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THE RELIANCE INTEREST IN INSOLVENCY LAW: A RESPONSE TO HARRIS AND MOONEY

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In their provocative contribution to this Symposium,[1] Steve Harris and Chuck Mooney launch a full frontal assault on proposed section 103 of the Employee Abuse Prevention Act of 2002 ("Durbin-Delahunt").[2] That provision would amend section 544(a) of the Bankruptcy Code[3] to elevate the Trustee in Bankruptcy ("TIB" or "trustee") from a mere

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[1] Steven L. Harris & Charles W. Mooney, Jr., *The Unfortunate Life and Merciful Death of the Avoidance Powers under Section 103 of the Durbin-Delahunt Bill: What Were They Thinking?*, 25 CARDOZO L. REV. 1829 (2004). Note, this response was initially drafted in response to Harris and Mooney's oral presentation at the Cardozo Law Review Symposium. As the footnotes show, they had the benefit of this response as they drafted the final version of their article.

[2] Employee Abuse Prevention Act of 2002 (also known as the Durbin-Delahunt bill), S. 2798, H.R. 5221, 107th Cong. § 103, *available at* http://thomas.loc.gov/home/c107query.html. Section 103 provides as follows:

> (a) Trustee as lien creditor. Section 544(a) of title 11, United States Code, is amended—
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> (1) by inserting ", the debtor," after "knowledge of the trustee";
> (2) by inserting ", property of the estate," after "property of the debtor";
> (3) in paragraph (2), by striking "or" at the end;
> (4) in paragraph (3), by striking the period at the end and inserting "; or"; and
> (5) by adding at the end the following:
> "(4) a good faith purchaser of property that—
> "(A) gave value for such property as of the time of the commencement of the case;
> "(B) gave such value in reliance on incorrect information contained in any public registry of security interests or liens; and
> "(C) either—
> "(i) took possession of the property, whether or not such creditor actually could take possession of the property; or
> "(ii) satisfied any applicable non-bankruptcy law such that no creditor on a simple contract could have obtained a prior judicial lien on such property whether or not such a creditor exists."
>
> (b) Preferences. Section 547(e)(1)(B) of title 11, United States Code, is amended by striking "creditor on a simple contract cannot acquire a judicial lien" and inserting "good faith purchaser for value of such fixture or property that reasonably relied on available information cannot acquire an interest".

Id.

[3] 11 U.S.C. § 544(a) (2000).

"lien creditor" with regard to personal property, to that of a "good faith purchaser for value."

Curiously, at the time of this Symposium, section 103 was politically dead.[4] An assault on a corpse seems redundant, indeed perverse, and hence this response would be doubly perverse but for the fact that proposed section 103, with whatever flaws (real or imagined) responded to a very real, very live, concern about Revised Article 9. Under Revised Article 9, a secured creditor, who, prior to lending, checked the filing system and reasonably relied on a financing statement that contained incorrect information about the debtor's address, and/or the debtor's status as a corporation, and/or the debtor's jurisdiction of organization, would be protected.[5] An unsecured creditor who similarly relied would not.[6] Such discrimination did not exist under old Article 9,[7] and it should be eliminated.

By contrast, as Harris and Mooney make clear in their essay, the drafters of Revised Article 9 did not—and do not—think that this discrimination is harmful, because they do not believe that such a reliance interest exists.[8] In this brief essay, I seek (1) to show how Revised Article 9 undercuts the unsecured creditors' ability to rely on the Article 9 filing system; (2) to demonstrate that such a reliance interest exists and is non-trivial, both in terms of honoring creditor expectations *ex post*, and creating appropriate systemic incentives *ex ante*; and (3) to suggest a solution that addresses the legitimate concern of secured creditors about the burden on filers, without undercutting creditor reliance.

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4 It still is. *See, e.g., ABI Roundtable Discussion: Remember When—Recollections of a Time when Aggressive Accounting, Special Purpose Vehicles, Asset Light Companies and Executive Stock Options Were Positive Attributes*, 11 AM. BANKR. INST. L. REV. 1, 14 (2003) ("Durbin-Delahunt . . . really went nowhere beyond the proposal stage . . . . Senator Durbin was [not] in any way prepared for the breadth and strength of the opposition to it from all quarters . . . .") (statement of attorney Philip S. Corwin).

5 Revised U.C.C. § 9-338 (2000).

6 *Id.*

7 *See* U.C.C. § 9-402(8) (1998) ("A financing statement substantially complying with the requirements of this section is effective even though it contains minor errors which are not seriously misleading.").

