Predicting When The Uniform Law Process Will Fall: Article 9, Capture and the Race to the Bottom

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PREDICTING WHEN THE UNIFORM LAW PROCESS WILL FAIL:
ARTICLE 9, CAPTURE, AND THE RACE TO THE BOTTOM

Edward J. Janger

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"Not only were conservative tendencies present during the drafting; they were visible on the horizon at the legislative stage. The draftsmen and the members of the sponsor organizations knew that to draft a dead-letter bill would accomplish nothing. The Code had to be enacted . . . ."

Homer Kripke

Article 9 of the Uniform Commercial Code ("UCC") is, by all accounts, the crowning achievement of the UCC project, and perhaps of the entire uniform law enterprise. Not just a codification of pre-Code law, Article 9 transformed the law of secured transactions. According to Grant Gilmore, "[p]re-Code personal property security law may be described as closely resembling that obscure wood in which Dante discovered the gates of hell." Gilmore and Alison Dunham, the principal drafters of Article 9, hoped that "with a little pruning and clearing, [they] could turn the obscure wood into a peoples' park where widows and orphans and country bankers could enjoy their innocent pleasures, safe from the attack of ravening wild beasts and trustees in bankruptcy." Gilmore and Dunham had three goals: to simplify and regularize the law, to make it uniform, and to make secured

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2. The UCC project is jointly administered by the American Law Institute ("ALI") and the National Conference of Commissioners on Uniform State Laws ("NCCUSL").
3. See Steven L. Harris & Charles W. Mooney, Jr., A Property-Based Theory of Security Interests: Taking Debtors' Choices Seriously, 80 Va. L. Rev. 2021, 2021 (1994) ("In embarking upon the revision of what many consider the most successful commercial statute ever . . . ."); Edward L. Rubin, Efficiency, Equity and the Proposed Revisions of Articles 3 and 4, 42 Ala. L. Rev. 551, 557 (1991) (hereinafter Rubin, Efficiency, Equity) ("For commercial law professors [born in the 1940s], the greatest conceptual achievement in the field was Article 9 of the U.C.C. Its drafters, Gilmore and Dunham, had unified the various forms of security instruments—chattel mortgages, trust receipts, field warehouses, pledges and so forth—into a single coherent framework with a new, generic terminology.").
5. This is in stark contrast to Articles 3 and 4, which went to great lengths to recreate and codify the earlier Negotiable Instruments Law and Bank Collections Code. Rubin, Efficiency, Equity, supra note 3, at 553-54.
7. Gilmore, Good Faith Purchase, supra note 6, at 620.
8. The goals of simplicity and uniformity are stated in the U.C.C. itself. Section 1-102(2) states that the Code's "purpose" is "(a) to simplify, clarify and modernize the law governing commercial transactions; (b) to permit the continued expansion of commercial practices
credit "safe" for widows and orphans. Within the constraints of existing technology, they accomplished the first two goals and, by inventing the Article 9 filing system, made great strides towards achieving the third.

Because Article 9 has been such a success, efforts to revise that Article offer an excellent lens for viewing both the strengths and weaknesses of the uniform law drafting process. The current effort to revise Article 9 has pursued the goals of simplicity and uniformity, and the revisers ("Revisers") have prepared a draft that responds successfully to technological change. Concerns remain, however, about safety. While the Article 9 drafters addressed the dangers of secured credit that related to disclosure, by 1981, when Gilmore wrote the passage quoted above, the scope of his concerns had broadened. He recognized, as have others, that Article 9 may raise concerns that go beyond giving widows and orphans notice of an existing security interest. Secured credit may create an incentive for debtors to make unreasonably small investments in product and workplace safety while imposing the costs of this risky strategy on involuntary creditors and other creditors who do not have a meaningful ability to protect against or adjust to this risk. The Article 9 revision process has not explored or responded to this concern in any meaningful way.

In addition to concern about the third-party effects of secured credit, concerns have been raised since Gilmore's death about the need to protect consumers from some of the harsh effects of Article 9's remedy provisions. While these concerns were fully aired at meetings of the drafting committee, here too, the Proposed Final Draft does nothing to make secured credit safer for consumers.

through custom, usage and agreement of the parties; [and] (c) to make uniform the law among the various jurisdictions." U.C.C. § 1-102 (1995). Simplicity was achieved by making it easier to create, id. § 9-203, and perfect, id. § 9-302, security interests. Uniformity was achieved by replacing the wide variety of pre-Code security devices with a single security device called a "security interest," id. § 1-201(37), and more importantly by the fact that the statute was adopted by all fifty states.

9. See infra notes 173-80 and accompanying text. Writing about a law reform in progress is always a tricky exercise. One is writing about a moving target. When the first draft of this article was completed, the August 1997 Draft was the current version. When it was accepted for publication, the February 1997 Draft was the current version. As the article goes to press, in April of 1998, the Drafting Committee is completing its work, and has promulgated a Proposed Final Draft of Revised Article 9. In particular, developments relating to consumer protection provisions in the Revision have required me to take later events into account. In April of 1997, the representatives of the consumer credit industry and consumer advocates were at loggerheads. This provided a straightforward example of the difficulties that the uniform law process has in dealing with distributive questions. Since that time, events have taken an interesting turn. In a series of extraordinary eleventh hour negotiations guided by Marion Benfield, Neil Cohen, and others acting as mediators, the two adversaries concluded a peace treaty under which the consumer credit industry agreed to support, and consumer advocates agreed not to oppose, the Proposed Final Draft. This is a remarkable achievement. I have made a number of revisions to reflect these events but in all fairness they require a more thorough treatment than this particular Article could accommodate.

10. See infra text accompanying note 110.

11. See infra text accompanying notes 142-50.
In this Article, I develop a theoretical model, based on the Revisers' desire for universal adoption of revised Article 9 (the "Revision"),\(^{12}\) that (1) explains both the inability of the Revisers to address concerns about safety (others might use the terms "efficiency"\(^{13}\) or "distributive justice"\(^{14}\)) and their success with regard to the goal of simplicity, and (2) can be used to predict when the uniform law process will fail in other contexts.

