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The Truth About Secured Financing

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THE TRUTH ABOUT SECURED FINANCING

Robert E. Scott†

- I. ASKING THE RIGHT QUESTIONS..... 1440
 - A. Why Do Debtors Issue Security? 1440
 - 1. *What Theory of Finance Explains Why (And Predicts When) Debtors Will Issue Secured Debt Rather than Unsecured Debt or Equity?*..... 1440
 - 2. *Does a Later Security-Financed Project Reduce the Value of Earlier Unsecured Claims (And Would Positive Value Projects Be Financed in a World Without Security)?*..... 1441
 - 3. *What Are the Effects of Systematic Nonadjustment by Earlier Unsecured Debt on the Increased Nonpayment Risk Caused by Subsequent Secured Debt?*..... 1443
 - B. What Explains the Peculiar Patterns of Security We Observe and the Regulatory Scheme that Influences Those Patterns?..... 1443
 - 1. *When Do Debtors Issue Secured Debt and Why Do They Say that They Do It?*..... 1444
 - 2. *What Explains the Patterns of Regulation Embodied in Article 9 of the UCC and the Bankruptcy Code?*... 1444
 - 3. *To What Extent Does the Political Economy of the UCC and the Bankruptcy Law-Making Process Influence Regulatory Outcomes?*..... 1446
- II. WHAT WE DO (AND DO NOT) KNOW ABOUT SECURED DEBT 1447
 - A. The Search for a Theory of Secured Finance 1448
 - 1. *A Promising Beginning: Using Leverage to Respond to the Problem of Risk Alteration* 1448
 - 2. *Using Leverage to Reduce Underinvestment Conflicts* . 1453
 - 3. *Testing the Theory of Leverage Against the Rules of Article 9*..... 1454
 - B. Theory v. Practice: Explaining Observed Patterns of Secured Debt..... 1456

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- C. Market Imperfections that Support the Redistributive Story: The Nonadjustment Phenomenon 1458
- D. The "Discontinuity Assumption": Secured Debt as the Only Method of Financing Positive-Value Projects 1460
- III. NORMATIVE IMPLICATIONS 1462

The debate over the social value of secured credit (and the appropriate priority for secured claims in bankruptcy) is entering its nineteenth year. Yet the continuing publication of succeeding generations of articles exploring the topic have yielded precious little in the way of an emerging scholarly consensus about the nature and function of secured credit.¹ Put simply, we still do not have a theory of finance that explains why firms sometimes (but not always) issue secured debt rather than unsecured debt or equity. Moreover (and perhaps because of the lack of any plausible general theory), we lack any persuasive empirical data to predict whether, in any particular case, a later security-financed project will generate sufficient returns to offset any reduction in the value (i.e., the bankruptcy share) of prior unsecured claims.

¹ For a review of the early debate, see F.H. Buckley, *The Bankruptcy Priority Puzzle*, 72 VA. L. REV. 1393 (1986); Thomas H. Jackson & Anthony T. Kronman, *Secured Financing and Priorities Among Creditors*, 88 YALE L.J. 1143 (1979); Saul Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 YALE L.J. 49 (1982); Alan Schwartz, *A Theory of Loan Priorities*, 18 J. LEGAL STUD. 209 (1989); Alan Schwartz, *Security Interests and Bankruptcy Priorities: A Review of Current Theories*, 10 J. LEGAL STUD. 1 (1981); Alan Schwartz, *The Continuing Puzzle of Secured Debt*, 37 VAND. L. REV. 1051 (1984) [hereinafter Schwartz, *The Continuing Puzzle*]; Robert E. Scott, *A Relational Theory of Secured Financing*, 86 COLUM. L. REV. 901 (1986); Paul M. Shupack, *Solving the Puzzle of Secured Transactions*, 41 RUTGERS L. REV. 1067 (1989); James J. White, *Efficiency Justifications for Personal Property Security*, 37 VAND. L. REV. 473 (1984).

A second generation of articles added new voices, but little in the way of an emerging consensus. See Barry E. Adler, *An Equity-Agency Solution to the Bankruptcy-Priority Puzzle*, 22 J. LEGAL STUD. 73 (1993); Richard L. Barnes, *The Efficiency Justification for Secured Transactions: Foxes with Soxes and Other Fanciful Stuff*, 42 KAN. L. REV. 13 (1993); James W. Bowers, *Whither What Hits the Fan?: Murphy's Law, Bankruptcy Theory, and the Elementary Economics of Loss Distribution*, 26 GA. L. REV. 27 (1991); Steven L. Harris & Charles W. Mooney, Jr., *A Property-Based Theory of Security Interests: Taking Debtors' Choices Seriously*, 80 VA. L. REV. 2021 (1994); Hideki Kanda & Saul Levmore, *Explaining Creditor Priorities*, 80 VA. L. REV. 2103 (1994); Lynn M. LoPucki, *The Unsecured Creditor's Bargain*, 80 VA. L. REV. 1887 (1994); Randal C. Picker, *Security Interests, Misbehavior, and Common Pools*, 59 U. CHI. L. REV. 645 (1992); George G. Triantis, *Secured Debt Under Conditions of Imperfect Information*, 21 J. LEGAL STUD. 225 (1992).

A third generation of scholarship has appeared within the past year. See, e.g., Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857 (1996); Ronald J. Mann, *Explaining the Pattern of Secured Credit*, 110 HARV. L. REV. 625 (1997). The articles in this Symposium will no doubt add more fuel to the fire. To date, there is little evidence that anyone has tried to review the literature for any purpose other than to assert that most (if not all) prior contributions are flawed.

The security debate has generated more heat than light because the opposing sides have divided primarily along methodological rather than normative lines. As a result, each side has generally failed to learn from, and adjust to, the legitimate insights offered by the other. But although we have much to learn, there is much about secured financing that we already know. In this Article, I build upon the existing scholarship and seek to answer three questions. First, what are the right (and the wrong) questions to ask if we are to advance our understanding of secured credit and its appropriate priority? Second, what do we know (and not know) about the answers to any of these questions? Third, what normative stance is justified in a world of uncertainty in which many of the key questions are unlikely to be answered for some time (if ever)?

Before I proceed, however, one needs first to separate and classify the participants in this debate. The division, perhaps predictably, is between those who believe that truth comes from the top down (the theorists) and those that believe that truth is built from the bottom up (the empiricists or contextualists). These categories are quite broad, however. Some of those who begin with theory have sought to test their claims against available evidence, while some of those whose beliefs are shaped by experience and context have sought to critique the theory on its own terms. In neither case, however, have these forays into the other domain been very successful. Moreover, because the divide is methodological, the participants rarely join issue on particular normative claims. Some theorists are skeptical about the efficiency claims of secured credit, while others have sought to fashion positive theories that purport to explain some (or all) of the patterns of financing that we observe. On the other side, a common hostility toward (or skepticism about) economic theory joins together those who passionately defend the institution of secured credit as a major contributor to social welfare with those who seek to restrict the priority granted to secured interests in bankruptcy. The end product of this strange conversation has been a tendency to recycle old ideas and old criticism and to pay more attention to the methodological warfare than the search for truth. In the process, the few genuine insights that the debate has generated—both empirical and theoretical—have largely been overlooked.

The Article proceeds as follows. In Part I, I identify the necessary and sufficient questions that we must ask (and answer) before we can resolve the issues that divide us. These questions can be grouped conveniently into two separate categories. The first set of questions are conceptual. Each seeks to respond to the inquiry: why do debtors issue security? The second set of questions are observational: what explains what we see? Only by working to resolve both sets of ques-

tions can we begin to understand the nature and function of secured credit.

I use this framework in Part II to focus on what we do (and do not) know about secured financing. I conclude that the best theoretical explanation for secured credit that survives observation centers on the unique advantages of leverage over the debtor provided by the foreclosure options given to secured creditors in Article 9. The leverage of secured credit is used to solve several different contracting problems for certain classes of debtors and creditors. These solutions carry both social and private benefits as well as offsetting costs. The social benefits derive from the ability of security-created leverage to control vexing problems of overinvestment and underinvestment that are ubiquitous in financial contracting. The private benefits derive from the use of leverage to improve repayment probabilities vis-a-vis other creditors. Unhappily, the costs of security are high, and thus, security is observed in the world only where the social and private benefits work in combination. This combination of social and private benefits means that the answer to the question whether secured credit does (or does not) promote social welfare is both currently unknown and unknowable.