8 Harris and Mooney concede that this discrimination exists. They simply deem it "trivial." *See* Harris & Mooney, *supra* note 1. I agree that my concern is not earthshaking. However, neither would the cost of fixing section 9-338 be all that great. Rather than respond to this real concern, Harris and Mooney feign an inability to understand what section 103 sought to do, and hypothesize numerous hypothetical rationales, *id.*, which they then treat as straw men, subjecting them to sequential reductions to the absurd. *See id.* I don't know what section 103 sought to do either, but I do know what's wrong with section 9-338, and contend that the point is neither "incoherent" nor "trivial." As such, I seek to show what a well-drafted statute along the lines of section 103 might seek to achieve.

I.

My concern can best be understood in historical context. Under former Article 9, a secured creditor who sought to perfect a security interest by filing was required to file a financing statement that contained certain information designed to put potential creditors on notice of its interest in the debtor's property.[9] The required items were (1) the name and address of the debtor; (2) the name and address of the secured party; and (3) a description of the collateral.[10] Incorrect information did not fulfill the notice function, and Article 9-402 required that the financing statement *not* contain errors that were "seriously misleading."[11]

The consequence of filing a seriously misleading financing statement was straightforward. The financing statement was "[in]sufficient"[12] and "[in]effective."[13] The creditor's security interest was "unperfected," and would lose a priority battle with (1) a perfected secured creditor; (2) a lien creditor; and hence (3) the bankruptcy trustee (who holds the status of a "hypothetical lien creditor").[14] If one wanted the benefits of a property interest that beat third parties, one had to jump through the hoops.

Invalidation of a misleading financing statement benefited all consensual creditors who relied directly or indirectly on the Article 9 filing system—perfected secured creditors, lien creditors, *and* the bankruptcy trustee. Subsequent secured creditors and the bankruptcy trustee received the same treatment in priority battles with a prior inaccurate filer.[15] Even non-consensual creditors benefited, though they

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[9] U.C.C. § 9-402(1). Former section 9-402(1) provided:

> A financing statement is sufficient if it gives the names of the debtor and the secured party, is signed by the debtor, gives an address of the secured party from which information concerning the security interest may be obtained, gives a mailing address of the debtor and contains a statement indicating the types, or describing the items, of collateral.

Id.

[10] Former section 9-402(1) also required the signature of the debtor. *Id.* Revised Article 9 does away with that requirement, and replaces it with the requirement of authorization in an authenticated record. Revised U.C.C. § 9-509.

[11] U.C.C. § 9-402(8).

[12] *Id.* § 9-402(1).

[13] *Id.* § 9-402(8).

[14] *Id.* § 9-301.

[15] *Id.* § 9-402(8). Indeed, this equality has roots in the history of secured credit, and its interrelationship with the law of fraudulent conveyances. Historically, in the absence of a statute which provided a mechanism for giving notice, non-possessory property interests in personal property were viewed as frauds against unsecured creditors. Only with the advent of various personal property security acts in the nineteenth century, and the passage of Article 9 in the middle of the twentieth century did personal property security interests become a routine financing device. *See, e.g.*, Sturtevant v. Ballard, 9 Johns. 337, 339 (N.Y. Sup. Ct. 1812)

did not rely on the filing system at all.

Revised Article 9 changed all that. Revised section 9-516(b) includes an augmented list of information about organizational filers (type of organization, organizational jurisdiction, and organizational identification number) that must be included on a financing statement.[16] This additional information is useful to searchers, so long as it is correct. If information listed in section 9-516(b) is missing the filing officer is supposed to reject the filing.[17] More information is good, and this is not the basis of my concern. According to Harris and Mooney, participants in the drafting process expressed concern that increasing the amount of required information would correspondingly increase the risk of filer error (and the resulting harsh consequences).[18] Accordingly a compromise was struck; the secured creditors agreed to place the burden of filer error on the unsecured creditors, but spared themselves.[19]

The mechanics of the compromise were twofold:

- First, a distinction was drawn between information that was *required for effectiveness* and information that was *required by the filing office.* The name of the debtor, the

(discussing the statute of 13 Elizabeth, the English statute governing fraudulent conveyances, and its re-enactment in New York); Twyne's Case, 76 Eng. Rep. 809 (K.B. 1601); *see also* GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY 129-38 (1965).

[16] Revised section 9-516(b) (Refusal to accept record; filing does not occur) provides, in pertinent part:

> Filing does not occur with respect to a record that a filing office refuses to accept because:
>
> ....
>
> (5) in the case of an initial financing statement or an amendment that provides a name of a debtor which was not previously provided in the financing statement to which the amendment relates, the record does not:
>
> (A) provide a mailing address for the debtor;
>
> (B) indicate whether the debtor is an individual or an organization; or
>
> (C) if the financing statement indicates that the debtor is an organization, provide:
>
> (i) a *type of organization* for the debtor;
>
> (ii) a *jurisdiction of organization* for the debtor; or
>
> (iii) an *organizational identification number* for the debtor or indicate that the debtor has none....