**A. The Article 9 Revision: Consensus on Simplicity and Division on Safety**

The Article 9 revision process has generated two broad types of reform proposals. The first type aims to further Gilmore's goal of simplicity.\(^{16}\) These proposals seek to bring Article 9 out of the 1950s and into the 1990s by recognizing and accommodating advances in technology and financial practice.\(^{17}\) The second type of proposal aims to further the goal of safety,\(^{12}\) The Revisers' desire for universal and uniform adoption is placed in high relief in the Reporters' Prefatory Comments to the *Proposed Final Draft* of Revised Article 9. Late in the drafting process, disagreements between consumer advocates and representatives of the consumer credit industry threatened to derail the process. An eleventh hour agreement was struck at the February and March 1998 Drafting Committee meetings. The resulting statutory provisions were described by the Reporters as follows:

>[The proposed solution of the consumer-related issues has been recognized by all concerned as a compromise. The statutory text that has emerged is less than ideal in substance and approach. It represents a balance struck in the hope that it will enhance the opportunities for prompt and uniform enactment of revised Article 9.](proposed-final-draft-xxxiii)


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13. Alan Schwartz, Bob Scott, Saul Levmore, and others fall into this category.

14. Lynn LoPucki, Elizabeth Warren and Bill Woodward would fall into this group. I prefer to use the term "safety," because it incorporates both concerns. Secured credit may be "inefficient" if it causes debtors to underinvest in workplace safety, or if it creates an incentive for the shareholders of an undercapitalized company to embark on an unreasonably risky business strategy. But Gilmore's concerns, articulated in 1981, seem to encompass more than mere efficiency. In his view, some people (i.e., widows and orphans, or, perhaps, consumers) may simply need to be protected from the harsh effects of secured credit. Gilmore, *Good Faith Purchase*, supra note 6, at 627.

15. James White argues that the lack of consensus regarding the rules contained in the Article 9 (and Article 2) revisions creates a significant risk that the proposed revisions will not achieve uniform adoption. James J. White, *Comments at 1997 AALS Annual Meeting: Consumer Protection and the Uniform Commercial Code*, 75 Wash. U. L.Q. 219, 222 (1997) [hereinafter White, *Comments*].

16. For example, Professor LoPucki has argued that the debtor's location or state of incorporation should be the state of filing for all types of collateral. Lynn M. LoPucki, *The Article 9 Filing System: Why the Debtor's State of Incorporation Should Be the Proper Place for Article 9 Filing: A Systems Analysis*, 79 Minn. L. Rev. 577, 580 (1995) [hereinafter LoPucki, *Filing*]. This change reflects the fact that it is now possible for attorneys to search the UCC records in distant states through the use of on-line services. *Id.*; see also David M. Phillips, *Secured Credit and Bankruptcy: A Call for the Federalization of Personal Property Security Law*, 50 Law & Contemp. Probs. 55, 73 (1987) (noting that technological advances make a national filing system feasible).

17. The Article 9 drafters could not have envisioned the advances in technology that have occurred since 1951. Article 9 was drafted prior to the advent of electronic copiers and
broadly construed. These safety oriented proposals fall into two further subcategories. One group of proposals turns on the recognition that the success of Article 9 has created a new set of dangers to creditors who are not parties to the secured financing transaction—the rule of full priority for secured claims makes it possible, in certain situations, for the shareholders of highly leveraged businesses to shift the costs of risky business strategies and dangerous activities from themselves to employees, tort claimants, and other creditors who cannot adjust the interest rate they charge to account for the increased riskiness of their investments. The costs of these gambles by highly leveraged debtors will be borne largely by Gilmore's "widows and orphans."

The second group of proposals turns on the recognition that Article 9 has made it easier for creditors to take security interests as part of consumer credit transactions, and that provisions that make sense in the commercial context may lead to unduly harsh results and unfair surprise where unsophisticated parties are involved.

The drafting committee for the Article 9 Revision (the "Drafting Committee"), chaired by William Burke, and the co-reporters, Professors Charles Mooney and Steven Harris, have shown a markedly different willingness and capacity to respond to these two broad types of proposals.

Computers, and well prior to the invention of the Internet. Carbon paper was the principal method of duplication. The drafters hoped that the Article 9 filing system would provide a cheap and effective means of providing notice of a security interest at a time when the costs of transactional filing were prohibitive. Douglas G. Baird, Security Interests Reconsidered, 80 Va. L. Rev. 2249, 2249-50 (1994); see also Peter A. Alces, Abolish the Article 9 Filing System, 79 Minn. L. Rev. 679 (1995) (proposing a system under which state officials would give authoritative opinions on priority).


19. Bebchuck & Fried, supra note 18, at 882-83; LoPucki, Bargain, supra note 18, at 1898; see infra Part II.A.3. An unreasonably risky business strategy increases the risk of business failure faced by employees. An inadequate investment in workplace or product safety increases the risk faced by tort claimants that the claim will go unpaid.

20. The burden is likely to be borne principally by tort claimants, lifetime employees of the debtor and unsophisticated investors. Employee and tort claims are of greater concern than those of trade creditors. Trade creditors can factor the risk that an individual customer will fall into the price that they charge all customers. By contrast, an employee is not in a position to spread the risk of employer failure. Neither is the employee likely to ask for a raise the day after the corporation becomes the subject of a leveraged buyout. When tort claimants are involved, the claim is not the product of a consensual transaction, so there is no mechanism for obtaining a risk premium. See also infra text accompanying notes 143-50.

21. There have been a number of proposals aimed at protecting consumers from the harsh effects of consensual secured transactions. Gail Hillebrand of the Consumers Union has spearheaded this effort, and while she initially had some success in softening the effect of Article 9's remedial scheme on consumers, the current version of the Revision contains fewer consumer protection provisions than earlier drafts. See infra Part II.B.
Proposals aimed at the goal of simplicity have met with favor—discussions of technological and technical issues have been spirited, and the Revisers have incorporated a number of important suggestions for reform.22 By contrast, the response of the Revisers to concerns about the third-party effects of secured credit and consumer protection—the safety of secured credit—has proven more divisive. To deal with the third-party effects of secured credit, Professor Elizabeth Warren proposed an amendment to section 9-301 (the “Warren Proposal”) that, if included in the Revision would have required a debtor’s bankruptcy trustee to set aside twenty percent of the proceeds of the sale of collateral to pay the claims of unsecured creditors.23 Professor Mooney has been openly hostile to the substance of the Warren proposal, arguing, only half seriously, that a better solution lies outside the UCC, in “abolishing the limited liability of corporate shareholders.”24 The Revisers initially relegated the question of absolute priority and consideration of the externality of secured credit to a statement of policy issues,25 and ultimately Warren’s proposal was summarily rejected by the Drafting Committee with virtually no discussion. The question then vanished from the agenda.26 The Revision does not

22. For example, in response to LoPucki’s suggestion that a corporation’s state of incorporation should determine the appropriate location for filing, Professors Harris and Mooney stated: “We are pleased to see this article, not only because we are inclined to agree with its conclusion, but also because its appearance supports one of the strengths of the UCC revision process.” Steven L. Harris & Charles W. Mooney, Jr., Choosing the Law Governing Perfection: The Data and Politics of Article 9 Filing, 79 Minn. L. Rev. 663, 663 (1995). Indeed, section 9-301 of the Proposed Final Draft amends current section 9-103 to provide that the law of the jurisdiction in which the debtor is located will govern filing. Proposed Final Draft, supra note 12.