Finally, in Part III, I offer some views about which normative claims should reveal in a world of uncertainty. Some claims for restricting the priority of secured credit (either in bankruptcy or by amendment to Article 9) rest on distributional fairness. To the extent that secured credit redistributes wealth, that redistribution is largely regressive. Thus, the normative bite of any claim grounded in distributional fairness turns largely on the perceived inadequacy of the Article 9 filing system to alert unsophisticated debtors to the risks of subordination. Other arguments for limiting the priority of secured claims rest on the potential inefficiencies of secured financing. The available evidence suggests that secured credit may generate net inefficiencies, but the magnitude of those inefficiencies is unknown. In a world of uncertainty, therefore, I argue that the intellectual burden of proof should turn on an analysis of the political economy of both the Article 9 and bankruptcy lawmaking processes. Will the lawmaking processes that shape both Article 9 and the Bankruptcy Code enact optimal legal rules, assuming they can be identified *ex ante*? And, are there any reasons to prefer one legislative product to the other? I conclude that, in formulating normative recommendations to policymakers, scholars should focus less on relatively small efficiency gains or losses in formulating the optimal legal rules, and more on the efficiency gains or losses attributable to the processes by which real law is made.

I

ASKING THE RIGHT QUESTIONS

The fundamental problem with the ongoing debate over the social value of secured credit is that the participants are not asking the *same* questions (even when they are purporting to evaluate the contributions of others). Moreover, few if any participants in the debate are asking the right questions (or, if they are, they fail to link the questions they are asking with others equally important to any resolution of the central issues). Properly conceived, the line of questions runs from the abstract and theoretical to the concrete and contextual. Too often, scholars have begun at one pole of this continuum with insufficient appreciation of the significance of following the line of inquiry to the other pole. The simple truth is that we will not come to understand the nature and function of secured credit in our economic system without *both* a sound theoretical foundation and a thorough knowledge of how particular security devices function, not only in the world, but also in relation to the peculiar regulatory regime of federal bankruptcy law and the Uniform Commercial Code.

A. Why Do Debtors Issue Security?

One of the most profound areas of misunderstanding between those who focus on theory and those who start from experience occurs at the outset when the fundamental question is posed: Is secured debt efficient? The problem stems from the fact that this deceptively simple question actually embraces at least three very different questions.

1. *What Theory of Finance Explains Why (And Predicts When) Debtors Will Issue Secured Debt Rather than Unsecured Debt or Equity?*

Properly understood, this theoretical question is what is implied by asking whether secured debt is efficient. It is *not* the same as asking a related empirical question: would both prior creditors and the debtor be better off if a project with positive expected value was financed with secured debt? Nor is it the same as asking whether these same creditors and debtors would be better off assuming the project could only be financed with secured debt. This latter question merely begs the theoretical question, because it then requires a further question: why are certain debtors unable to finance positive value projects with unsecured debt (assuming creditors can adjust rates of return to reflect changes in risk)? Indeed, the theoretical question cannot be answered by any claim about the current state of the world *per se*. Rather, it is a comparative question. What *welfare* theory explains why debtors issue secured debt (sometimes but not always) rather than is-

suing unsecured debt or equity? Put another way, what are the welfare advantages to the firm of financing certain projects with secured debt that are superior to alternative methods of financing those projects?²

The "efficiency question" follows from the premises that creating secured debt is costly and that selling priority claims to particular creditors will necessarily reduce the value of unsecured claims *relative to alternative methods of financing the project*. What makes this question interesting is precisely the fact that we live in a world in which some debtors issue only unsecured debt, others issue primarily secured debt, and still others issue some debt secured and some unsecured. Thus, security must offer some advantages, under some circumstances, to the financing parties (the debtor and the secured party) that other alternatives cannot replicate. This much is clear. But what are these advantages? There are only three basic possibilities. First, security may offer a means of reducing financing costs to the contracting parties that increases the net expected value of the financing opportunity. Second, security may offer a means of redistributing wealth from other creditors to the contracting parties. Third, security may offer combinations of these advantages that vary from circumstance to circumstance.

The theoretical question is both the most daunting and the most interesting in the secured financing debate. There are, however, important subsidiary questions that may be more tractable.

2. *Does a Later Security-Financed Project Reduce the Value of Earlier Unsecured Claims (And Would Positive Value Projects³ Be Financed in a World Without Security)?*

Most of the "contextualist" analyses of secured financing ignore the theoretical question and focus instead on a more functional empirical question: What is the effect of a later-in-time security-financed project on the value of earlier-in-time unsecured claims? Quite clearly, if the later-in-time project did not enhance firm value and thus reduced the risk of bankruptcy for the firm, the subsequent granting of security would reduce the value of prior unsecured claims. If the project enhances firm value, and thus reduces the risk of bankruptcy by more than it reduces the unsecured creditors' share of the firm's assets upon bankruptcy, then *financing this particular project with secured debt is Kaldor-Hicks efficient*.

² See Alan Schwartz, *Taking the Analysis of Security Seriously*, 80 VA. L. REV. 2073, 2075-81 (1994).

³ By positive value project, I mean to include both growth opportunities as well as the liquidity needed to fully exploit existing projects.

While this question is interesting empirically, it is not interesting as a theoretical matter. This is because, "[i]n reality, . . . the effect of new financing on existing claims depends on what [the debtor's] managers do with the [money]."⁴ To the extent that (1) the new financing is used to exploit positive value growth opportunities, and (2) those growth opportunities provide greater coverage for the claims of unsecured creditors than any concomitant reduction in the share of firm assets should the firm become insolvent, the new financing is efficient.⁵ To the extent that the managers dissipate some or all of the proceeds of the new financing, or that the expected value of the additional coverage is less than the reduction in asset share, the new financing redistributes wealth from existing creditors to the financing creditor and the debtor's managers.

The empirical question is given more bite in the contemporary debate by the claim of a number of the contextualists that many debtors (particularly those facing a heightened risk of insolvency) can only finance positive value projects by issuing secured debt.⁶ This assumption is strong because it is counter-theoretical. Theory would predict that in a world without secured credit, positive value projects could be financed either with unsecured debt adjusted for risk or with equity. (This follows from the conventional assumption that where the expected returns from a project are positive and financing sources can balance their risk portfolios, a competitive market will generate financing opportunities for the firm.) Thus, the claim, derived from observation, that many debtors cannot otherwise finance growth opportunities or secure needed liquidity for existing projects that carry a positive expected value leads inexorably to the familiar theoretical puzzle: What are the cost-reducing benefits of security that cause it to dominate other methods of financing in certain circumstances? And, are those benefits benign (welfare-enhancing) or malign (redistributive) or both?

⁴ George G. Triantis, *A Free-Cash-Flow Theory of Secured Debt and Creditor Priorities*, 80 VA. L. REV. 2155, 2162 (1994).

⁵ See Triantis, *supra* note 1, at 235-36.

⁶ See, e.g., Harris & Mooney, *supra* note 1, at 2042-45; Homer Kripke, *Law and Economics: Measuring the Economic Efficiency of Commercial Law in a Vacuum of Fact*, 133 U. PA. L. REV. 929 (1985); Steven L. Schwarcz, *The Easy Case for the Priority of Secured Claims in Bankruptcy*, 47 DUKE L.J. (forthcoming Dec. 1997) (manuscript at 31, on file with author) (arguing that "a debtor's real choice is often between borrowing on a secured basis and trying to reorganize under Chapter 11 of the Bankruptcy Code").

3. *What Are the Effects of Systematic Nonadjustment by Earlier Unsecured Debt on the Increased Nonpayment Risk Caused by Subsequent Secured Debt?*

Another way of getting at the secured credit puzzle is to challenge its underlying assumption that unsecured creditors will adjust (either *ex ante* or *ex post*) to the issuance of subsequent secured debt by increasing their interest charges to reflect the reduction in the share of the firm's assets available to unsecured claims upon insolvency. In an important article, Lucian Bebchuk and Jesse Fried demonstrate that many classes of unsecured debt will fail systematically to adjust (or will be incapable of adjusting) to subsequent secured debt.⁷ In addition to tort claimants and other classes of involuntary creditors, suppliers and other trade creditors will often find it rational to assess an average risk premium to account for the generic risk of future secured debt rather than adjust interest charges in individual cases. Systematic nonadjustment raises a number of interrelated questions. What are the efficiency effects of nonadjustment on debtors' financing choices? What are the distributional consequences of nonadjustment? To some extent, the answers to these questions turn on the resolution of the question posed earlier: Would subsequent positive value projects be financed without secured debt? If secured debt is, in certain circumstances, the optimal (or only) method of financing positive value projects, then the efficiency and distributional effects are much different than if these projects could be financed, for example, with unsecured debt protected by loan covenants.

B. *What Explains the Peculiar Patterns of Security We Observe and the Regulatory Scheme that Influences Those Patterns?*

The theoretical and empirical questions may seem tractable so long as they are posed generically. But the question of whether to grant secured creditors full priority in bankruptcy is a question one can answer only in the context of the existing transactional reality in which security is issued, and the particular regulatory regime of Article 9 of the UCC and the federal Bankruptcy Code. A much more complex set of questions arises, therefore, when one asks whether any of the attempts to justify or question secured credit can pass the following three demanding tests.

