would change as we altered the rules for allocating chairs. Suppose that some players were allowed to reserve chairs ahead of time: how would that influence the play of the game for those players and for the other players? Suppose that other chairs could not be subject to such a reservation: how would that effect competition for those chairs?

Ask the same questions about competition among creditors for the assets of the failing firm, and focus on the way that the secured transactions rules can influence that competition. The instruments we might draw upon to do this might be the cost of creating secured transactions; the scope of assets subject to a security interest; and whether the effectiveness of a security interest is absolute or dependent on the resolution of one or more contingencies. For example, the costs of undertaking a secured transaction might be influenced quite directly by the setting of a fee for the filing of a financing statement. A high fee would discourage secured transactions, a low fee, encourage them. Different fees for different asset types—say, low fees for equipment and high fees for deposit accounts—would tilt the tables in favor of security interests in one asset and against security interests in a second.

Lest this be thought of as bizarre, we should remember that this is effectively the world we have lived in, once we note that filing fees are not the only costs associated with secured transactions. U.C.C. § 9-104's general exclusion of deposit accounts from Article 9's coverage meant that security interests in deposit accounts were created in reliance on nonuniform law, a leftover from the days before Article 9's systematization of the law of secured transactions. It was on average easier and therefore cheaper to create a security interest in equipment, which, of course, was covered under Old Article 9, than it was to create a security interest in excluded deposit accounts. The exclusion of deposit accounts created the two-tier cost structure described before, and cost and exclusion operate as linked policy instruments.

Cost differentials undoubtedly influence the competition that takes place among creditors. Fewer security interests were taken in deposit accounts under the nonuniform system; this meant that there was a greater chance of a ready pool of assets available in a bankruptcy to fund the administrative apparatus required to run such a bankruptcy. Changing Article 9 by making it possible to take a perfected security interest in a deposit account

creates new uniformity and reduces the cost of taking security interests in deposit accounts. How much that cost is reduced turns directly on the method of perfection used for deposit accounts.

E. Matching Collateral and Creditors: Reliance and Non-Reliance Creditors

Cost differentials not only influence whether assets are available to priority and unsecured creditors; they also influence the match that takes place between assets and particular secured creditors. If there is no marginal cost for taking a security interest in a deposit account, we should expect many creditors to take deposit accounts. Making security interests in deposit accounts perfectible through filing might have had that effect in most transactions. The fixed cost is the filing itself, not the amount of information that goes on the filing.

This is turn could influence the amount of credit available to borrowers, and could, paradoxically, reduce the amount of credit available. Given our desire to protect the integrity of the payment system, money leaving a deposit account will leave free of the security interest, at least if this takes place in the ordinary course of business.[35] If I get cash out from an ATM and buy dinner, the restaurant needs to be able to receive the cash free and clear of preexisting security interests. As a result, absent a fair degree of monitoring or preplanning, a secured creditor cannot depend on receiving anything from the deposit account. For a secured creditor to be willing to undertake this preplanning, it must have a way of getting a return on its costs. A prior filed statement covering the deposit account would reduce the incentive of a subsequent secured creditor to incur the planning costs required to capture value in the deposit account. This will either require the subsequent secured creditor to negotiate a subordination agreement as to the deposit account with the first creditor, or to simply decline to lend in reliance on the deposit account. We have mismatched priority in the deposit account: the non-reliance creditor has priority, while the reliance creditor would have been junior. The non-reliance creditor did not extent credit based on the deposit account—it had no plans to monitor the account and would just take whatever was in the account when the debtor got in financial trouble—while the reliance creditor refuses to extend

[35] See, e.g., J. I. Case Credit Corp. vs. First National Bank, 991 F.2d 1272 (7th Cir. 1993).

credit, as it cannot be assured of a return on the costs necessary to make reliance sensible, given the existence of the priority non-reliance creditor. To say that the two creditors should negotiate a subordination agreement is to give only a partial response, at best, as this will often be quite costly.