24. Audio tape of meeting of the Commercial Law Section of the American Association of Law Schools (Jan. 1996) (on file with author and available from the AALS); see also Susan Block-Lieb, The Unsecured Creditor’s Bargain: A Reply, 80 Va. L. Rev. 1989, 1993 (1994) (“The question therefore becomes whether the secured creditors of a corporate debtor are better cost avoiders than its shareholders.”); id. at 1996-97 (arguing that analysis of the “second-best cost avoider” is also necessary); id. at n.26 (presenting others’ views regarding parties (e.g., contract creditors, corporate sponsors) best able to absorb the expense of tort recovery or pension claims); cf. LoPucki, Bargain, supra note 18, at 1915 (responding that reforms producing either unlimited liability or involuntary creditor priority alone are incomplete solutions to the same problem).


26. William J. Woodward, The Realist and Secured Credit: Grant Gilmore, Common Law Courts, and the Article 9 Reform Process, 82 Cornell L. Rev. 1511, 1512 (1997) (“However, despite the central nature of priority in the institution of secured credit, the Warren Proposal received a hostile reception within the Article 9 reform process. There was, perhaps predictably, a flurry of letters and short articles decrying either the details of the Proposal or what it would do to deserving borrowers. Subsequently, the Article 9 Drafting Committee unanimously rejected it, apparently, without any voice in its support.”). Among the articles criticizing the Warren Proposal are Lisa M. Bossetti & Mette H. Kurth, Professor Elizabeth Warren’s Article 9 Carve-Out Proposal: A Strategic Analysis, 80 UCC L.J. 3 (1997), Hugh Ray, Bankruptcy Law, Tex.
presently include any substantive provisions aimed at addressing this problem. The response to proposals aimed at creditor overreaching was more complicated. A number of these proposals were incorporated into early drafts of the Revision. These, however, proved highly controversial and led to a walk out by members of the consumer credit industry. Only an eleventh hour compromise saved the process. Under that compromise virtually all of the controversial provisions were removed from the Proposed Final Draft in return for deletion of provisions that would have been harmful to consumers.

Professor Mooney’s response to the substance of Professor Warren’s proposal is illustrative on two levels. First, it reflects his recognition that the safety of secured credit is a concern that goes to the very core of the law of corporate finance; debtors may use either secured credit, limited liability, or both to render themselves judgment-proof. Second, and more important, Mooney’s response, and the fate of the proposed consumer protection provisions reflects a belief (probably correct) that any effort to resolve these problems through the Article 9 revision process will likely doom the Revision project. In short, Article 9 may have reached a point where the Revisers cannot pursue the goals of safety and uniformity simultaneously. To achieve the goal of uniformity the Revisers may have to sacrifice the goal of safety.

B. Hobson’s Choice: Uniformity or Safety

Since the inception of the uniform law project, its sponsor organizations, the American Law Institute (“ALI”) and National Conference of Commissioners on Uniform State Laws (“NCCUSL”), have measured the success of each uniform drafting effort by counting the number of uniform adoptions. Under this criterion, the UCC has been a great success.

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28. See infra notes 171-72.
29. Mooney’s comment was made in January of 1996, which predates the publication of the Warren Proposal by several months. However, proposals for a 20% carveout and for priority of tort claims had been made previously, see supra note 18, and Mooney was responding to those proposals.
30. See Lynn LoPucki, The Death of Liability, 106 Yale L.J. 1, 14 (1996) [hereinafter LoPucki, Death] (“[S]ecured debt strategies are the most complex and the most common of the judgment proofing strategies.”).
31. Harris and Mooney have stated their views on the efficiency and desirability of secured credit:

[We take as our “first principle” that ... Article 9 should facilitate the creation of security interests ... [W]e think the transfer of an effective security interest ought to be as easy, inexpensive, and reliable as possible ... The law should not impair the ability of debtors to secure as much or as little of their debts with as much or as little of their existing and future property as they deem appropriate.

Harris & Mooney, supra note 3, at 2021-22.
32. Indeed the NCCUSL web page contains a special section devoted to tallying the
Although it is showing its age, all fifty states have adopted it, and it remains a significant improvement upon the laws that it replaced. That the UCC has won out in the competition among legislative alternatives is generally viewed as evidence of its substantive superiority. Commercial law scholars have given little thought, however, to whether this desire for uniformity among state laws might have a darker side.

In this Article, I argue that, in the competition among statutory rules and the competition among states, there are a number of predictable and identifiable reasons why the best statute may not win out. When these concerns are implicated, the desire of uniform law drafters for uniform adoption will cause the ALI and NCCUSL to promulgate inappropriate

number of states that have adopted various uniform laws. The address for this page is http://www.nccusl.org/targetacts.html.


36. When I use the term “appropriate” or “optimal” to describe a legal rule, I am intentionally avoiding both the economist’s term “efficient,” and the philosopher’s term “just.” “Appropriateness” as I use the term contains both an efficiency component and a legitimacy component. First, other things being equal, a legal rule should be “efficient,” or to be more exact, “Pareto optimal.” It should not be a rule that creates unnecessary transaction costs or deadweight loss. Second, appropriateness has a legitimacy component. While I do not pretend to be presenting a unified conception of a “just” rule, at the very least, a legal rule should be generated by a procedurally fair legal process. That is to say that the political process that
legal rules. I identify these factors and demonstrate that their presence explains, at least in part, the unwillingness of the Revisers to incorporate provisions into the Revision that regulate the externality of secured credit or that seek to protect consumers. At the same time, the absence of these factors explains why the drafting effort has been successful at dealing with proposals that respond to technological change.