⁷ Bebchuk & Fried, *supra* note 1, at 880-95.

1. *When Do Debtors Issue Secured Debt and Why Do They Say that They Do It?*

Critics of the efficiency theorists have correctly observed those theorists' tendency either to ignore data or to operationalize data by shaping it to fit an appropriate theory.⁸ To be sure, much of the theoretical debate has failed to deal with the lacunae of secured credit. Some firms rarely issue secured debt, some have a mixed portfolio, and others issue most debt on a secured basis. What explains these patterns? Contextualists argue for a bottom-up approach in which speculations about the social value of security are built upon a better understanding of why and when security is actually used in practice. What are the patterns of secured financing that we observe in the world and do they cohere with any of the theoretical speculations?

This question, however, is a good deal more demanding than most of the contextualist scholars appear to recognize. For example, how can one test the claim that subsequent secured debt that finances positive value projects (either business growth or liquidity) is efficient and distributionally fair? Central to the claim that such financing should be encouraged is the assumption that the value-enhancing opportunity can best be financed (or in some cases can only be financed) by secured debt. But how can that claim be tested? Some contextualists propose to test it by reference to experience. Financers, they assert, do not otherwise provide new money to viable debtors who face a liquidity crisis. But is that practice a function of the efficiency attributes of secured credit or the redistributive effects of nonadjusting unsecured claims (or both)? Unhappily, efforts to determine the social utility of security by looking to existing practice are often subject to the naturalistic fallacy of seeking to derive "what ought to be" from "what is".

Empirical observation can (and does), however, have a disciplining effect on those theories that seek to justify secured financing by offering positive explanations for observed patterns of behavior. Clearly, to the extent that explanatory theories are counter-factual, they are undermined. Similarly, explanations for the use of security that are built upon observations of existing practice must be tested against a theoretical framework to determine whether they are normatively benign or malign.

2. *What Explains the Patterns of Regulation Embodied in Article 9 of the UCC and the Bankruptcy Code?*

In addition to the contextualist challenge to explain patterns of observed behavior, a second challenge is to explain the patterns of

⁸ See Mann, *supra* note 1, at 628-29.

legal regulation under which not all secured debt is equal. Some forms of security are privileged over others. This bias is most apparent in the exceptions that Article 9 establishes to its general first-in-time principle. The first-in-time priority system is based upon the acquisition and publication of a property right in the debtor's assets.⁹ Although this system may seem facially neutral, it in fact results in granting certain classes of secured creditors specially-protected priority claims.

The first departure from the first-in-time principle is the extraordinary protection afforded the floating lien. After an appropriate filing, a general financing creditor may claim a priority in any or all of the debtor's current and future assets, with the creditor's priority status fixed from the time of filing rather than from the time property rights in particular assets are acquired.¹⁰ The second major exception to the first-in-time principle is the "superpriority" granted to purchase money security interests. This priority status trumps even prior creditors holding floating liens.¹¹ The third exception to consider concerns the priority of paperized assets, such as chattel paper and instruments. A prior, perfected secured creditor will lose in a priority contest with a subsequent purchaser of chattel paper who gives value and takes possession in the ordinary course of business.¹²

How can we understand these diverse rules of priority? And, to what extent are these explanations compatible with either extant theories or observed behavior in practice? Surprisingly, most scholars have largely ignored this question, even though most, if not all, of the participants in this debate—whether theorists or contextualists—are lawyers. Thus, few, if any, of the prevailing theories seek to test whether the peculiar pattern of priorities embedded in Article 9 can be justified. Even more surprisingly, few, if any, of the contextualists who seek to justify security by reference to observed behavior and revealed preferences have examined whether their justification supports or undermines the regulatory structure of Article 9. Property understood, however, *both* the financing and the legal regulatory contexts are crucial methods of testing various speculations about the relative efficiency of secured credit.

Thus, for example, we need to ask: What justifies the floating lien and the priority of subsequent advances? Even more startling than the priority granted security interests in after-acquired assets is

⁹ See, e.g., U.C.C. §§ 9-203 to -303 (1994); see also ALAN SCHWARTZ & ROBERT E. SCOTT, *COMMERCIAL TRANSACTIONS: PRINCIPLES AND POLICIES* 568 (2d ed. 1991) (discussing perfection under Article 9).

¹⁰ See U.C.C. §§ 9-204(3), 9-312(7) (1994); see also SCHWARTZ & SCOTT, *supra* note 9, at 637-39 (discussing function of first-in-time rules).

¹¹ See U.C.C. §§ 9-312(3), (4) (1994).

¹² See *id.* § 9-308(a).

the parallel protection offered to the floating lien creditor who elects to make future, uncommitted advances to the debtor. Following an appropriate filing, these advances will enjoy the same priority even though they are made either without commitment or when the debt supporting the initial security agreement has been fully repaid, or even when the debtor faces imminent insolvency. Theories of security that seek to justify the priority of secured debt, either in general terms or by reference to particular practices, must also confront Article 9's existing scheme of priorities. In a thoughtful article, Steven Schwarcz argues that new money secured debt is efficient and often constitutes the only means available to viable debtors to solve liquidity crises.¹³ But if this is so, how can we square a new money explanation with the peculiar advantages offered to floating lien creditors and purchase money security interests (PMSIs)?¹⁴ In neither case does the extraordinary priority granted to these secured creditors fit the new money justification that Schwarcz develops from experience and observations from practice.

3. *To What Extent Does the Political Economy of the UCC and the Bankruptcy Law-Making Process Influence Regulatory Outcomes?*

The failure of the current debate to integrate even a rudimentary understanding of the political economy of the law-making process is astonishing given the competing normative theories that suggest either efficiency or redistributive explanations for secured debt. Most of the commercial law that regulates secured credit originates with private law-making groups. The American Law Institute (ALI) and the National Conference of Commissioners on Uniform State Laws (NCCUSL), both "self-perpetuating organization[s] of lawyers, judges, and academics,"¹⁵ have jointly created the Uniform Commercial Code, America's most influential commercial statute. Article 9, which regulates secured credit, is the centerpiece of that effort. Similarly, the Bankruptcy Code of 1978 was based largely on work done by the National Bankruptcy Conference. In formulating bankruptcy law, the Conference, together with other bankruptcy-oriented private legislatures, has a role that parallels in many respects the more entrenched private legislative efforts of the ALI and NCCUSL in interpreting and revising the UCC.

¹³ Schwarcz, *supra* note 6, at 60-66. Schwarcz claims that new money secured credit is class Pareto efficient, thus, unsecured creditors as a class should prefer full priority for secured claims in bankruptcy and should want a debtor to have access to secured credit. *Id.* at 63.

¹⁴ See U.C.C. § 9-107 (1994).

¹⁵ Alan Schwartz & Robert E. Scott, *The Political Economy of Private Legislatures*, 143 U. PA. L. REV. 595, 596 (1995).

While the product of these private legislatures is subject to ratification either by the states or by Congress, respectively, the degree of deference shown to these groups suggests that we should study them in much the same way that political scientists study ordinary legislatures.¹⁶ The current debate has evaluated the relevant legal rules as if they were produced by rule-generating "black boxes." Although academics have not hesitated to critique the legal rules that regulate secured credit, until recently, they have paid scant attention to the internal workings of the institutions that produce such laws. As a result, a key question has often gone unasked: To what extent is the legal regulation of secured credit a function of the law-making process? In particular, to what extent is the private legislative process more susceptible to interest group influence than the products of ordinary legislative bodies?¹⁷ The answer to this last question is crucial to any normative evaluation of the priority to be granted to secured claims. The arguments for and against granting full priority to secured credit must ultimately rise or fall with the justification for the existing scheme of priorities entrenched in Article 9. Thus, the normative debate turns largely on the level of confidence that one has about the ability of the lawmaking process to enact legal rules that are generally congruent with social welfare.

II

WHAT WE DO (AND DO NOT) KNOW ABOUT SECURED DEBT

The preceding discussion reveals the central difficulty with virtually all of the extant scholarship concerning the social value of secured credit. The debate persists with relatively small increments of progress largely because participants are asking fundamentally different questions. It is not that either side is wrong; rather it is that both sides are guilty of incomplete analyses. In truth, we cannot solve the puzzle of secured credit until we have *both* a coherent theory of finance that explains the welfare benefits of security *and* a database (derived from observation) that describes the patterns of security that actually exist in the world. Only then can we evaluate the regulatory regime of Article 9 and the Bankruptcy Code in order to make norma-

¹⁶ A literature on the political economy of private legislative groups, and especially commercial statutes, is beginning to appear. See, e.g., Susan Block-Lieb, *Congress's Temptation to Defect: A Political and Economic Theory of Legislative Resolutions to Financial Common Pool Problems* 39 ARIZ. L. REV. 801 (1997); Eric A. Posner, *The Political Economy of the Bankruptcy Reform Act of 1978*, 96 MICH. L. REV. 47 (1997); Larry E. Ribstein & Bruce H. Kobayashi, *An Economic Analysis of Uniform State Laws*, 25 J. LEGAL STUD. 131 (1996); Schwartz & Scott, *supra* note 15; Robert E. Scott, *The Politics of Article 9*, 80 VA. L. REV. 1783 (1994).