Revised U.C.C. § 9-516(b) (2001) (emphasis added).

[17] *Id.* § 9-520(a) ("A filing office shall refuse to accept a record for filing for a reason set forth in Section 9-516(b) and may refuse to accept a record for filing only for a reason set forth in Section 9-516(b).").

[18] Harris & Mooney, *supra* note 1.

[19] *Id.* I do not doubt the political assessment, that without a compromise, the legislation would have failed. I also agree that including additional information on the financing statement is more likely to be helpful than harmful. However, I am not bound by a compromise struck during the Uniform Law drafting process, and neither is Congress. Accordingly, if the additional information is good, why not give searchers a real remedy if the information provided is inaccurate? More importantly, I fail to see the justification for actually *reducing* the amount of "important information" by eliminating "address of the debtor" from the information required for effectiveness under section 9-502.

name of the secured party, and a description of the collateral were required for effectiveness, while the addresses of the secured party and debtor, along with the new organizational information were relegated to the second, less important, category.[20]

- Second, with regard to the consequences of erroneous information in the "less important" category, a distinction was drawn between *secured creditors* and *purchasers for value* on the one hand, and *lien creditors* on the other.[21]

Under the compromise, a financing statement that contains seriously misleading information of the less important (section 9-516(b)) type is still sufficient to trump the interests of a lien creditor *but not* that of a secured creditor.

It is this second change that is troubling. This change undoes the historic parity between secured creditors and lien creditors that existed under old Article 9. Lack of parity, is not, however, the only concern. This change has consequences that matter. Imagine that a corporate group consisted of three corporations, "Jones Corporation" ("JC") the parent, "Jones Corporation, Inc.," ("JCI") a subsidiary, and "Jones, Inc.," ("JI") a separate operating subsidiary. Jones Corporation is a Delaware Corporation, but the other two entities are New York Corporations. The tax ID numbers for the three companies are 1, 2, and 3 respectively. Big Bank takes a security interest in the assets of all three companies, filing financing statements against JC in Delaware, and JI in New York. By mistake, or on purpose, Big Bank files an erroneous financing statement in New York, which lists JCI's correct name, but contains incorrect section 9-516(b) information. The jurisdiction of incorporation is listed as Delaware, the address line lists the address of JC's chief executive offices in Wilmington, and the Tax ID number is listed as 1, instead of 2.

[20] For effectiveness, a financing statement need only list the name of the debtor, the name of the secured party, and a description of the collateral. Revised U.C.C. § 9-502. By contrast, the filing officer may reject a filing if *any* of the items listed in section 9-516(b) are missing.

[21] Revised U.C.C. section 9-338 provides:

> If a security interest or agricultural lien is perfected by a filed financing statement providing information described in section 9-516(b)(5) which is incorrect at the time the financing statement is filed:
>
> 1) the security interest or agricultural lien is subordinate to a conflicting perfected security interest in the collateral to the extent that the holder of the conflicting security interest gives value in reasonable reliance upon the incorrect information; and
>
> 2) a purchaser, other than a secured party, of the collateral takes free of the security interest or agricultural lien to the extent that, in reasonable reliance upon the incorrect information, the purchaser gives value and, in the case of chattel paper, documents, goods, instruments, or a security certificate, receives delivery of the collateral.

Id. § 9-338.

Now imagine Second Bank looks at the record, concludes (reasonably)[22] that the erroneous financing statement covered JC (the Delaware Corporation), not JCI (the New York Corporation), and as a result makes an unsecured loan to JCI. Because of section 9-338, Second Bank would still lose in a priority battle with Big Bank, even though it was Big Bank which filed the incorrect information. Indeed, even if JCI defaulted, and Second Bank obtained a judgment lien, its lien would still be subordinate to that of Big Bank. By contrast, if a different lender, Finance Company, relied—in exactly the same way—on the erroneous information in the record, but loaned on a secured basis, its security interest would take priority over Big Bank's judgment lien. In sum, because of section 9-516(b)'s distinction between important and unimportant information, the unsecured judgment lien creditor would lose to the erroneous filer, while a secured creditor who went through the same investigation would win.[23]

In short, unsecured creditors are not entitled to rely on erroneous section 9-516(b) information placed in the filing system by secured creditors (whether inadvertently or with intent to deceive). Secured creditors, by contrast, have recourse. To put it another way, at least in this regard, Revised Article 9 does not protect unsecured creditors who reasonably rely on incorrect information in the Article 9 filing system; it protects only "secured" creditors.