We should ask why the debtor agreed in the first place to give the security interest in the deposit account to the non-reliance creditor. It was suggested above that the marginal cost of creating the security interest in the deposit account was zero, given that a security agreement and financing statement were already in the works. But, you might respond, that focuses only on the ministerial costs of creating the interest; from the debtor's perspective, the biggest cost should be the borrowing opportunities lost from giving this security interest. In this story, the debtor has given something of little value to the non-reliance creditor and seems to have received nothing in return. The debtor would have been better off to save the security interest in deposit accounts for the later reliance creditor. So why was the security interest given to the non-reliance creditor? In consumer transactions and in many small-business commercial transactions, many people would not regard this as a particularly meaningful inquiry. These would be described as contracts of adhesion—take it or leave it contracts—without any meaningful possibility of negotiation.[36]

But the problem may be even more fundamental. Suppose we have two types of borrowers. Some borrowers will have little understanding of the contracts and will not seek to negotiate over details. They will make decisions over those items they do understand readily—perhaps price—and will ignore the rest. Other borrowers will have the knowledge and ability to negotiate but may be unwilling to do so. Borrowers that do understand the contracts may risk signaling to a prospective lender—by negotiating over the scope of the security interest—that they will aggressively pursue their rights against the lender. The lenders, as a group, may prefer to screen out these aggressive borrowers, as they may be higher-cost borrowers to deal with. A lender might offer two contracts, a contract with the deposit account clause, and lower fees, and a second without the deposit account clause, and higher fees. Ignorant borrowers would decide on price and would accept the contracts with the deposit account clause. What would the informed borrower do? Such a borrower might lose more from being separated from the ignorant—which would identify the borrower as

[36] See E. Allan Farnsworth, Contracts §4.26 at 295 (1982).

an aggressive borrower—than she would gain from avoiding the deposit account clause, so she might accept the contract with the deposit account as well. Put differently, aggressive borrowers may prefer to be pooled with more passive borrowers.

We should be clear about the source of the market failure here. Cross-subsidization drives this for the informed borrowers. They want to avoid being known as such so they can dump off on ignorant borrowers some of the costs they will later impose on lenders, and that will, in turn, be passed through to consumers. In the pooling outcome, these costs are borne by all consumers—the ignorant subsidize the knowing as to these costs—when they are passed on to consumers by lenders. The only question is which contract will result in the pooling equilibrium. We could easily end up in the inefficient deposit account contract where the non-reliance creditor takes the security interest in the deposit account. If the costs of taking the security interest in deposit accounts were higher, the non-reliance creditor might not do so, the reliance creditor could then do so, as it would have priority and could recover the policing costs for the deposit account, and more credit would be available.[37]

IV. Perfection Hierarchies

I have suggested that permitting filing of security interests against deposit accounts as original collateral might have had the perverse effect of reducing the availability of credit as compared to the prior nonuniform system for taking security interests in deposit accounts. This story shows two possible policy instruments at work, differential costs by collateral type, and exclusion from Article 9 as a clumsy way of creating costs differentials. It might be possible to include deposit accounts in Article 9, increase uniformity and reduce transaction costs without reducing available credit in the way described above. Indeed, this is perhaps exactly what has been done in Revised Article 9 by insisting that a secured creditor take control

[37] An alternative characterization might be that the cross-subsidy is the way in which the ignorant consumers compensate the knowing for actions by the latter that redound to the benefit of the former. This turns on the question of to what extent the actions by the knowing that induce the higher costs redound to the private benefit of the knowing consumer and to what extent they spillover to benefit all consumers.

over a deposit account to have a perfected security interest in it as original collateral.

A. Restoring the Right Match

In the non-uniform system under Old Article 9, deposit accounts as original collateral were matched with reliance creditors through the high costs that had to be incurred to create a perfected interest. By bringing deposit accounts into Article 9 but maintaining a marginal cost for perfecting the security interest in deposit accounts, we may have achieved the same successful match. The requirement that the secured creditor take control over the deposit account to perfect its security interest in it as original collateral does exactly this. The higher costs associated with control will reduce the chances that secured creditors will take casually a security interest in deposit accounts.

Note that, for these purposes, it would have been sufficient to have embraced the idea of a perfection hierarchy completely, as we have done for investment property, letters-of-credit rights and electronic chattel paper. We could have permitted a secured creditor to perfect a security interest in a deposit account through filing, but allowed a secured creditor who subsequently took control over that deposit account to trump the first secured creditor's position. Such a two-tiered perfection approach would have made it possible for a later secured creditor to obtain priority over an earlier-filed secured creditor without negotiating a subordination agreement with that creditor. As noted before, this priority may be essential for the reliance creditor to be able to obtain value from the deposit account, and therefore essential if the creditor is to lend against that asset. Such a two-tiered priority scheme—and recall that this is the one we have embraced for investment property, letter-of-credit rights and electronic chattel paper—would have made it possible to get the right match between potential collateral and secured creditors with an attendant expansion of credit. The critical question, though, for this to work, is whether the costs of obtaining control—really the marginal costs relative to filing—are sufficiently large so as to discourage the non-reliance creditor from taking control.