¹⁷ Both theory and casual empiricism point to the claim that in several important respects, private legislative bodies, such as the ALI and NCCUSL do not function as well as ordinary legislatures and are more susceptible to influence from dominant interest groups. See Schwartz & Scott, *supra* note 15, at 650-51.

tive recommendations to policymakers. In this section, I seek to show that, although we have gaps in our understanding, we are much closer to the answers to our central questions than is commonly supposed.

A. The Search for a Theory of Secured Finance

Because the theoretical questions have been so imperfectly understood, it may be useful to repeat them. The question at the core of the secured financing puzzle is not whether a given security-financed project is efficient for a firm to pursue. The answer to that question is quite clear: security-financed projects are efficient when the reduction in the expected bankruptcy share of prior creditors is less than the expected returns to the firm from the financed project. This question, however, is tangential to the security debate. Rather, the fundamental theoretical question requires a comparison between project financing with security and project financing without security. Thus the core question remains: why and when does the *method of financing* increase the net revenues from any positive value project the firm elects to pursue?

1. *A Promising Beginning: Using Leverage to Respond to the Problem of Risk Alteration*

We do not yet have a fully persuasive theory of secured finance that withstands empirical refutation, but, contrary to the assertions of many skeptics, we have made some significant progress. We do know *something*. Virtually all the explanations for the efficiencies of secured financing focus on the ways in which secured credit can better control agency costs within the firm by reducing conflicts of interest between the debtor's managers (representing the residual equity claimants) and the firm's debt holders.¹⁸ Four main types of conflict (commonly designated as "debtor misbehavior") have been identified.¹⁹ Of these, the twin problems of overinvestment (or risk alteration) and underinvestment are the most promising candidates for explaining the welfare benefits of secured financing.

The risk alteration conflict has the most general application. Debt is, in many cases, an optimal means of financing new projects that add value to the firm. However, debt carries as well the potential conflict of risk alteration: there is an incentive for the firm's manag-

¹⁸ Most of the early work on the agency cost theory of secured debt focused on reductions in monitoring costs. See, e.g., Jackson & Kronman, *supra* note 1, at 1149-61; Levmore, *supra* note 1. These early efforts are criticized in Schwartz, *The Continuing Puzzle*, *supra* note 1. Much of the recent work has shifted focus to the bonding advantages of security. See *infra* pp. 1450-52.

¹⁹ The classic typology—dividend payment, claim dilution, asset substitution, and underinvestment—is attributed to Charles W. Smith & Jerold B. Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. FIN. ECON. 117, 118-19 (1979).

ers, who represent residual equity interests, to engage in higher-risk projects than they would if they bore the full share of the down-side risk of project failure. If the project succeeds, the equity interests capture all the gains, but if the project fails, the losses are shared with the debtholders. The debt cushion, in other words, can lead to excessively risky investments.²⁰

The risk alternation problem generates agency costs that reduce firm value. All parties have an incentive to structure their financing contracts so as to reduce these costs. Thus, if one method of financing offers the parties a superior mechanism for ameliorating the risk alteration problem, it is in the interests of all to select the cost minimizing alternative. There are plausible reasons, supported by some substantial empirical data,²¹ to believe that secured financing is superior to other financing alternatives in reducing the costs of risk alteration by permitting the debtor credibly to commit not to pursue inferior higher-risk projects.²² The empirical data suggests that the comparative advantage of security derives principally for the singular advantages of leverage. By taking a security interest in specific assets of the debtor, the secured creditor enjoys rights of foreclosure upon default that can inflict substantial costs on the debtor's business. The leverage of secured financing reduces the enforcement costs of loan covenants that forbid the debtor from incurring additional debt without permission.²³

Precisely how does security function to reduce the costs of financial contracts? The contractual relationship between debtor and creditor is a relational contract in which one party performs a service for another. A key goal in the regulation of such agency relationships is to encourage the agent to serve its principal's interests as well as its

²⁰ See generally Fischer Black & Myron Scholes, *The Pricing of Options and Corporate Liabilities*, 81 J. POL. ECON. 637 (1973) (deriving a theoretical valuation formula for options, corporate liabilities, and the optimal discount to apply).

²¹ In his study of creditors' and debtors' financing decisions, Ron Mann found that "one of the . . . most significant advantages of secured credit in practice is that it enhances the lender's ability to limit subsequent borrowings." Mann, *supra* note 1, at 641; see also FRANK P. JOHNSON & RICHARD D. JOHNSON, *BANK MANAGEMENT* 160 (1983) ("For most secured commercial loans, the purpose of collateral is to provide a backup source of repayment in case of default and to limit the borrower's capacity to borrow from other sources."). Mann identifies the value of security as a means of "mitigating [the] incentive problems" that result from the debtor's incentives to engage in "risky conduct". Mann, *supra* note 1, at 649 (emphasis omitted). Although he rejects the conventional terms of analysis, Mann's findings are strong confirmation that financiers take security as a means of regulating the risk alteration problem.

²² See F.H. BUCKLEY, *OPTIMAL PERSONAL LEVERAGE AND FRESH START POLICIES* 43-44 (1994); Adler, *supra* note 1, at 78-79; Kanda & Levmore, *supra* note 1, at 2108-18.

²³ The key significance of leverage was first identified in Scott, *supra* note 1, at 926-30. Subsequent field studies have confirmed its significance in influencing the choices that financiers and debtors make among alternative methods of financing projects. See Mann, *supra* note 1, at 638-68.

own. Several characteristics of agency relationships contribute to the risk of self-interested actions. In contrast to performance under a simple contingent contract, the agent's performance is complex and not readily reducible to specific obligations. Satisfactory performance demands considerable decisionmaking discretion, and monitoring the quality of the agent's performance may be difficult. The objective for the parties in structuring the optimal financial contract is, first, to encourage the debtor to take the creditor's interests properly into account in making decisions, and second, to facilitate detection of its failure to do so.²⁴

The means used to achieve the desired goals are usefully grouped into two broad categories. Monitoring arrangements allow the creditor to supervise the debtor's actions so as to detect and sanction conduct, such as risk alteration, in pursuit of selfish ends. Bonding arrangements, on the other hand, align the interest of the debtor with that of the creditor through self-limiting constraints that serve a precommitment function. Although they constrain the debtor's behavior, bonding arrangements will be desired equally by both debtors and creditors, to the extent that they substitute for even more costly monitoring efforts.²⁵ Thus, a debtor is motivated to accept the imposition of foreclosure sanctions upon default, thereby providing assurance to a creditor that the debtor will not act contrary to the creditor's ends. In sum, the unique features of security function as a highly effective bonding mechanism to ensure faithful compliance with the terms of the financial contract. By offering its assets as a hostage, the debtor invites the sanction of foreclosure should it breach the terms of the agreement.

The singular advantages of leverage are widely understood among financiers. In a field study I conducted in 1986, creditors uniformly reported that they valued security principally for its "psychological advantage[s]."²⁶ Creditors reported that the threat of foreclosure increased significantly the debtor's level of compliance with loan covenants, especially negative pledge clauses. The primary value of collat-

²⁴ See Charles J. Goetz & Robert E. Scott, *Principles of Relational Contracts*, 67 VA. L. REV. 1089, 1092-94 (1981).

²⁵ See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976). Jensen and Meckling were the first to establish rigorously the reciprocal relationship between bonding and monitoring functions. Through bonding, the agent guarantees that she will not take certain actions which would harm the principal or ensures that the principal will be compensated if she does take such actions. Ex ante, these precommitments benefit the agent as well as the principal to the extent that they increase the value of the performance being provided. The enhanced performance is reflected in a higher price paid to the agent for her services. Thus, self-limiting constraints will be voluntarily assumed whenever these precommitments can substitute for more costly monitoring alternatives.