C. The Dark Side of Uniformity: Enactability, Capture and the Race to the Bottom

At first glance, concern about the dynamics of federalism would not appear relevant to efforts to promulgate uniform laws. The purpose of the ALI/NCCUSL project is, after all, to neutralize the effects of the federal system on commercial and other transactions by making state laws uniform. However, as states revise their commercial codes and decide whether to adopt revisions to the UCC, individual interest groups may capture the legislative process in a particular state. Moreover, even if an interest group has not captured the legislature, state legislators have an incentive to draft or adopt statutes that will enhance that state’s attractiveness to businesses; states may use commercial law as a means to compete with each other. When either capture of individual state legislators or state competition is likely to lead to nonuniform adoption, the drive for uniform and universal adoption will force the drafters of uniform laws to anticipate the results of capture and of state competition and adopt legal rules that neutralize these forces in an effort to smooth the path of the statute through state legislatures.

A number of commercial law scholars have recognized the possibility that the uniform law process itself might be captured. Indeed, suggestions of capture in the Article 4 context have caused the discussion to take on an generates the rule should not be one that is systematically stacked in favor of one interest group, regardless of the merits of its position.

37. There is no doubt that many participants in the revision process sincerely believe that the Warren Proposal is a bad idea. For a description of the Drafting Committee meeting that resulted in rejection of the Warren Proposal, see Alvin C. Harrell, Article 9 Drafting Committee Considers Consumer Issues Subcommittee Report, 50 Consumer Fin. L.Q. Rep. 189, 193-94 (1996) (reporting statements that Professor Warren’s observations regarding secured creditor behavior did not comport with the experiences of those present). See also Woodward, supra note 26, at 1512. Moreover, empirical work remains to be done. See infra text accompanying notes 148-50. However, at least some participants in the revision process appear to be driven by concern about uniformity. Professor Mooney’s “not in my Code” response seems to fit into this category.

38. Professors Rubin and Patchel have detailed the influence of the banking industry on the revisions of Articles 3 and 4 of the UCC. Kathleen Patchel, Interest Group Politics, Federalism, and the Uniform Laws Process: Some Lessons from the Uniform Commercial Code, 78 Minn. L. Rev. 83, 103-105 (1993); Rubin, Efficiency, Equity, supra note 5, at 552-60; Edward L. Rubin, Thinking Like a Lawyer, Acting Like a Lobbyist: Some Notes on the Process of Revising UCC Articles 3 and 4, 26 Loy. L.A. L. Rev. 743, 744-59 (1993) [hereinafter Rubin, Thinking Like a Lawyer]. Professor Scott has suggested that the Article 9 Study Group may have been captured by banking interests. Robert E. Scott, The Politics of Article 9, 80 Va. L. Rev. 1783, 1822-47 (1994).
These scholars have not recognized, however, that actual capture may not be the problem. Even when an interest group has not captured the uniform law drafting process, the drafters may be forced, in the interest of enactability, to anticipate and approximate the rule that would be produced by a captured state legislature. Thus, when seeking to predict the success or failure of the uniform law process, it is crucial not only to predict capture, but to predict when the anticipated capture of state legislatures is likely to drive the uniform law drafting process.

In addition to anticipating capture, the drafters of uniform laws must anticipate the effects of state competition. In this regard, corporate law scholars have long recognized that the dynamic forces of federalism can operate as a double-edged sword. Competition among states (for corporate charters, for example) may cause states to adopt efficient rules to attract incorporations, causing what Judge Frank Easterbrook and Professor Daniel Fischel, among others, have described as a “race to the top.” But states may also seek to attract corporations by adopting rules that allow corporate managers—who control the incorporation decision—to transfer value from shareholders and other corporate constituencies. When this is the case, competition among states will result in what Professor William Cary first described as a “race to the bottom.”

39. Professor Rubin’s suggestion that the Article 3 and 4 revision process was captured has clearly engendered some animosity. At the 1997 Annual Meeting of the Commercial Law Section of the American Association of Law Schools, Donald Rapson criticized Rubin for failing to attend the meetings of the Article 3 and 4 drafting committees. Concerns about capture are not new. In 1962, Homer Kripke felt the need to respond to the allegation that the UCC was a sell-out to banking interests. Kripke, supra note 1, at 327-28.

40. Id. at 327 (“[N]ot only were conservative tendencies present during the drafting, they were visible on the horizon at the legislative stage.”) As Kripke appears to have recognized, this insight is important for political as well as descriptive reasons. If the desire for uniformity, rather than actual capture, is the culprit, the language of anticipated capture may allow the drafters to discuss the problem of interest group influence without resorting to name calling.


42. This transfer of value may occur in the form of high salaries, stock options or business opportunities.

43. William L. Cary, Federalism and Corporate Law: Reflections Upon Delaware, 83 Yale L.J. 663, 665-66 (1974). Although Cary first coined the phrase “race to the bottom,” the same phenomenon was described earlier by Justice Brandeis as a “race to laxity.”

The removal by the leading industrial States of the limitations upon the size and powers of business corporations appears to have been due, not to their conviction that maintenance of the restrictions was undesirable in itself, but to the conviction that it was futile to insist upon them; because local restriction would be
When the drive for uniformity causes the drafters of a uniform law to mimic the results of a race to the top the effect is beneficial. When state competition will lead to a race to the bottom, the desire for uniform adoption will compel the drafters to find the floor. The universal adoption of a uniform statute may thereby facilitate and accelerate the adoption of an inappropriate rule. Thus, so long as the state legislatures can be expected to act in the public interest, the scrutiny of fifty state legislatures will be a beneficial aspect of the uniform law process. However, if state legislatures are likely to be captured by special interests, anticipation of capture by the uniform law drafters will make such scrutiny counterproductive. Similarly, if state competition is likely to yield a race to the top, then the desire for uniformity will be beneficial, but if such competition is likely to yield a race to the bottom, the effect will be to cause the promulgation and uniform adoption of an inefficient or otherwise inappropriate rule.

D. The Decision Rule—Predicting the Effects of Anticipated Capture and Anticipated State Competition

In Part I, I argue that it is possible to predict when anticipated capture or an anticipated race to the bottom will drive the uniform law drafting process. I therefore seek to develop a decision rule that the Revisers can use to determine which legal questions the uniform law process should seek to tackle, and which legal questions should be left to nonuniform and/or federal law. First, I argue that uniform state law should not be used to promulgate rules where interest group theory would predict capture of the uniform law process or of state legislatures. This concern circumvented by foreign incorporation. Indeed, local restriction seemed worse than futile. Lesser States, eager for the revenue derived from the traffic in charters, had removed safeguards from their own incorporation laws. Companies were early formed to provide charters for corporations in states where the cost was lowest and the laws least restrictive. The states joined in advertising their wares. The race was one not of diligence but of laxity. Incorporation under such laws was possible; and the great industrial States yielded in order not to lose wholly the prospect of the revenue and the control incident to domestic incorporation.