If we step back and ask what the secured transactions system should seek to achieve, we might want priority devices that had different costs for different creditors so that the appropriate collateral match was achieved. The opposite extreme—identical costs of creating priority positions as against the relevant assets—runs the risk of substantial mismatches of col-

lateral and creditor, with an overall reduction in the level of credit available. Financing statements are in a basic sense the great cost leveler. The marginal cost of perfecting (and absent a multi-tiered perfection/priority system, of achieving priority as to) a security interest in additional collateral is zero. Only by reintroducing a marginal cost do we make it possible to correctly match creditors and collateral.

B. The Role of Control

The decision to not allow filing against deposit accounts reflects other interests unrelated to structuring competition among secured creditors. Instead, this reflects a judgment that a non-reliance secured creditor who does not take control over the deposit account has no legitimate claim to whatever value happens to be found in that account on some settling date. Of course, we do not insist that secured creditors take control of collateral generally, so the basis for distinguishing deposit accounts from, say, inventory or accounts, is not immediately obvious. We therefore should turn to assessing the role of control in secured transactions more generally.

Control has important historical roots in secured transactions in the United States and continues to play a deciding role in the British system of secured transactions. Dominion over the collateral was precisely the issue at stake in what is perhaps the best known decision in early U.S. secured transactions law, that in Benedict v. Ratner, 268 U.S. 353 (1925). It is worth recounting the facts of that case. Slightly four months before its eventual demise, the Hub Carpet Company purported to assign all present and future accounts to one Ratner to secure certain loans made by him to the company. Accounts in existence at the time of the original deal were enumerated in a listing given to him then. Every month thereafter, Ratner received a listing of new accounts arising since the last listing. Benedict, who took over initially as receiver and then as trustee in Hub Carpet's bankruptcy, challenged the assignment as fraudulent against creditors and therefore void.

Although Ratner had the right to insist that proceeds of the receivables be paid over to him, Hub had no duty to do so absent a demand. Indeed, Hub had the right to use the proceeds as it saw fit, to buy new inventory to create new receivables or to squander the money on worthless investments. Of course, everyone expected Hub to buy new inventory with the proceeds. The standard cycle is to borrow money, buy inventory, sell it and

thereby create receivables, collect the receivables and plow the money back into the business.

Ratner argued that the doctrine of ostensible ownership did not apply to accounts receivable. As intangibles, there was nothing for other creditors to observe, and therefore no basis for confusion from "ostensible ownership." The Court pushed this aside quickly and honed in on Ratner's failure to control the proceeds of the receivables:

> But it is not true that the rule stated above and invoked by the receiver is either based upon or delimited by the doctrine of ostensible ownership. It rests not upon seeming ownership retained, but upon a lack of ownership because of dominion reserved. It imputes fraud conclusively because of the reservation of dominion inconsistent with the effective disposition of title and creation of a lien.[38]

It is the "unrestricted dominion over the proceeds" which is dispositive in defeating Ratner's claim. The Court makes clear the steps Ratner should have taken to preserve his position:

> Where the mortgagor of chattels agrees to apply the proceeds of their sale to the payment of the mortgage debt or to the purchase of other chattels which shall become subject to the lien, the mortgage is good as against creditors, if recorded.[39]

So record, and insist upon payment or the purchase of new receivables.

Step back and consider the decision on the merits. On one view, the Court tossed a major wrench into the basic gears of secured transactions. Receivables are the proverbial Heraclitan river, ever changing yet remaining the same. The floating stock of receivables changes, to be sure, day by day, but the individual items comprising the mass aren't the issue, the mass itself is. If a secured creditor cannot get an effective security interest on after-acquired receivables, we have removed an important source of collateral for supporting loans.

Of course, *Benedict* didn't say anything like this. Instead, the decision merely insists that secured creditor police its debtor—control the debtor—

[38] Pin cite.