²⁶ Scott, *supra* note 1, at 945.

eral was thus thought to be the power to enforce the debtor's contractual commitments.²⁷ A more expansive field study recently undertaken by Ronald Mann has strongly confirmed the results I found in 1986.²⁸ Mann finds that, "[t]he lender's ability to inflict severe losses on the borrower through the exercise of the lender's rights in the borrower's collateral enhances the borrower's incentive to refrain from conduct that the lender views as unduly risky and to operate its business in accordance with the lenders' desires."²⁹

The theoretical literature has underestimated the significance of the leverage that security offers. The conventional theoretical objection to the leverage theory has been that creditors could accomplish the same goal simply by writing into the contract loan covenants that would call the loan whenever the debtor engaged in risk alteration. Such a "forcing contract" would simply require the debtor not to undertake subsequent investments that do not carry positive present value for the firm. The problem, however, is that while the financier can observe the disfavored action, it would be extraordinarily complex to describe in a contract the relation between the optimal action (eschewing inefficient investments) and the state or the world as it materializes in a manner sufficient to persuade a third party (such as a court) that the action has occurred. The disfavored behavior is observable but nonverifiable.³⁰

Thus, security solves a contracting problem for the parties by allowing them to "design verifiability"³¹ in the contract. Although the financier cannot verify that a subsequent investment is inefficient, it can observe such action. The ability to foreclose on the collateral once an inefficient investment decision is observed precludes the necessity of verifying that action to a court.³² In an important sense, the contract becomes self-enforcing.

²⁷ See *id.* at 944-46.

²⁸ Mann, *supra* note 1, at 638-58.

²⁹ *Id.* at 655.

³⁰ The assumption that certain actions are observable but not verifiable is a common assumption in the contract decision theory literature. See Benjamin E. Hermalin & Michael L. Katz, *Judicial Modification of Contracts Between Sophisticated Parties: A More Complete View of Incomplete Contracts and Their Breach*, 9 J.L. ECON. & ORG. 230, 236-42 (1993). A factor is observable when a party can observe it. A factor is verifiable when the facts relevant to the factor can be proved to a court in a cost-justified way. Some factors, such as the true state of the world, can be observed but are thought to be too complicated to make describing them in a contract, and proving them to a court, to be cost-justified. The empirical evidence suggests that risk-altering investment decisions are such a factor. See generally Alan Schwartz, *The Default Rule Paradigm and the Limits of Contract Law*, 3 S. CAL. INTERDISC. L.J. 389 (1993) (addressing the deficiencies in contracts scholarship relating to the analysis of default rules).

³¹ The notion of designing verifiability was first suggested by Randy Picker. Randal C. Picker, *Designing Verifiability: Implementing Mechanisms for Distributing Assets in Bankruptcy* (Jan. 30, 1997) (unpublished manuscript on file with author).

³² See Mann, *supra* note 1, at 655; Scott, *supra* note 1, at 926-27.

The results of these field studies and other reports from observation thus suggest that security provides an enforcement mechanism that significantly increases the effectiveness of certain loan covenants.³³ Creditors rely heavily on the precommitment of security as a bonding mechanism to reduce the agency costs of enforcing negative pledge clauses and other prohibitions against future debt. Moreover, because the secured creditor can focus its monitoring on specific assets, the debtor is more willing to commit to covenants that will more efficiently control risk alteration. Common provisions include prohibitions on the sale of the collateral without the creditor's consent (a form of risk alteration often designated as asset substitution), as well as covenants that condition future business decisions on prior approval from the secured creditor.³⁴ Because the secured creditor can focus its energies on preservation of the collateral, it can more effectively control the conflicts that otherwise would require more broad-based monitoring of the general stability of the debtor's business.

The risk alteration problem is tricky, however, because efforts to correct for excessive investment may create the reverse problem of excessive conservatism. In short, a mechanism that works to align the incentives of the equity holders may cause an offsetting misalignment of the incentives of the debtholders. Once secured debt is issued, the effects of leverage may lead the creditor to be myopic in refusing to permit the firm to finance positive value projects. The debtholder, with a fixed return, has a perverse incentive to forbid the debtor from taking additional risks, even though the opportunities have positive value for the firm. One method of resolving the problem of excessive conservatism of existing secured creditors is to contract for authority to seek alternative sources of secured financing for the assets needed to pursue additional positive value projects. Such an agreement permits the debtor to obtain new assets for new ventures by offering another creditor a security interest superior to the earlier-in-time secured claim. While this escape hatch of superpriority for certain types of secured credit (such as PMSIs and purchasers of chattel paper) may help solve the problem of creditor myopia, it does so only at the cost of diminishing the potency of the initial leverage that justified the issuance of secured debt in the first instance.³⁵ Thus, the cost-reducing properties of leverage are, at best, a blunt instrument that may be incapable of precise manipulation through legal rules.

³³ See Mann, *supra* note 1, at 651.

³⁴ See *id.*

³⁵ See Scott, *supra* note 1, at 962-63.

2. Using Leverage to Reduce Underinvestment Conflicts

The risk alteration conflict is ubiquitous and occurs in all debt contracts. There is a final conflict that is peculiar to exclusive financing arrangements, and for which secured financing offers similar advantages over financing alternatives. The problem of underinvestment occurs when a debtor, having recouped a portion of its investment in a joint venture with a creditor, siphons off its resources to other projects from which it will reap more of the gain. The debtor will act in this manner even if further effort in the joint venture would enhance the firm's net worth.³⁶ Once again, the leverage offered by a security interest in the debtor's assets gives a secured creditor the ability credibly to threaten sanctions if it discovers that the debtor is undertaking inadequate efforts to fully develop the financed project.

A wrap-around security interest (or "floating lien") offers several advantages to the creditor and debtor seeking to cement an exclusive financing relationship.³⁷ The leverage of security has the effect of giving the creditor an economic hostage to ensure the debtor's faithful performance of the financed project.³⁸ If the debtor defaults on any of the covenants in the financial contract, the creditor retains the power to foreclose and take operational control of the assets. The debtor agrees to this arrangement because there are significant costs to the creditor in exercising the power of foreclosure that deter frivolous or bad faith actions by the creditor. The effectiveness of the debtor's bond encourages the creditor, in turn, to provide financial

³⁶ See Stewart C. Myers, *Determinants of Corporate Borrowing*, 5 J. FIN. ECON. 147 (1977). Growth opportunities are analogous to call options. The value of these options depends on whether the firm uses them optimally. But if the firm has outstanding risky debt, situations can arise in which shareholders do not benefit even from highly profitable investment decisions, because the benefits go primarily to the debtholders. In these instances, the "options" may not be exercised at all, and the firm's value is accordingly reduced. *Id.* at 148-49.

³⁷ In his recent paper, Ron Mann rejects the claim that I had advanced in 1986 that floating lien security interests are used to cement exclusive financing relationships and that there are significant efficiency gains to the parties from relational security. Mann, *supra* note 1, at 656-57. His evidence that relational financing is not a significant factor in financial contracting is based upon the data from Berger & Udell that shows that only 26% of secured loans are made in exclusive financing relationships. Allen N. Berger & Gregory F. Udell, *Relationship Lending and Lines of Credit in Small Firm Finance*, 68 J. Bus. 351, 372 (1995). This appears to be a classic baseline problem. I never suggested in 1986, nor do I believe now, that exclusive financing relationships were the only pattern of secured financing. My only claim was that exclusive financing was an important lending pattern and that participants reported, and theory confirmed, that the leverage granted by security could reduce conflicts inherent in these relationships. In my view, the Berger & Udell data support the claim that secured credit is used in important classes of cases as a method of solving underinvestment problems in exclusive financing relationships.

³⁸ See Scott, *supra* note 1, at 928-29; Oliver E. Williamson, *Credible Commitments: Using Hostages to Support Exchange*, 73 AM. ECON. REV. 519, 522-26 (1983).

management and counseling to enhance the general business prospects for the debtor. The creditor cannot provide these valuable services as cheaply unless it can structure the relationship so as to capture the returns from its efforts. Secured financing ensures that the debtor will heed the creditor's financial advice. Once again, however, the benefits of leverage are not cost-free. Debtors must submit to substantial administrative supervision that imposes significant burdens on the firms' decisionmaking processes.

Justifying secured financing as a uniquely effective means of controlling the conflicts of interest generated by risk alteration and underinvestment seems quite promising as a normative theory of finance. The theory claims that secured debt is able to reduce agency costs for firms financing positive value projects and thus returns benefits to the firm that other financing alternatives could not capture. The theory recognizes, however, that the leverage benefits of security carry offsetting costs. Thus, it does not predict that secured credit would be ubiquitous. Rather, it predicts that parties to financial contracts will choose this method of financing in those contexts where the expected benefits from leverage exceed the costs. To the extent, then, that the net returns inform value from this method of financing are greater than those obtainable from other methods of financing the project, and exceed any reduction in the bankruptcy share of unsecured creditors, secured credit is Kaldor-Hicks efficient.