44. Here, I stand on the shoulders of Patchel, supra note 38, at 83; Rubin, Efficiency, Equity, supra note 3, at 551; Rubin, Thinking Like a Lawyer, supra note 38, at 753; and Scott, supra note 38, at 1783.

arises where the rule is distributive and there is an asymmetric allocation of power among interested groups. Second, I argue that uniform state law should not be used to promulgate rules where interest group theory would predict either a race to the bottom, or an anticipation of a race to the bottom by the uniform law process. These concerns arise where a rule creates the possibility of either intrafirm or interstate externality. When a uniform law implicates any of these concerns, there is reason to believe that federal or nonuniform state legislation will produce more efficient and more equitable rules.46

In Parts II and III, I ask whether capture, anticipated capture, or anticipated state competition are having a discernible effect on the content of Revised Article 9. In Part III, I examine current efforts to revise Article 9 and contrast the Drafting Committee's response to proposals that aim to reform the priority scheme or protect consumers with the Drafting Committee's response to proposals that aim to simplify and modernize the statutory scheme. In Part IV, I ask whether capture, anticipated capture or anticipated race to the bottom explain the Article 9 Revisers' unwillingness to incorporate proposals addressed to the negative externalities of secured credit and their simultaneous willingness to include proposals addressed to simplicity. I conclude that, although the drafting process probably is not captured, anticipated capture has played a role in the debate over consumer protection provisions, and both anticipated capture and anticipated state competition (in its pernicious form) have played a significant role in the debate over the Warren Proposal. By contrast, anticipated state competition (in its beneficial form) appears to have driven the Revisers' efforts to respond to technological change.

In Part IV, I ask whether nonuniform state law or federal law provide a better legislative forum to generate legal rules when the uniform law process is likely to fail. I conclude that collective-action problems and state competition will seriously impair state law efforts to legislate, but that a federal solution, while not perfect, is possible. While collective-action problems may still exist at the federal level, they are less powerful than at the state level. More importantly, use of federal legislation eliminates the perverse effects of state competition entirely. As a result, palliative responses, such as enhancement of representation of underrepresented

46. There is a third category of statutes when use of uniform laws may not be appropriate. In some instances the existence of a race to the top will counsel against use of the uniform law process. There actual state competition may be preferable to anticipated state competition. See F. Stephen Knippenberg & William J. Woodward, Jr., Uniformity and Efficiency in the Uniform Commercial Code: A Partial Research Agenda, 45 Bus. Law. 2519, 2524 (1990) (discussing the reasons for and effects of nonuniform provisions in the U.C.C.); Larry E. Ribstein & Bruce H. Kobayashi, An Economic Analysis of Uniform State Laws, 25 J. Legal Stud. 131, 140 (1996) ("A decentralized decision-making process normally can produce more possible solutions to a problem than could a single rulemaker."). In these instances, the benefits of competition must be weighed against the benefits of uniformity. Where commercial law is involved, however, the need for uniformity is paramount, and the relevant choice is between uniform state law and federal law.
groups, may be more successful.

This Article concludes, therefore, that the Revisers should continue to focus their efforts on reducing the transaction costs associated with secured credit, but that the fundamental policy choices implicated by the rule of full priority and consumer protection should be addressed through federal or nonuniform state law.

I. PREDICTING WHEN THE UNIFORM LAW PROCESS WILL FAIL

Recent efforts to revise the Uniform Commercial Code have prompted a number of efforts to study and explain the uniform law process. Some commentators have focused on interest group forces while others have focused their attention on federalism. On the interest group side of the equation, Alan Schwartz and Robert Scott, \(^{47}\) Edward Rubin, \(^{48}\) and Kathleen Patchel \(^{49}\) have pointed out that interest groups may, at times, capture the ALI/NCCUSL process. On the federalism side, Larry Ribstein and Bruce Kobayashi have concluded that the imprimatur of the uniform law project impairs the ability of states to distinguish efficient from inefficient uniform enactments. \(^{50}\) Standing alone, these two approaches are incomplete. In this Part, I seek to unify these two strands of scholarship—the interest group approach and the federalism approach—by articulating a simple decision rule to allow uniform law drafters and federal and state legislators to predict when the uniform law process is most likely to generate efficient or equitable rules and when it is most likely to generate inefficient or inequitable rules. In the remainder of the Article, I seek to show that this decision rule is descriptive, predictive and prescriptive; it describes what has already happened in connection with the Revision of Article 9 and other articles of the UCC; and it can be used to define and circumscribe the appropriate domain for uniform laws.

\(^{47}\) See Alan Schwartz & Robert E. Scott, The Political Economy of Private Legislatures, 143 U. Pa. L. Rev. 595, 638-43 (1995) (discussing the influence that banks had on the creation and revisions of Articles 3 and 4); Scott, supra note 38, at 1822-47 (examining the influence of interest groups on the Article 9 revision process).

\(^{48}\) See Rubin, Efficiency, Equity, supra note 3, at 589 (“The bankers and bank attorneys who have dominated the U.C.C. drafting process are probably aware of the concerns that consumer representatives would tend to raise. But they evaluate these concerns from their own particular perspective.”); Rubin, Thinking Like a Lawyer, supra note 38, at 787 (“In the process of drafting and enacting the revisions of Articles 3 and 4 . . . one of the major forces was not present. Banks were well represented; corporate users were represented intermittently; but consumers were virtually unrepresented. The result was that the banking industry and its attorneys dominated the entire process, save for a few brief interludes.”).

\(^{49}\) Patchel, supra note 38, at 126 (“Why does the uniform law process tend to produce commercial laws that fail to protect consumer interests effectively? . . . [T]he answer seems to lie in the absence of adequate consumer representation in the uniform laws process.”).

\(^{50}\) See Ribstein & Kobayashi, supra note 46, at 132 (“First, we show that the states most widely adopt the NCCUSL's proposals in situations in which uniformity is most efficient . . . However, we also find evidence that indicates the NCCUSL has proposed many laws in which uniformity is not efficient and that the NCCUSL can increase the probability that these proposals are adopted by some states.”).
A. The Benefits of the Uniform Law Process

The first step in determining when the uniform law process will fail is to ask why it is ever better than nonuniform state law or federal law. First, the uniform law process is administered by the ALI and the NCCUSL. Both of these bodies have a demonstrated ability to identify and engage talented drafters and informed professionals to participate in the drafting process. Second, because the ALI and NCCUSL are relatively obscure, the drafters are able to engage in a careful deliberative process. Third, the goal of uniform adoption places a severe discipline on the uniform law drafters. They must draft a statute that will survive the scrutiny of fifty state legislatures.

