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## The Mythology of Article 9

Robert E. Scott\*

*Debt Collection as Rent Seeking*<sup>1</sup> marks an important moment in contemporary jurisprudence: the transformation of David Carlson from trenchant, fire-in-the-belly, no-holds-barred critic to abstract-modeling, implausible-assuming, game-theorizing, law and economics maven. On that basis alone, it is a great read.

Before I trace this remarkable journey, let me reveal my biases. I am a faithful reader of David Carlson, but often an unhappy one. My reaction to his work is sharply conflicted. This is because David Carlson, the scholar, has two entirely different sides. On the one hand, he is a smart lawyer; and on the other hand, he is, depending on your politics, either a very brilliant, or a very tedious polemicist (I should note that unlike his scholarly persona, I have always thought David Carlson, the person, to be charmingly diffident and rather sweet). In any case, *Debt Collection as Rent Seeking* begins in familiar fashion with the standard crit moves, then introduces a good idea (so good, in fact, that it had occurred independently to me some years ago) and concludes with Carlson's heart on the left (as it has been for so long) and his mind on the right (which understandably makes him pretty uncomfortable at the end).

I had planned on making a series of amusing points about Carlson's penchant for trashing other scholars' work, but mature reflection—and the fear that it wasn't very funny—has led me to demur. Therefore, I have absolutely nothing to say about Carlson's polemics, except to note the delicious irony of his defending the legal protection granted to the institution in our society—secured financing—that ensures that large concentrations of wealth will be maintained in the hands of the few on the grounds that it is “a socialistic intervention into free markets.”<sup>2</sup> At this point, I am confident that the CEO of CIT Financial

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1. David Gray Carlson, *Debt Collection as Rent-Seeking*, 79 MINN. L. REV. 817 (1995).

2. *Id.* at 831.

Corp., if not Adam Smith, would smile, and that Duncan Kennedy, if not Karl Marx, would cringe.

Now on to Carlson, the smart lawyer and the good idea. Carlson introduces the idea in a particularly unpromising fashion as a "study in class warfare between debtors and creditors—a war in which I will endeavor to be neutral."<sup>3</sup> Stripped of the jargon, the idea is this: local creditors are able to obtain a positional advantage over other, more distant creditors, which allows them to capture economic rents by selecting debtors who are less likely to misbehave and more likely to pay upon default.<sup>4</sup> What results is a "separating equilibrium" (in the lingo of game theory) in which the national creditors are left (after adverse selection) with a higher risk pool from whom they must demand premium interest rates to cover their higher risk.<sup>5</sup> The function of Article 9 filing, then (as well as bankruptcy redistribution, and as I will show, much else in Article 9), is to eliminate that positional advantage by tying information disclosure to the retention of property rights in the security taken by the local creditor.<sup>6</sup> The effect of this, Carlson claims, is both efficient in the sense that credit markets will operate more competitively and rents will be dissipated,<sup>7</sup> and also morally correct in that it promotes nation-building and other collective goods.<sup>8</sup>

This moralism may seem quite similar to the aphorism attributed to Charles Wilson, former CEO of General Motors and Defense Secretary under President Eisenhower, that "what is good for General Motors is good for America."<sup>9</sup> Nevertheless, I believe Carlson is right, both normatively and descriptively, as a matter of theory. Indeed, I think the idea can be used to explain other provisions of Article 9—such as section 9-308—as well as the principle of negotiability in Articles 3 and 4. To confirm the power of the idea that commercial law, at its best (and in the-

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3. *Id.* at 822.

4. *See id.* at 826-28 (detailing local creditor's advantage over distant creditors).

5. *Id.* at 826-27.

6. *Id.* at 828-31.

7. *Id.* at 831.

8. *Id.* at 831, 833-34.

9. Wilson actually testified before the Senate Armed Services Committee on his proposed nomination that "for years I thought what was good for our country was good for General Motors, and vice versa." *Excerpts From Two Wilson Hearings Before Senate Committees on Defense Appointment*, N.Y. TIMES, Jan. 24, 1953, at 8.

ory), works to open up credit to national markets, let me apply the idea to a related puzzle. Consider the following two cases:<sup>10</sup>

*Case 1:* The first creditor (C1) has a perfected security interest in the debtor's (D) accounts receivable, either directly or as the proceeds of a security interest in inventory. The debtor subsequently sells the accounts to a second creditor (C2).

*Case 2:* C1 has a perfected security interest in D's chattel paper (or instruments) either directly or as the proceeds of C1's security interest in D's inventory. D sells the chattel paper (or instruments) to C2.