[39] Pin cite.

if the security interest in receivables is to be effective. *Benedict* provides a road-map as to how to make these transactions effective. Indeed, lawyers were sufficiently successful that a robust industry in these arrangements arose. Nonetheless, the costs of these arrangements were ultimately seen to outweigh the benefits. In the drafting of Old Article 9, *Benedict* was overruled by statute;[40] a fully-effective security interest could be granted in present and future receivables and the secured creditor need not police how the proceeds of these receivables are used.

It is interesting that the British system of fixed and floating charges is tied directly to these issues of control, and comes out squarely in favor of the regime defined by *Benedict* and abandoned by Article 9. In the British system, the freedom given to the debtor in the use of the charged property—the collateral—determines whether property may be subject to a fixed or a floating charge. Property that the debtor holds and uses but does not intend to transfer to third parties can be subject to a fixed charge.[41] Equipment is a natural example: the debtor uses the equipment and in the ordinary course of business intends to hold it. After registration of the fixed charge—public recording—third parties take the property subject to the fixed charge. This is true both for purchasers and for execution creditors. Both of these results track the Article 9 rules for a security interest in equipment, as such a security interest would survive a sale, see R § 9-315(a)(1), R § 9-320(a), and would be prior to the interest of a lien creditor.

In contrast, assets that the debtor deals with freely as to third parties—inventory is the key example—cannot be subject to a fixed charge and may only be subject to a floating charge.[42] The floating charge is in some sense inchoate: it is not effective against buyers and execution creditors prior to an event known as crystalization. As to these charges, Article 9 and the British system are in sync for buyers in the ordinary course. R § 9-320(a) cutoffs a security interest in inventory, while the British buyer is not subject to the uncrystalized floating charge.[43] The key difference is the treat-

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[40] See U.C.C. § 9-205 and its official comments.

[41] See R.M. Goode, Legal Problems of Credit and Security 9 (Sweet & Maxwell, 2nd ed. 1988).

[42] Id. at 15.

[43] Id. at 52.

ment of a lien creditor. The Article 9 security interest in inventory is good against the lien creditor, both genuine lien creditors under R § 9-317(a) and hypothetical lien creditors under section 544 of the Bankruptcy Code. The uncrystalized floating charge is not good against a lien creditor nor is it spared from the invasion of claims given a statutory preference in a liquidation.[44] The structure of this system means that a group of assets—those that can be subject to no more than a floating charge—are always up for grabs. The holder of the floating charge can lose out to execution creditors prior to crystalization.

In this scheme, the control that the debtor exercises over inventory prevents the secured creditor from having a fully effective charge against those assets. This is similar in many ways to the scheme contemplated by *Benedict*, and all of this suggests that we should be cautious in embracing Article 9's choice in favor of perfected floating security interests on inventory and receivables without the secured creditor exercising some control over the collateral.

In fact, we might say more. Until very recently, Article 9 has had two primary ways of perfecting a security interest, filing and possession. Although filing may be an acceptable substitute for possession as to the notice provided to third parties, it is a very poor stand-in for possession when it comes to exercising control over the collateral. For the debtor to give up possession of the collateral also entailed giving up control over the collateral and assured all creditors of the debtor that the debtor could not misuse the asset. In contrast, filing has no direct consequence for control. The filed secured creditor can ignore the debtor and still enjoy priority based on its earlier financing statement.

Perfection through possession is in many ways a holdover from secured transaction's days in the primordial soup. It has been used only infrequently as an instrument of policy for influencing outcomes, U.C.C. § 9-308 being the prime example. That has left us with only one policy instrument, the financing statement, and we have done nothing with that, such as having different filing fees for different asset types or for situations where a creditor was taking a security interest in more than one asset type. (Fees could follow a step-ladder: take one asset type, pay once price, take two asset types, pay more, etc.) We also could introduce control much more generally into Article 9 and use that as a policy instrument, and, to

[44] Id.

some extent, Revised Article 9 has done so. As suggested above, control might ensure that we avoid mismatches between collateral and reliance and non-reliance creditors. To a large extent, reliance and control should travel together. In the deposit account example, the non-reliance creditor exercised no control over the deposit account but hoped to reap the benefit of the reliance creditor's control efforts. Of course, under plausible conditions, that means that no one exercises control, and hence the pool of assets available as collateral shrinks.