These strengths of the uniform law process are also its greatest weaknesses. Just as the drafters' expertise and the insulation of the process allow contemplative drafting, they also constrict the number of people and groups that participate in the drafting process. While the scrutiny of fifty state legislatures may produce a better statute, such scrutiny may have detrimental effects as well. When the behavior of state legislatures is likely to diverge from the public interest, either because of capture or because the states' parochial interests diverge from the national interest, this scrutiny may cause the uniform law drafters to facilitate capture or a race to the bottom. In short, there are two forces that may lead to a failure of the uniform law process: failure of representation at either the ALI/NCCUSL.

51. Steven L. Schwarcz, A Fundamental Inquiry Into the Statutory Rulemaking Process of Private Legislatures, 29 Ga. L. Rev. 909, 921 (1995) ([The uniform-law process] brings together, in ways that an individual state legislature could not, experts from around the country to pool their knowledge and ideas in the development of nationally uniform statutes); James J. White, Symposium, One Hundred Years of Uniform State Laws: Ex Proprio Vigore, 89 Mich. L. Rev. 2096, 2096 (1991) [hereinafter White, Ex Proprio Vigore] ("Although the Commissioners are technically public officials, they are an elite group. Most of the Commissioners are prominent lawyers not chosen on the same basis used to choose a legislator, but chosen because they have a more intellectual interest in uniform law than would a typical legislator.").

52. See White, Ex Proprio Vigore, supra note 51, at 2096 ([Commissioners] are elected not by a vote of the electorate but by the single vote of the governor. This mode of election doubtless removes the Commissioners further from the people than the typical state legislator . . . .).

53. Id. ("These acts become the law of various states only ex proprio vigore--only if their own vitality influences the legislators of the various states to pass them.").

54. In an earlier draft I referred to this as a failure of "interest group representation." Lynn LoPucki offered the following comment that has led me to change my terminology: "Failure of interest group representation" is bad? Most people would probably say it was good." He goes on,

[You assume] a "public choice" perspective throughout. That is, the "polity" or voting public does not exist. The world is composed solely of interest groups that are perfectly cohesive and fight it out among themselves. But that is not the way the world works. When the polls show that 60% of Americans think X, it is pretty likely that the political system will favor X--regardless of who has a "collective-action problem" and who does not.

Letter from Lynn LoPucki, Professor of Law, Cornell Univ., to author (June 12, 1997) (on file
level or at the state level, and state competition in its pernicious form.

B. Capture

The ALI and NCCUSL are private or quasi-private organizations. Nonetheless, these uniform law drafting bodies operate as private legislatures. Legislatures are, from time to time, captured by the representatives of special interests who then turn the public process of legislation to their private ends. Capture is often a product of a collective-action problem and is most likely when a legal rule affects both a small and concentrated group and a large, diffuse group. Under these circumstances, the relevant question for the uniform law drafter is not, "what does the public think?" but instead "is the public likely to notice?" If the answer to the latter question is yes, then the instinct of the drafters is likely to be to exclude the controversial provision from the uniform law.

When the public does notice, this is not necessarily bad. As Einer Elhauge has pointed out, process cannot be completely divorced from substance. Einer R. Elhauge, Does Interest Group Theory Justify More Intrusive Judicial Review?, 101 Yale L.J. 31, 109 (1991). For example, one might argue with regard to tort claimants that they are amply represented by the American Trial Lawyer's Association, yet they are unable to obtain a tort first priority. This is likely because many, if not most, Americans think that the tort system is even more fundamentally flawed than the secured credit system.

55. Indeed, when both a regulating agency and its supervising committee are captured the result is referred to as an "iron triangle:"

[These tripartite coalitions influence the allocation of government goods and services in such a way that the congressional committee members get credit for "bringing home the bacon" to their constituents, the administrative agencies expand their budgets, personnel, and turf, and the interest groups get what they want from government.

Daniel McCool, Command of the Waters 5 (1987); see also Martha Derthick & Paul J. Quirk, The Politics of Deregulation 12-13 (1985) ("The general view was that a triumvirate (an 'iron triangle') of regulators, regulated industries and key members of Congress, influenced by campaign contributions from the regulated industries, constituted an insuperable barrier to any reform that was contrary to industry interests.").

circumstances, the small and concentrated group can use its own resources—votes, financial resources, and promises of future employment—to acquire rules favorable to itself and possibly detrimental to the larger, diffuse group.

For example, when the costs of a proposed rule will be widely distributed, any individual who seeks to challenge the rule will bear the full cost of the challenge, while recovering only a pro-rata share of the benefit, and even that individual will have an incentive to free ride on the efforts of others. Therefore, unless the pro-rata benefit exceeds the cost of the challenge, no individual will have an incentive to participate in the legislative process. As a result, the affected group is likely to be underrepresented.\(^{57}\) Thus, when there is interest group asymmetry and a rule that is distributive, the uniform law drafting process will likely be a mechanism for ensuring that benefits of the rule accrue to the smaller, well-organized group.\(^{58}\)

1. Capture of the ALI and NCCUSL?

The product of the ALI/NCCUSL drafting process is a uniform law that is designed to be adopted by fifty state legislatures. As such, capture of the uniform law process is particularly troubling in that it can cause the effective capture of fifty state legislatures. Indeed, there are a number of reasons why the uniform law process may be more subject to capture than state legislatures or Congress. First, as I have noted above, the process is private. Second, the subject matter of uniform laws is often quite technical and unlikely to hold the interest of anybody but an expert, an academic, or a party with a well defined interest in the statutory outcome.\(^{59}\) Historically, the ALI and NCCUSL have recognized these drawbacks and have sought to limit the scope of the uniform law process to technical codification of the law and to avoid efforts to enact social policy through uniform law

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\(^{57}\) As I suggested in an earlier article:

For example, when the relevant outcome of the political process is a defense expenditure, no individual taxpayer has an economic incentive to become involved in the appropriation process. Only the defense contractor has sufficient stake in the outcome to take an interest in the substance of legislation. Similarly, when the legislative output is a regulation, only the regulated industry has a sufficient stake to be a consistent player before the regulating process.

Janger, \textit{supra} note 56, at 91-92.