This discrimination seems unfair, but even more troubling is Harris and Mooney's explanation for why the change is appropriate. Harris and Mooney state simply: "The bankruptcy trustee neither looks at the financing statement, nor gives value, nor relies (let alone reasonably relies)" on the information contained in the filing system.[24] This assertion is incorrect, and the error matters.

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[22] Harris and Mooney state that such reliance would not be reasonable because a financing statement filed under the name of the proposed debtor, even with an incorrect address, organization of jurisdiction, and organizational identification number, would be sufficient to put the prospective lender on "inquiry notice." Harris & Mooney, supra note 1. Even assuming that they are right, it would not be difficult to fix this problem. For example, what if the name of the debtor were incorrect as well, listing the debtor as Jones Corporation? There would then be a New York financing statement containing the name, address, and organization of jurisdiction and tax identification number of a real Delaware corporation. Perversely (though this is a topic for another day), that financing statement would still be sufficient to perfect a security interest in JCI's assets so long as the search logic of the New York Secretary of State's Office would reveal the incorrect financing statement when the Bank searched under the debtor's correct name (JCI). Revised U.C.C. § 9-506(c). Harris and Mooney might argue in response that this means it is unreasonable to lend. This, proves too much, however, unless they are willing to admit that Revised Article 9 has, in one fell swoop, destroyed the ability of people named "Smith" or "Jones"—or in New York, "Schwartz"—to obtain secured credit.

[23] Indeed, this creates the possibility, perhaps only theoretical, of a circular priority problem. If the Second Bank became a lien creditor, and then a later secured creditor ("SP2") loaned, the priority would be as follows: Big Bank would beat Second Bank. SP2 would beat Big Bank; but Second Bank would beat SP2.

[24] Harris & Mooney, *supra* note 1.

II.

Harris and Mooney take the view that the TIB never looks at the Article 9 filing system, so there is no reason to give the trustee priority over an Article 9 creditor who files an erroneous financing statement.[25] This statement fundamentally misconstrues both the role of the bankruptcy trustee, and the role of the filing system in the secured credit system. This misunderstanding caused the drafters to undercut both the utility of the filing system, and to alter the existing balance between secured and unsecured creditors.

On one level Harris and Mooney are indisputably correct when they state that a TIB does not rely on the filing system before extending credit. This is true by definition, but this is not only a tautology, it is also irrelevant. The TIB is not appointed, and the legal status of the TIB does not arise until the debtor files a bankruptcy petition. The TIB never extends credit him or herself, but the TIB succeeds to the position, and acts on behalf of the creditors who extended credit before the petition was filed. The Bankruptcy Code recognizes this expressly, in section 544, when it states that the TIB's status as a hypothetical lien creditor operates "without regard to any knowledge of the TIB or of any creditor."[26] Even though the TIB never looks at the filing system prepetition, he or she stands in the shoes of people who either did look, could have looked, or relied on others who looked at the files.

Thus, Harris and Mooney cannot be relying on the TIB's lack of knowledge, they appear instead to be saying something even more radical—that unsecured creditors as a class never look at the filing system. While it is certainly true that many unsecured creditors do not check the filing system, it is not true that *no* unsecured creditors do so, and even those who do not look often rely on it. To understand this point, imagine a department store chain. Such a company will have a wide variety of creditors, but for these purposes they can be divided into three groups: bank lenders, trade creditors, and employees. Each has a different relation to the filing system:

- A bank lender who loans to a business is likely to check the filing system, and determine whether there are any secured lenders. They are likely to include negative covenants in their loan documents, which prohibit secured debts and make it a default if the debtor's property is liened. Such an unsecured creditor certainly relies on the filing system, and if it has not become a lien creditor prior to bankruptcy,

25 *Id.*

26 11 U.S.C. § 544(a) (2000).

relies on the TIB's hypothetical lien creditor status for any recovery in bankruptcy.