In Case 1, C1 prevails over C2 in a contest over the accounts per sections 9-201 and 9-312(5). This result follows from the first-in-time principle<sup>11</sup> and is consistent with the priority given a perfected security interest once the information has been disclosed through a public filing. C2, armed with the requisite information, should screen out D in favor of a better quality alternative.

In Case 2, however, if C2 gives D new value for the collateral and takes possession of it, C2 prevails over C1's interest under section 9-308(a), unless C2 has knowledge of C1. Even with knowledge, C2 prevails under section 9-308(b) so long as C1 claims merely as the proceeds of inventory.

Why the different treatment? Why are subsequent, sophisticated secured parties who finance the debtor by purchasing intangible assets able, under specified conditions, to defeat a perfected prior financing creditor? Those who defend the Article 9 scheme call this "fairness." One person's fairness, however, is another person's craven concession to special interests.

The best theoretical explanation, as I have argued previously,<sup>12</sup> is one that focuses on the problem of specialized versus distant or, in Carlson's terms, local versus national credit markets.<sup>13</sup> A purely competitive market would support strict adherence to the first-in-time principle. We operate, however, under the more plausible assumption that the credit market is better visualized as consisting of smaller (specialized or local) markets.

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10. Both cases are explicated in ALAN SCHWARTZ & ROBERT E. SCOTT, *COMMERCIAL TRANSACTIONS: PRINCIPLES AND POLICIES* 655-59 (2d ed. 1991).

11. "The first-in-time priority system is based upon the acquisition and publication of a property right in the debtor's assets . . . . The general rule provides that parties secured with the same collateral take amongst themselves according to a first-in-time rule." Robert E. Scott, *The Politics of Article 9*, 80 VA. L. REV. 1783, 1795 (1994).

12. SCHWARTZ & SCOTT, *supra* note 10, at 658-59.

13. Carlson, *supra* note 1, at 826.

Moreover, the local creditor with the positional advantage acquires a reservoir of information from his experience with the debtor in other settings. The specialization of markets provides a comparative advantage for creditors within the specialized market over external sources of financing. As a result, what I have called distant, or what Carlson calls national, creditors cannot compete for the best loans within the specialized market because their costs of investigating for credit-worthy debtors are higher. By granting priority to subsequent purchasers of chattel paper, the local credit market is expanded and presumably becomes more competitive—rents are dissipated, and nations are built.

My criticism is not with the attractiveness of the idea in theory (in fact, I think it explains a lot), but with the uncritical lens that Carlson fixes upon Article 9. As I have argued elsewhere, Article 9 simply cannot be rationalized as a panglossian experiment in nation-building.<sup>14</sup> It is, as Carlson should be the first to admit, a statute at war with itself.

The mythology of Article 9, which Carlson accepts uncritically,<sup>15</sup> asserts that informed creditors use the filing system to signal less informed creditors, and that this signaling function justifies the unique priority position certain creditors in turn enjoy. Absent a successful and fully functioning filing system, rent-seeking and other opportunities to exploit informational asymmetries would emerge as a severe problem; it would be the fox guarding the henhouse.

There is, however, another side to the story, a side that is most clearly reflected in the current Article 9 revision process. There is a tension that is often depicted as fairness versus efficiency,<sup>16</sup> but which I express as a tension between the filing system's goals of eliminating information asymmetries, and the goals of providing an efficient mechanism for repeat players. A moral moment most poignantly illustrates this tension: At the end of the last Article 9 Study Group meeting in Philadelphia,

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14. See Scott, *supra* note 11, at 1791-1803 (outlining several Article 9 justifications including efficiently providing information to secured creditors and combatting the misbehavior of debtors and the costs of this misbehavior to third parties).

15. "Article 9 . . . permits national creditors to discover debtor quality. It does so by advertising encumbrances that preexist the contemplated loan." Carlson, *supra* note 1, at 830.

16. 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).

Harry Sigman made a motion that the Study Group table the revision process on the grounds that the filing system was more myth than reality and the revision process was merely perpetuating the myth.<sup>17</sup> This motion came at the end of three years of work and, not surprisingly, there was a hush in the room. Harry's motion failed for want of a second. I did not support Harry, but not because I did not think he was right; I did, and I still do. Rather, I chose to be silent because I could have been wrong, and many of my friends had put in many hours of work on the revisions. Instead, I decided to do what academics do: write a law review article.<sup>18</sup> If I was wrong, everyone would ignore the article for all the right reasons; if I was right, people would ignore it for all the reasons stated in my article.