\(^{59}\) Patchel, \textit{supra} note 38, at 132.
drafting. Nonetheless, some uniform laws raise issues of social policy. When they do, there is a risk of capture. An interested group, such as the banking industry, may seek to turn the process to its own ends. When an interest group succeeds, the insular nature of the process may make this problem more difficult to identify and to correct. Thus, there is a risk of capture whenever a uniform enactment creates a rule that benefits a concentrated group at the expense of a diffuse group.

2. Lessons from Articles 3 and 4

A brief look at the history of Articles 3 and 4 of the UCC shows that concerns about capture are not merely theoretical. Although Article 3 has not engendered much dispute, Article 4 is a different story. On two separate occasions, the Reporters chosen by the NCCUSL to draft Article 4 have been summarily dismissed because they attempted to incorporate consumer protection provisions into that Article. As Professor Rubin has noted, “The drafting of [original] Article 3 went quite smoothly. [William] Prosser, content to retain the basic structure and content of the [Negotiable Instruments Law], simply refurbished the statute by resolving most of the interpretive questions that had arisen during its half-century of existence.”

However, Fairfax Leary, the initial drafter of Article 4, was not so lucky.

Leary produced a draft that represented a reconceptualization of the field, and thus a significant departure from the American Bankers Association’s Bank Collection Code. It reflected a thorough knowledge of the check collection process, and combined a realistic recognition of industry needs with a rare sensitivity to consumer interests. But the New York Clearing House Association reacted with fury, promptly informing Llewellyn that it would oppose the passage of the entire U.C.C. if Article 4 remained. Llewellyn responded by relieving Leary of his duties, and eliminating Article 4. A committee of bank counsel ultimately drafted Article 4, modeling it closely on the Bank Collection Code.

A quarter century later, history repeated itself. In 1977, Harvard Professor Hal Scott was appointed the Reporter for the revision of Articles 3, 4, and 8. Again, as Professor Rubin notes:

The New Payments Code was in trouble from the start. Although many things had changed in the payments area, the New York
Clearing House Association had not. Perceiving that the effort to meld check, credit card, and electronic fund transfer law would impose some of the consumer protection features of the federal legislation on the checking system, it reacted with its accustomed fury. Drafting continued and numerous changes were made, but the sessions became increasingly acrimonious and the opposition of the New York banks increasingly intense. With representatives of the consumer movement also opposed because the Code seemed dilute existing protection afforded for credit cards, and the academic community bewildered or uninvolved, countervailing support was nowhere to be found. After several years the ALI dismissed Scott as reporter and announced the end of the entire effort.51

Thus actual capture of the ALI/NCCUSL process is a real concern when a uniform enactment has the potential to benefit an organized group at the expense of a diffuse and disorganized group.

3. Uniformity and the Anticipation of Capture

Actual capture of the ALI/NCCUSL process is not the only manner in which an interest group can gain disproportionate influence over the uniform law drafting process. Because uniform law drafters seek universal and uniform adoption, consensus is required. An interest group (even one with very few, or even no votes in the drafting committee) may therefore be able to obtain a desired result by merely making a plausible threat to block enactment of the uniform law in one or a number of jurisdictions.52 Thus, when capture of state legislatures is a concern, the uniform law drafters may need to act like a captured legislature in order to achieve uniform adoption.

This is particularly troubling when one recognizes that the principal mechanism for preventing capture is to increase the representation of affected groups in the legislative process.53 Legislators may actively seek the involvement of affected groups by soliciting their participation at hearings. Regulators may try to reduce the costs associated with participation in the regulatory process by using regulatory negotiation to encourage early and

64.  Id. at 557-58. Professor Rubin ran into similar difficulties when he served as the chair of the Article 3 and 4 subcommittee of the ABA’s Ad Hoc Committee on Payment Systems. He found that efforts to ensure that consumer interests were considered in the drafting process were sufficiently controversial that he ultimately resigned his position. Rubin, Thinking Like a Lawyer, supra note 38, at 781 (“It did not seem appropriate for me to lead the subcommittee when my views diverged so markedly from those of the members, so I resigned my position as chair in November of 1990.”).

65.  Rubin, Efficiency, Equity, supra note 3, at 558; see also Kripke, supra note 1, at 327 (“Difficult legislation like [the Code] without a popular appeal can seldom be passed without a broad consensus of agreement of interested parties.”).

effective participation by affected groups. Because of the need for uniformity, representation enhancement at the ALI/NCCUSL level will not remedy the problem of anticipated capture. Even if all affected groups were represented in the uniform law drafting process, this would not likely be the case in the legislatures of the fifty states. Moreover, representation enhancement in the legislatures of all fifty states is simply not feasible.

C. State Competition

A second reason that the uniform law process may fail, even in the absence of capture, lies in the dynamics of federalism. Concern about a race to the bottom may force the uniform law drafters to facilitate the adoption of inefficient rules.

1. Lessons from Corporate Law Scholarship

The corporate law debate over the merits of state competition helps explain how federalism may affect the content of uniform laws. Since the 1970s, corporate law scholars have sought to account for the overwhelming number of corporations that choose to incorporate in the state of Delaware. Three explanations have emerged: (1) the race to the bottom; (2) the race to the top; and (3) the product approach.

The race-to-the-bottom theory views state competition for corporate charters as a malevolent force. Professor William Cary pointed out that Delaware, by all accounts the victor in the interstate competition for corporate charters, is also at the forefront in relaxing corporate law restraints on managerial discretion. According to Cary, Delaware’s legislators recognize that corporate managers make the incorporation decision and that Delaware can woo these corporate decisionmakers by adopting rules that favor managers over shareholders. Although the shareholders nominally control the company, they face a collective-action problem. Shares in public companies are often widely held. Therefore individual shareholders have no incentive, and are not in a position, to actively monitor the behavior of the officers. Under Cary’s account, Delaware’s legislators also recognize that, for the most part, the citizens of Delaware do not bear the costs of these decisions in the form of reduced share value. Delaware legislators can therefore use liberal corporate law to curry favor with their constituents, such as local citizens, who benefit from franchise taxes, and lawyers in Wilmington who specialize in corporate law. Therefore, according to Cary, federal regulation of corporate governance is necessary.

67. Id. at 105-06.
68. Bebchuck, Federalism, supra note 45, at 1444-45; Charny, supra note 45, at 430-33.
70. The rise of mutual funds that represent large aggregates of shareholders may alleviate this problem somewhat.
Race-to-the-top theorists, such as Judge Frank Easterbrook and Professor Daniel Fischel, argue, by contrast, that Cary’s view ignores the market for corporate control, which operates to discipline managers who act opportunistically. If managers are acting inefficiently, their self-interested behavior will depress the value of the corporation’s stock. If investors recognize that the stock is undervalued, the company will become a takeover target. Once purchased, the new owners will replace the opportunistic managers. Like the race-to-the-bottom theorists, the race-to-the-top theorists recognize that Delaware wins in the competition for state charters because of its liberal corporate law rules. The race-to-the-top theorists, however, conclude that Delaware’s victory in the race occurs because these same rules are efficient and operate to enhance the value of the company.