3. *Testing the Theory of Leverage Against the Rules of Article 9*

The first test of any theory of secured financing requires that the theory be roughly congruent with the priority scheme that is institutionalized in Article 9. As Hideki Kanda and Saul Levmore have shown, we can rationalize many of the priority rules of Article 9 as attempts to balance the advantages and disadvantages of using security to ameliorate the agency costs of risk alteration.³⁹ Specifically, we can understand the first-in-time priority granted to perfected secured creditors over prior-in-time unsecured creditors, and the superpriority granted to both subsequent purchase money security interests and subsequent purchasers of chattel paper over prior-in-time perfected secured creditors, as means of metering subsequent new money financing.

The first-in-time priority granted to secured claims by the terms of Article 9 can be explained as a cost-effective mechanism for preventing risk alterations that would disadvantage prior creditors. The leverage over the debtor that Article 9 grants to secured creditors is an effective bonding mechanism by which debtors offer their assets

³⁹ Kanda & Levmore, *supra* note 1, at 2108-21.

as hostages against the commitment not to engage in further risky investments. Security also focuses the monitoring efforts of the creditor and further reduces the agency costs of debt. Other financing alternatives, lacking the leverage features of security, provide less credible commitments by the debtor and, in turn, impose more costly monitoring efforts.

Nevertheless, the first-in-time rule is something of a blunt instrument. Using security as a hostage may control the debtor's incentives, but it also sets in motion a parallel set of conflicts involving the creditor's incentives. Fully protected by the hostage of security, creditors are motivated to be excessively cautious in refusing to permit subsequent financing that would enhance total returns to the firm. Thus, the first-in-time rule must be tempered with a scheme of superpriorities that offer the debtor an escape hatch to guard against creditor myopia. Hence, purchase money security interests and subsequent purchasers of chattel paper are granted priority over prior-in-time secured creditors as a means of balancing the effects of using assets as hostages. As Kanda and Levmore suggest, therefore, one can explain the prominent contours of the priority system in Article 9 largely as a crude, but effective, compromise between the advantages and disadvantages of new money financing.⁴⁰

The Kanda and Levmore explanation leaves one salient feature of Article 9 unexplained: the institutionalization of the floating lien. Here, the underinvestment problem is a useful supplement. Some classes of debtors (the current estimate is twenty-six percent of secured claims)⁴¹ choose to enter into exclusive financing relationships with creditors. For certain classes of debtors, these long term relationships offer singular advantages in terms of providing financial counseling and general business guidance. For those firms that find exclusive financing optimal, the problem of underinvestment is peculiarly salient. Once the debtor and creditor enter into these kinds of joint ventures, the financing creditor is properly concerned about a further conflict: the motivation that the debtor may have to pursue other projects through which it can capture a greater share of the returns. The unique priority Article 9 grants to the floating lien general creditor in all the debtor's present and future assets appears to be a sensible method of using the same hostage device to solve the underinvestment problem that exclusive financing arrangements generate. In a world without secured credit, these arrangements might proceed only at greater cost, and some parties would not pursue otherwise beneficial exclusive financing arrangements.⁴²

⁴⁰ *Id.* at 2114-21.

⁴¹ See Berger & Udell, *supra* note 37, at 372.

⁴² See SCHWARTZ & SCOTT, *supra* note 9, at 680-85; Scott, *supra* note 1, at 930-33.

For certain debtors, then, the blanket priority Article 9 gives to the floating lien secured creditor invites the creditor to become a joint venturer in the business opportunity. Thereafter, the creditor has an incentive to provide financial counseling and management advice to the debtor firm and, just as importantly, has the leverage to ensure that firm acts on the advice. These benefits accrue to all parties with claims against the firm to the extent that they enhance the returns from financed projects.

In sum, it is fair to conclude that a regime that privileges secured credit *may* enhance social welfare and that the scheme of priorities institutionalized in Article 9 is roughly congruent with plausible explanations of the comparative advantages of secured financing over other financing alternatives.

B. Theory v. Practice: Explaining Observed Patterns of Secured Debt

The central problem with this (and any other) theory of secured financing is the inconsistency between the predictions of the theory and observations of the actual patterns of secured financing that exist in the world. The leverage theory would predict that secured credit, although not ubiquitous (because it entails substantial costs), would nonetheless be observed in all segments of the credit market. This is because the agency problems upon which the theory rests are common to firms of all types, large and small, stable and volatile. Here, however, the empirical evidence casts substantial doubt on the efficacy of any agency cost explanation to explain fully the puzzle of secured debt. In a recent study of over one million business loans, Allen Berger and Gregory Udell concluded that the issuance of secured debt positively correlates to both the riskiness of the project and the financial volatility of the debtor.⁴³ This study confirms the evidence from field studies that secured debt remains, to this day, a method of financing that dominates second-class markets as the "poor man's" means of obtaining credit. Although security is observed in large and small firms, the single most salient correlation is the relative absence of secured credit from the balance sheets of most financially sound companies.⁴⁴

Why should that be? Ron Mann's field study suggests that, for many debtors, the substantial administrative costs of submitting to creditor monitoring and supervision outweigh the efficiency benefits

⁴³ Allen N. Berger & Gregory F. Udell, *Collateral, Loan Quality, and Bank Risk*, 25 J. MONETARY ECON. 21, 27-40 (1990).

⁴⁴ See John D. Leeth & Jonathan A. Scott, *The Incidence of Secured Debt: Evidence from the Small Business Community*, 24 J. FIN. & QUANTITATIVE ANALYSIS 379, 383, 389 (1989); Mann, *supra* note 1, at 668-74; Scott, *supra* note 1, at 940-41.

of leverage.⁴⁵ Most debtors and creditors see these costs as sufficiently high such that the decision to grant security can be justified only when the efficiency benefits of leverage work in combination with the ability of the creditor to use that same leverage to improve its probability of repayment vis-a-vis other creditors. The leverage the secured creditor can use to reduce the conflicts stemming from risk alteration is also available to increase the probability of repayment of the secured creditor's debt.⁴⁶

Let me hasten to note that neither Mann nor his subjects seem to recognize the powerful theoretical implications of this data. Indeed, Mann seems to believe that his work provides some support for the grant of full priority to secured creditors in bankruptcy.⁴⁷ But, if these field observations accurately reflect the justifications for issuing secured debt, they clearly imply that the efficiency benefits of security are generally insufficient to justify the substantial administrative costs occasioned by loss of control and flexibility in decisionmaking. Only when those social benefits combine with a private benefit—the reduction in the issuing creditor's risk of nonpayment—will a secured loan be cost-justified.

A moment's reflection reveals the problem: this private benefit is redistributive. The only way that a creditor can increase the probability of repayment out of a fixed pool of assets is by insuring that its debt will be preferred over others. The risk of nonpayment arises when the total amount of creditors' claims exceeds the value of the debtor's assets. Thus, any increase that leverage can generate in the probability of repayment of a secured creditor produces a corresponding reduction in the probability of repayment of other creditors' claims.⁴⁸

What exactly is the nature of this repayment leverage and how does it function? In Mann's study, creditors identify this leverage as a variation on the "lost value" problem: the perception that, owing to operational synergies, the collateral has greater value in the debtor's

⁴⁵ Mann, *supra* note 1, at 658-68.

⁴⁶ *See id.* at 645-49.

⁴⁷ *Id.* at 682-83.

⁴⁸ This point seems clear, but because it seems to have been lost on many of those who pursue bottom-up analyses, it bears repeating. In short, the claim that security is issued because it reduces a creditor's risks is more properly understood as the claim that debtors issue security in order to redistribute wealth away from uninformed creditors to themselves and sometimes to their informed creditors. There are two normative objections to this explanation for secured credit. First, in a risk reduction story, the issuance of security does not increase society's wealth; rather, it just makes some parties richer at the expense of others. Under this analysis, given that security is costly to issue, secured debt is normatively objectionable because it generates social costs but has insufficiently offsetting social benefits. The second objection rests on distributional fairness; that is, secured credit redistributes wealth in the wrong direction. *See infra* Part III.

hands than in the creditor's.⁴⁹ Repossession thus can inflict more loss on the debtor than the value of the asset that is securing the debt.⁵⁰ Security, in this conception, functions once again as a hostage. This time, the hostage bonds the debtor to a commitment to prefer the creditor's claim over the claims of others in the event of insolvency.

Even though secured debt is perceived as carrying the singular benefit of increasing the probability of repayment, financing parties understand it as an extremely crude device. Because providing assets as hostages imposes corresponding risks of creditor misbehavior, Mann reports that creditors and debtors are reluctant to use security except where significant reductions in nonpayment risks supplement its efficiency advantages.⁵¹ In other words, when the *ex ante* risk of nonpayment is significant, the redistributive benefits derived from leverage offer the additional advantages that justify the costs of using secured financing.⁵² Mann's analysis thus provides a coherent account for the persistent pattern of secured debt issued primarily by firms with unproven track records or firms that are financially volatile. For financially stable firms, secured debt remains unattractive presumably because the risk of nonpayment is trivial and the efficiency benefits of security are inadequate, standing alone, to justify the substantial costs.⁵³

C. Market Imperfections that Support the Redistributive Story: The Nonadjustment Phenomenon

It is dangerous, of course, to draw too many conclusions from observations by market participants. Perceptions by debtors and creditors that secured credit is cost-justified only when the redistributive benefits of leverage are substantial may not reflect the underlying eco-

⁴⁹ Mann, *supra* note 1, at 665-66.