- Trade creditors, such as inventory suppliers, do not generally search the UCC records, but it is not unusual for the credit manager to check a company's Dun and Bradstreet report before initiating a credit relationship, and periodically thereafter. A Dun and Bradstreet report summarizes the financial position of the debtor, listing both secured and unsecured debt. This too relies on the filing system (through Dun and Bradstreet), and on the trustee.
- While many trade creditors do not even conduct this level of investigation, they often look at what other suppliers are doing, and in this regard they free-ride on the investigation conducted by bank lenders, and diligent suppliers.
- Finally, while rank and file employees certainly do not search the filing system, this hardly seems a reason to subordinate them to the secured creditor. To the extent that they rely on the discipline of credit markets to ensure that their employer remains creditworthy, they too rely indirectly on the filing system, and on other creditors to monitor the debtor.[27]

Therefore, section 9-338 disables even those unsecured creditors who *do* look at the filing system and are fooled. By contrast, a similarly situated secured creditor would take priority because of the erroneous information. The policy issue is not punishment, but fairness. A secured creditor controls the information that they place in the public record. Imagine that a lender places information in the record that is so erroneous that it misleads two reasonable creditors, one of whom takes a security interest, and the other of whom does not. There is no reason to treat these two creditors differently. If the state of the record is such that another creditor could come along and lend in reliance upon it, and then be primed by the pre-existing creditor—the section 9-338 state of affairs—we have done violence to the assumption that unsecured creditors can protect themselves by looking at information that is publicly available.

Indeed, this is the heart of the matter. Not only is section 9-338 unfair, it is inefficient. By privileging secured creditors over unsecured creditors without notice, Revised Article 9 allows secured creditors yet another opportunity to externalize risk, at the expense of unsecured creditors, and works a complete reversal of the historical role of the

[27] Another section of the Durbin-Delahunt Bill, S. 2798, H.R. 5221, 107th Cong. § 203 (2002), would have addressed this problem more directly by giving certain employee claims priority over secured claims.

filing system.[28] Harris and Mooney seem to forget that unsecured credit was once the norm, and debt secured by personal property was an illegitimate cousin of dubious reputation. Notice is the *sine qua non* for recognizing a non-possessory security interest in personal property. Historically, that notice has always been for the benefit of both unsecured creditors who might seek to levy, and potential consensual lien claimants.

Long ago, secured credit was viewed as criminal. In *Twyne's Case*,[29] the court of the Star Chamber convicted Twyne for opposing a sheriff's efforts to seize a debtor's property. Twyne took the position that he had purchased the property from the Debtor. Lord Coke, for the Court, listed Twyne's failure to take possession of the property as one of a number of badges of fraud. Secret liens were fraudulent as to unsecured creditors and potential purchasers. The filing system "solves" the secret lien problem, but only if the information is accurate. Inaccuracies burden both unsecured creditors and secured creditors; it is baffling why the drafters of section 9-338 saw it as fair, appropriate, or efficient to draw a distinction in favor of secured creditors who search the filing system, and against unsecured creditors who make the same search.

III.

While proposed section 103 of the Durbin-Delahunt Bill generated a commotion and formed the basis for Harris and Mooney's article, this should not obscure the inequity created by section 9-338. A simple solution to the problem created by section 9-338 would be to subject all errors on a financing statement to the "seriously misleading" standard. If a secured lender placed incorrect information in the filing system that could mislead a reasonable subsequent creditor, secured, or unsecured, the filer would lose to such a subsequent secured creditor, to a judgment lien obtained by a misled unsecured creditor, and to the bankruptcy trustee. This would change the compromise struck during the drafting process, it would reinstate the ability of unsecured creditors to rely on the financing system, and enhance the secured creditor's incentive to place accurate information in the filing system. Moreover, the commercial risk would not be great. It is difficult to imagine that a financing statement that lists the correct name of the debtor, as required

[28] Notice is inherent in the concept of perfecting a security interest, and the importance of notice to perfection of property interests long predates Article 9. Real property mortgage filing systems have a long provenance, and notice was also a function of pre-Code security devices, such as N.Y. PERS. PROP. LAW § 45 (1911) (codifying the Factor's Lien Act).

[29] 76 Eng. Rep. 809 (K.B. 1601).

by section 9-502 will be deemed seriously misleading because of erroneous information of the type listed in section 9-516(b). Only where the erroneous information was of the type that would convince a potential creditor that a different debtor (of the same name) was meant, would the error mislead.[30] This seems unlikely to matter in very many cases, except where the filer is either extremely careless or actively seeks to deceive. More importantly, in the rare cases where this does occur, the error would fool both potential secured *and* unsecured creditors. Is it too much to ask that they receive the same treatment?

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30 However, contrary to Harris and Mooney's assertion, *see* Harris & Mooney, *supra* note 1, just because I acknowledge that fixing section 9-338 will not affect the result in many cases, or in all likelihood lead to many decided cases, does not mean that the change is not commercially significant. Fixing section 9-338 will increase the secured party's incentive to ensure that they place accurate information in the public filing system, and impose consequences if they do not.