We can let our imaginations run as to the ways that control might be used. Consider two schemes briefly. We could expand the financing statement records to embrace control and non-control creditors (or active and passive secured creditors, if you prefer). The financing statement would permit a designation of the type of creditor. Passive creditors—either so designated or as the default designation—could be subordinated to later-filing active creditors, again by identification on the financing statement. Of course, all creditors would want to be active creditors, absent a kicker, so the real question becomes what it should be. We could use filing fee differentials. This scheme is a before-the-fact designation scheme for control. An alternative is to allow a competitive market in exercising control to evolve, with after-the-fact judicial evaluation of the contributions made by the creditors in exercising control over the debtor. We get some of that already now, since control is one of the indicia giving rising to liability in lender liability litigation.[45] We would want to distinguish bad control—typically relating to direct control over the decisionmaking of the debtor—from good control, which focuses on the treatment and use of the collateral.

V. Conclusion

Possession long ago ceased to be a meaningful instrument for implementing secured transactions policy. The move every day to electronic transactions means that we need to find a substitute instrument, and control is the natural successor to possession. Having two robust perfection methods—filing and control—makes it possible to embrace a strong scheme of perfection hierarchies and to move back from the elemental rule of U.C.C. § 9-

45 Cite.

312(5). Revised Article 9 has taken careful, small steps down this path, as befits the natural conservatism associated with large-group law reform. This also takes us away from temporal priority, and to one that tracks the desire for secured creditor attention to collateral seen in *Benedict v. Ratner*. We should be willing to embrace perfection hierarchies tied to control. In reaching that conclusion, this Article has emphasized the following points:

- *Inducing Fidelity through Penalties.* Creditors insist that their debtors tell them about outstanding security interests. Absent a legal bar, these representations and warranties could be tied to a penalty clause. Creditors would then invest resources in determining whether the debtor had breached its promise, and the threat of enforcement of the clause against the debtor in good times might induce the debtor to comply with its promise. This approach is limited, though, by legal limits on the use of penalty clauses.
- *Voluntary Disclosure of Prior Secured Creditors.* Debtors might *want* to disclose the existence of a prior secured creditor. Secured creditors play a policing role that may redound to the benefit of all creditors.
- *Filing's Beneficiaries: Unperfected Security Interests and Lending Decisions by Unsecured Creditors.* Unsecured creditors should not key their lending decisions to the state of the public filing record against the debtor. Unsecured creditors always face a loss of priority to a later secured creditor. There is therefore little reason to think that public recordation of security interests is important for the lending decisions of unsecured creditors.
- *The Levy as Public Good: Unperfected Security Interests and Enforcement Decisions by Unsecured Creditors.* This may not be true of enforcement decisions. Unsecured creditors may consult the public records before undertaking involuntary collection to see if there are any free assets available. If secret security interests—unperfected security interests—were effective against a levying unsecured creditor, we would make it less likely that an unsecured creditor would bother to collect. That might be a bad thing, as a levy conveys valuable information about the debtor to other creditors.

- *Structuring Competition Among Creditors.* Public filing rules help define the structure of competition that takes place among creditors, both for lending and for monitoring and enforcement.
- *Cost Differentials and the Scope of Security Interests.* Having collateral subject to Article 9 and its rules covering financing statements makes the cost of creating and perfecting a security interest the same for all creditors. Excluding collateral from Article 9—as we have traditionally done with deposit accounts—creates cost differentials among creditors.
- *Matching Collateral and Creditors: Reliance and Non-Reliance Creditors.* Cost differentials can help match collateral with creditors. Absent a cost, creditors may take too much collateral. Uninformed borrowers will ignore the scope of the security interest sought, while informed borrowers may be reluctant to tip their hands by negotiating over the scope of the security interest. An initial creditor may take a very broad security interest without any intent of taking the steps necessary to ensure a return on some of the collateral. At the same time, the breadth of the security interest taken by the non-reliance creditor may impair the ability of a reliance creditor to obtain a return on its investment in monitoring collateral. All of this shrinks the credit available to the debtor.
- *Perfection Hierarchies.* A perfection hierarchy may solve this problem. Let perfection through filing vest priority rights against one class of creditors, say unsecured creditors and lien creditors. At the same time, create a second method of perfection—say, control—that makes it possible for a second creditor to jump ahead of the filed secured creditor. If this second method of perfection is sufficiently costly, we will discourage non-reliance creditors from using it, and thereby create a way for reliance creditors to recover on their efforts by allowing them to obtain priority. This structure does a better job of matching collateral taken and reliance on it, assuming that control is a good proxy for reliance.