The hard truth is that Article 9 contains provisions, such as those institutionalizing the floating lien<sup>19</sup> and PMSI priority,<sup>20</sup> that allow certain classes of creditors to escape many of the constraints of a first-in-time filing system. Not surprisingly, as the filing system has become increasingly cumbersome, informed financiers have become less willing to tolerate it. They seek expanded safe harbors freed from filing rules. Thus, the institutional structure embodied in Article 9 filing that has produced its celebrated success also contains the seeds of its own disintegration. This is an institutional and structural problem, a function of the political economy of the process by which the UCC is produced and revised.<sup>21</sup> It is a problem that is not soluble by the goodwill of the participants in the Article 9 revision process.

This Hegelian tension should be fodder for any critic to grapple with. It is proof positive of the fact that legal doctrine masks inherent and irreducible contradictions, and recalls that it is the role of the legal critic to expose these contradictions in order to displace the privileged status of law and return the de-

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17. This is a personal observation. I know of no official record. The meeting was held in Philadelphia in the Spring of 1992. See Working Group on the Article 5 Revision, American Bar Association, Report to the P.E.B. Article 9 Study Committee on Security Interests in Letters of Credit, in PERMANENT EDITORIAL BOARD FOR THE UNIFORM COMMERCIAL CODE, PEB STUDY GROUP, UNIFORM COMMERCIAL CODE ARTICLE 9: REPORT, 2, 4 (1992).

18. See Scott, *supra* note 11, at 1783; see also Alan Schwartz & Robert E. Scott, *The Political Economy of Private Legislatures*, 144 U. PA. L. REV. (forthcoming 1995).

19. U.C.C. §§ 9-201, 9-204, 9-205, 9-306, 9-312(7) (1990). See generally, Robert E. Scott, *A Relational Theory of Secured Financing*, 86 COLUM. L. REV. 901, 953-59 (1986) (describing the floating lien).

20. U.C.C. §§ 9-107, 9-312(3)(4). See Scott, *supra* note 19, at 961-64.

21. Scott, *supra* note 11, at 1803-22.

bate to the realm of pure politics.<sup>22</sup> But Carlson fails to take up this challenge. Indeed, he shies away from it entirely. Why, I wonder?

The astonishing answer to this question appears at the end of the article when the true character of Carlson, the scholar, is revealed. At this point, Carlson turns to the task of presenting a game theoretic model of national and local debt collection in order to prove, as a matter of theory, that a debtor would be better off upon default to prefer the national creditor over the local creditor because the higher costs local creditors face in finding good debtors makes investment in debt collection relatively more attractive for them. This model is introduced to refute Jim Bowers's vultures metaphor.<sup>23</sup> I had fully expected Carlson then to say (as he has so many times in the past), "but, as I have always told you, these silly models tell us nothing about the real world, because, as we know, everything in the real world is an empirical question where none of our limiting assumptions holds."<sup>24</sup> I was amazed, therefore, to read the concluding sentence in which David Carlson, of all people, makes a real world inference directly from his model and then goes on to state: "[Therefore, t]he debtor will tend to prefer the lowest valuing [creditor, i.e., the national creditor], *ceteris paribus*."<sup>25</sup> (All things being equal! David Carlson is the one who has always told us all things are never equal!).

As the son of missionaries, I know a conversion experience when I see one. So, my advice to David Carlson is heartfelt. Give up the fashionable leftist sentiments (everyone else has). Your brain has led you to the right place, and if you let it, your heart is sure to follow. After all, it's not so bad. As Winston Churchill reminded us: "Anyone under the age of thirty who is not a socialist has no heart, but anyone over the age of thirty who is still a socialist has no brain." To put it more clearly, most of the people who do law and economics are not bad people, or

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22. For a discussion of the dynamic character of this tension in contemporary legal theory, see Robert E. Scott, *Chaos Theory and the Justice Paradox*, 35 WM. & MARY L. REV. 329 (1993).

23. See James W. Bowers, *Whither What Hits the Fan?: Murphy's Law, Bankruptcy Theory, and the Elementary Economics of Loss Distribution*, 6 GA. L. REV. 27, 31-32 (1991).

24. See, e.g., David Gray Carlson, *On the Efficiency of Secured Lending*, 80 VA. L. REV. 2179, 2179 (1993) (concluding that the social utility of any given consensual arrangement is always an empirical question).

25. Carlson, *supra* note 1, at 849.

amoral, or unwilling to use history or other tools to serve what is, after all, the central mission we all share together: the search for truth.