⁵⁰ See Robert E. Scott, *Rethinking the Regulation of Coercive Creditor Remedies*, 89 COLUM. L. REV. 730 (1989). The "lost value" that results whenever the creditor forecloses on the security is, of course, a product of the hostage function that security plays. A self-enforcing remedy, such as foreclosure, has a valuable regulatory function, one that enables the parties to achieve mutually advantageous objectives. From an *ex ante* perspective, the lost value potential inherent in remedial options such as foreclosure is merely the modern version of an ancient institution: the effective particular mechanism is in advancing the parties' collective goals. It is important to emphasize that the right to repossess upon default is not an assurance that, if the debtor defaults, the asset will be sufficient to repay the debt. That may or may not be the case. Instead, the value of the commitment derives from the penalty that it imposes upon the debtor, not from the benefit that it offers the creditor. An effective commitment by the debtor includes any move that will leave the debtor in a position where the option of choosing to default will impose more costs than any benefits the debtor could derive from misbehaving. A credible commitment thus requires the debtor to assume a sufficiently severe penalty so that in all cases it would prefer to carry out the promise to pay in full. See *id.* at 741-49.

⁵¹ Mann, *supra* note 1, at 638, 39.

⁵² See *id.* at 639-41.

⁵³ See *id.* at 639, 671-74.

conomic reality. Thus, the related question recurs: if the market for credit is competitive, would not increases in the costs of extending credit experienced by unsecured creditors, whom secured debt disadvantages, be reflected in higher interest charges, and thus, in the debtor's total interest bill? Many have long recognized that nonconsensual creditors—such as warranty claimants and tort claimants—can recover only fixed-rate interest charges from debtors and would not be able to adjust to the presence of secured debt.⁵⁴ But surely, this relatively small group of creditors cannot drive the institution of secured finance?

Lucian Bebchuk and Jesse Fried have offered the most promising explanation for why debtors do not internalize the redistributive effects of secured credit.⁵⁵ Bebchuk and Fried explain the long term persistence of important classes of consensual creditors as “non-adjusting” creditors.⁵⁶ They rely essentially on a transaction-costs argument to explain why prior-in-time consensual unsecured creditors (even those with large claims) and all consensual creditors with small claims would not rationally adjust to the increased risk occasioned by a particular debtor's decision to issue secured debt. If the cost of designing and enforcing adjustable rate provisions is too high, a rational creditor will assign an average value to the heightened risk of nonpayment, a value that is not sensitive to the lending patterns of the particular debtor.⁵⁷ Any one of the classes of creditors Bebchuk and Fried identify may be insufficiently large to account for the redistributive effects of security. However, in combination, the presence of large numbers of creditors who either cannot or do not rationally choose to adjust to the increased risk of secured debt offers a strong market-based explanation for why debtors may systematically fail to internalize the redistributive costs of security.

Bebchuk and Fried emphasize the efficiency implications of nonadjustment.⁵⁸ It may well be that nonadjusting consensual creditors who are repeat players are fully compensated for the increased risks of doing business in competition with secured debt.⁵⁹ Nevertheless, the redistributive costs of security are independent of any fairness arguments that might be advanced in favor of involuntary or single-play participants in credit markets. The negative externalities that nonadjustment generates will skew the debtor's incentives in im-

⁵⁴ See, e.g., Thomas H. Jackson & Robert E. Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditor's Bargain*, 75 VA. L. REV. 155, 177-78 (1989); Lynn M. LoPucki, *The Unsecured Creditor's Bargain*, 80 VA. L. REV. 1887, 1896-1903 (1994).

⁵⁵ Bebchuk & Fried, *supra* note 1, at 898-900.

⁵⁶ *Id.* at 882-91.

⁵⁷ *See id.* at 887.

⁵⁸ *Id.* at 886.

⁵⁹ *See id.* at 886.

portant respects. To the extent that debtors and secured creditors do not internalize the costs of secured credit, the debtor's investment decisions are skewed. Debtors will issue more secured debt than would be issued in a world where the contracting parties appreciated all the costs and benefits. This inefficiency leads to underutilization of other financing alternatives that might better enhance the returns from financing positive-value projects.

D. The "Discontinuity Assumption": Secured Debt as the Only Method of Financing Positive-Value Projects

Several commentators have mounted a strong defense of secured credit that posits a class of debtors with positive value financing projects that is unable to secure financing except by issuing secured debt.⁶⁰ In other words, the claim goes, there is a discontinuity in the financing alternatives that are typically available to solvent debtors with positive-value projects. This claim was advanced some years ago by Homer Kripke⁶¹ and subsequently by Charles Mooney and Steve Harris.⁶² Most recently, Steven Schwarcz has argued that solvent debtors who confront a "liquidity crisis" are often unable to finance their projects or to fully realize the benefits from existing projects without new money that debtors can obtain on the market only by issuing secured debt.⁶³ Schwarcz, along with Kripke and Harris and Mooney, support this "discontinuity assumption" by reference to experience and to (unsystematic) field studies.⁶⁴

The discontinuity assumption is the linchpin of the argument for preserving full priority for secured credit. From the assumption that for many debtors new money financing can be obtained only by offering security, it follows that the security-financed project that offers a greater return to the firm than any corresponding reduction in bankruptcy share to unsecured creditors is Kaldor-Hicks efficient. Indeed, the efficiency problem of nonadjusting creditors largely disappears. Because using security to finance these projects is efficient, it follows that the misinvestment and precaution concerns Bebchuk and Fried raise are nonexistent.⁶⁵ A redistributive issue remains, of course, but even there one can advance the argument that most nonadjusting creditors are fully compensated in the enhanced returns from projects that creditors could not pursue *but for* security. Thus, given the assumption, the burden of proof on the empirical question should shift

⁶⁰ See *infra* notes 61-63 and accompanying text.

⁶¹ Kripke, *supra* note 6, at 969-70.

⁶² Harris & Mooney, *supra* note 1, at 2042-43.

⁶³ Schwarcz, *supra* note 6, at 18-58.

⁶⁴ Harris & Mooney, *supra* note 1, at 2028-37; Kripke, *supra* note 6, at 941-49; Schwarcz, *supra* note 6, at 44-49.

⁶⁵ Bebchuk & Fried, *supra* note 1, at 898-900.

to those who wish to constrain the choices market actors would otherwise select. The normative implication follows: secured claims that facilitate positive value projects should be accorded full priority in bankruptcy.

But, of course, nothing is as easy as it seems. The discontinuity assumption is not a theoretical claim about the efficiency of secured debt. Rather, it is an empirical claim that, given a world with secured credit, and given the reasons why debtors and creditors choose to finance new money with security, *whatever those reasons happen to be*, some positive-value projects can be financed only with security. This is not to say that, in a world without secured credit (or a world that granted reduced priority to secured claims), unsecured debt or equity would not finance these positive-value projects. Nor does it suggest that all (or even most) of the security-financed projects currently undertaken are efficient. Indeed, it is perfectly consistent with the discontinuity assumption, and with the evidence from field studies of existing patterns of secured financing, to assert that these liquidity-crisis projects demand security primarily for its redistributive effects rather than its efficiencies. The most plausible reason why solvent, high-risk debtors can issue only secured debt is that the leverage security provides can substantially reduce the risk of nonpayment for the secured creditor. It is unlikely, after all, that new money secured financing of viable, high-risk debtors is primarily aimed at controlling risk alteration or underinvestment conflicts.

Thus, the discontinuity assumption merely begs the question. Even if true, it tells us what we already know from observation: secured credit is issued for a number of complex reasons that all center on the unique advantage of leverage to the secured creditor. To some extent, that leverage seems to be a singularly useful means of reducing conflicts of interest inherent in financial contracting relationships. These benefits are efficiency enhancing. To some degree, however, that leverage also appears to be a singularly useful means of enhancing the creditor's probability of repayment relative to other creditors. If, as seems plausible, some (or many) of these other creditors do not adjust to this reduction in bankruptcy share, there is a redistributive benefit to the creditor that the debtor does not fully internalize in assessing its total interest bill. This, then, would lead to some inefficient uses of security (as well as raise problems of distributive fairness). The question, in short, is simple: What are the relative values of these two offsetting effects? At this point we do not have a clue.

III NORMATIVE IMPLICATIONS

What does the truth about secured credit imply? Any recommendations to policymakers must account for the fact that secured credit is a regime of offsetting effects—some efficiencies and some inefficiencies—in a combination that is largely unknown and is likely to remain an uncertainty for the foreseeable future.⁶⁶ This debate thus reduces to a central empirical question, the answer to which is currently unknown: What are the relative values of these two effects? If nonadjusting creditors are statistically insignificant, in either their number or the value of the claims that they hold, then the redistributive claim largely fails and the observed preference of many market actors for secured credit is strong evidence of the dominating effects of its cost-reducing properties. If the nonadjustment phenomenon is significant, then the redistribution story is plausible, perhaps even more plausible than the efficiency story.

In the absence of the data (which we may never know fully) what should lawmakers do? One approach is to resolve doubts in favor of Article 9 and the current regime of full priority for secured claims. Steve Harris and Charles Mooney argue strenuously that the redistributive effects of nonadjusting, nonconsensual creditors are trivial and that other voluntary creditors can compensate by charging rates that reflect, on average, the additional risks of subsequent security.⁶⁷ The other response, advocated by Lynn LoPucki⁶⁸ and Elizabeth Warren,⁶⁹ is to resolve doubts in favor of classes of nonconsensual and consensual unsecured creditors by granting them carve outs from the Article 9 priority scheme and/or special protections in bankruptcy.

This debate reflects two separate normative claims. The first is a fairness concern stimulated by the evidence of significant redistribution in debt financing. This objection rests on the claim that secured debt redistributes wealth in the wrong direction. Sophisticated lenders, such as banks and finance companies, will know of the existence of security. These creditors can (and do) protect themselves against

⁶⁶ It is fair to say that how much secured debt is issued for distributional reasons remains an open question. There is some recent evidence, however, to suggest that the fraction is not trivial. A recent study, for example, concluded that "the data suggest the existence of a class of unprotected creditors who provide a positive stimulus to the issuance of long term debt. The rationale for wealth transfer from this class has to come, a fortiori, from market imperfections like . . . asymmetric information." Sris Chatterjee & James H. Scott, Jr., *Explaining Differences in Corporate Capital Structure*, 13 J. BANKING & FIN. 283, 307 (1989).

⁶⁷ Harris & Mooney, *supra* note 1, at 2047-53.

⁶⁸ LoPucki, *supra* note 1, at 1941-47, 1964-65.

⁶⁹ Memorandum from Elizabeth Warren to the Council of the American Law Institute (Apr. 25, 1996) (on file with author) (regarding Article 9 Set Aside for Unsecured Creditors).

the issuance of secured debt through the interest rates they charge, or they share in the gains that security generates by forcing the debtor to split the pie. Creditors who are unlikely to know of the existence of security or unable to protect themselves against it include employees with wage claims, consumer purchasers who have warranty contracts with the debtor, actual and potential tort claimants, and small suppliers. The existence of secured debt may disadvantage all of these creditors. Hence, to the extent that the distributional story holds, security tends to redistribute wealth from the relatively poor and uninformed to the rich and sophisticated. Shifting wealth in this direction is contrary to prevailing redistributional theories.

Concerns about regressive redistribution are influenced largely by the degree to which unsophisticated creditors are adequately informed of these additional risks through the Article 9 filing system, Article 9's chief vehicle for overcoming information asymmetries. Here, the Article 9 revision process to date provides little grounds for supporting Harris-Mooney and some evidence favoring the LoPucki-Warren position. The Article 9 revision process reflects an unresolved tension between the filing system's goals of eliminating information asymmetries and the goals of providing an efficient mechanism for repeat players.⁷⁰ Indeed, several participants in the revision process have argued for tabling the entire process on the grounds that the filing system is more myth than reality, and the revision process is merely perpetuating the myth.⁷¹ Despite this anecdotal evidence, most neutral observers must still concede that the fairness case either way is inconclusive.

The more nagging and important question concerns the efficiency calculus. At this juncture, the efficiency debate (absent further data) is normative—it involves critical value choices about what law is best in a world we understand only imperfectly. Whatever position one takes on the merits, it is precisely the kind of debate for which the ALI-NCCUSL lawmaking process that creates the Article 9 rules is ill-suited. There is substantial reason to believe that when the products of these private legislative efforts are the kind of admirably clear, bright-line rules so distinctively present in Article 9, this is strong evidence that a dominant interest group has influenced the process. Bright-line rules are prevalent when an interest group dominates because they enable the interest group that prevails in the legislative

⁷⁰ See, e.g., James J. White, *Reforming Article 9 Priorities in Light of Old Ignorance and New Filing Rules*, 79 MINN. L. REV. 529, 534 (1995) (depicting this tension as fairness versus efficiency).

⁷¹ See Robert E. Scott, *The Mythology of Article 9*, 79 MINN. L. REV. 853, 856-57 (1995); see also Symposium, "Managing the Paper Trail": *Evaluating and Reforming the Article 9 Filing System*, 79 MINN. L. REV. 519 (1995) (providing further analysis of the Article 9 filing system).

process to preserve its victory in subsequent judicial interpretations of claims and rights.⁷²

Assuming such interest group influence exists, what effects can one predict? When a single interest group, such as asset-based financiers, banks, and their lawyers, are dominant in the private legislative process, the group can often block proposals it dislikes and secure passage of proposals it wants. The influence of such a group on the outcomes of the lawmaking process is a product of the poor quality of information the voters in the private legislature possess and the ability of the interest group to make credible representations about the consequences of particular proposals. (This phenomenon can be seen as well in the rules governing payment systems and credit instruments in Articles 3 and 4).⁷³

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

But, of course, even if this is so, the issue is not fully resolved. We are only beginning to understand the political economy of the private legislatures that produce Article 9 and we have even less understanding of the political economy of the bankruptcy lawmaking process.⁷⁴ There is some impressionistic evidence that representatives of unsecured creditors and debtors (through their managers) had a role in molding the 1978 Bankruptcy Code⁷⁵ to suit their needs, which were driven in large part by the sympathetic stance toward secured creditors in Article 9. One salient example of this influence is the tug-of-war over the validity of floating liens during insolvency. The treatment of floating liens in Bankruptcy Code § 547(e)(3),⁷⁶ supports the inferences that the Bankruptcy Conference is itself susceptible to interest group influence, and that interest groups seek to use the Bank-

⁷² See Schwartz & Scott, *supra* note 15, at 607-10.

⁷³ See *id.* at 643-45; see also Edward L. Rubin, *Thinking Like a Lawyer, Acting Like a Lobbyist: Some Notes on the Process of Revising UCC Articles 3 and 4*, 26 *LOV. L.A. L. REV.* 743, 748-59 (1993) (detailing industry influence during the deliberations of the ABA committee reviewing the revisions to Articles 3 and 4).

⁷⁴ Several forthcoming papers offer new insights into the political economy of the Bankruptcy Code. See, e.g., Block-Lieb, *supra* note 16; Posner, *supra* note 16.

⁷⁵ The Bankruptcy Code is codified in title 11 of the United States Code.

⁷⁶ 11 U.S.C. § 547(e)(3) (1994).

ruptcy Code in order to trump Article 9 concessions to secured creditors.⁷⁷

Rather than concentrating energies on further refinements in the debate over secured credit, it would seem far more profitable for scholars to begin to study the institutional processes which produce the relevant legal rules. Indeed, given what we do know about the private lawmaking process, it appears at best naïve to continue to frame the question solely in terms of whether secured claims should be granted full or only partial priority in bankruptcy. Not only the substance of the legal rules, but also the process that produces these rules, should be the focus of scholarly inquiry. Normative critique should take account of what the relevant lawmaker is capable of doing and is likely to do. Over the short run, this approach may well further obscure the choices among competing proposals for revision and reform. Over the longer term, however, our understanding of this potential trend and other value-laden debates can only be enhanced if academic attention focuses on inputs as well as outputs. In short, we need more theory and more evidence relating not just to the optimal rules governing secured credit, but to how the private lawmaking groups that produce those laws actually function.

⁷⁷ As I have noted previously,

The 1978 Bankruptcy Code was based on an act proposed by the National Commission on the Bankruptcy Laws of the United States, which in turn was based in large part on work done by the National Bankruptcy Conference. Any claims about the role played by interest groups, either directly or through the mediation of commercial lawyers . . . are necessarily speculative. . . . [Moreover,] the U.C.C. Article 9 Study Group and the National Bankruptcy Conference are not perfect mirror images of each other. The Bankruptcy Conference has experienced a modest decline [in] influence in recent years, and never enjoyed the official status of the U.C.C. Study Groups.

Scott, *supra* note 16, at 1849 n. 215 (citations omitted).