Finally, a third group of scholars has sought to explain Delaware’s victory as a race for predictability and stability. Although Delaware may be a leader in the liberalization of corporate law, these scholars note that many jurisdictions, in order to compete with Delaware, have adopted corporate laws that are very similar to those of Delaware. Nonetheless, Delaware has remained the incorporation champion. Professor Roberta Romano argues that Delaware’s corporate law must be viewed not just in terms of the substantive law, but in terms of the whole “product”: Delaware has an experienced corporate law bar; the bench is small and familiar with corporate law issues; and, lastly, the corporation code can only be amended by a two-thirds vote of both houses of the state legislature.

Recently, Professor Lucian Bebchuck has offered a hybrid theory that attempts to reconcile all three explanations and to incorporate them into a unified model. He points out that different corporate law rules are attractive to corporate managers for different reasons. Some rules attract incorporation decisions for efficiency-based, value-creating reasons (race to the top), some attract incorporation because they are well-drafted and consistently interpreted by the judiciary of that jurisdiction (product), and others may attract incorporation because they transfer value to managers at the expense of shareholders (race to the bottom).

Bebchuck argues that each of these three explanations will apply to some legal rules, but not others. He views competition among states as a

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72. See Easterbrook, supra note 41, at 540 (“[E]vidence suggests the power of competition and existing arrangements in protecting investors.”); Fischel, supra note 41, at 921 (arguing that the absence of regulation allows “private parties to enter into contractual arrangements that they find mutually advantageous”); see also Dodd & Leftwich, supra note 41, at 259 (arguing that the race to the top will help shareholders achieve greater than average returns); Winter, supra note 41, at 251 (arguing that “state corporate legal systems are protective of shareholders”).

73. See generally Romano, supra note 45, at 225; Romano, The State Competition Debate in Corporate Law, 8 Cardozo L. Rev. 709 (1987).

74. Romano, supra note 45, at 273-78.

75. Bebchuck, Federalism, supra note 45, at 1440.

76. Id.
good thing, most of the time. States will experiment and seek to adopt rules that are either substantively efficient or that constitute a superior product. Ordinarily, these rules will attract corporations because they are value-creating, and this will produce a "race to the top." Bebchuck then identifies two types of rules that will cause race to the bottom type problems: (1) rules that increase agency costs (i.e., increase intrafirm externalities); and (2) rules that create interstate externalities.\textsuperscript{77}

A corporate agency problem arises when corporate managers act in their own interests rather than in the interests of the shareholders. First, because managers control the incorporation decision, the race to the bottom will operate when a rule allows managers to capture value from shareholders. Second, a rule that limits market discipline will exacerbate this problem by further insulating corporate managers.\textsuperscript{78} Third, when a rule allows dominant shareholders to gain advantage at the expense of minority shareholders, the discipline of the market over managers and majority shareholders (who, after all, owe a duty to minority shareholders) will be further diluted.\textsuperscript{79} In each of these categories, the rule that increases agency costs has distributive consequences that benefit a group with control over the incorporation decision. Attempts by states to use these types of rules to attract corporations will cause a race to the bottom.

An opportunity for interstate externality exists if Delaware can adopt a rule that will benefit Delaware corporations at the expense of the citizens of, say, Oklahoma. Such a statute, which is not value-creating, and exists solely to transfer wealth from citizens of one state to citizens of another is not socially desirable. Such a rule will, however, maximize shareholder value for Delaware corporations. When a corporation decides to incorporate in Delaware to take advantage of such a rule, the decision will not be driven by an agency problem (or intrafirm externality), but by the ability of Delaware to benefit shareholders in Delaware corporations at the expense of citizens of other states.\textsuperscript{80} A number of corporate law rules fall into this category, such as regulation of takeover and proxy contests, protection of creditors, disclosure obligations, protection of constituencies other than providers of capital such as employees and consumers, and rules that reflect goals such

\textsuperscript{77} Id. at 1484.

\textsuperscript{78} As noted above, the race-to-the-top theory is predicated on the assumption that the market for corporate control will operate to discipline errant corporate managers. Under this view, antitakeover legislation that protects entrenched corporate managers is likely to be a product of a race to the bottom.

\textsuperscript{79} Bebchuck, \textit{Federalism}, supra note 45, at 1484.

\textsuperscript{80} One might argue that many shareholders in Delaware corporations will likely live out of state. These shareholders will have an interest in preventing the corporation from taking advantage of the ability to impose costs across state lines. Here, however, the problem of interstate externality becomes a form of intrafirm externality. Now Delaware-corporation shareholders will face both information problems (they won't know what the corporation is doing to harm them) and a collective-action problem. As a result, out-of-state shareholders are unlikely to be able to prevent a race to the bottom.
2. Anticipated State Competition as a Driving Force in Uniform Law Drafting

At first blush, it is difficult to see how state competition for corporate charters bears on the uniform law process. After all, the entire point of the uniform law project is to eliminate state competition by creating a law that all states will adopt. Such concerns do enter this discussion through the back door. The uniform law drafters wish to ensure that the statute they prepare will be widely adopted. They must therefore draft a statute where state competition will not induce states to enact nonuniform versions of the code. On the one hand, this competition will encourage drafters to produce a good product—a statute that is well drafted and substantively superior to competing nonuniform laws regulating the same subject matter. However, they must also anticipate the likely results of interstate competition and neutralize it. In the uniform law drafting process, the desire for universal and uniform adoption drives the drafters to predict and follow the direction that state competition will lead. If state competition will encourage a race to the top, the drafters will be driven to create an efficient rule. But if competition will yield a race to the bottom, the drafters, if they are to preserve uniformity, must scrape the bottom as well.

Thus, the dynamics of federalism will play a large role in the drafters' deliberations. The Revisers' concern will not turn on the desirability or undesirability of a particular rule, but instead on whether the rule will pose a threat to uniform enactment of the proposed law. It is therefore crucial to determine which rules are more likely to be subject to race to the top type pressures and which are more likely to generate a race to the bottom. Here, Bebchuck's categories are helpful.

According to Bebchuck, a race to the bottom is likely when a rule creates a principal-agent problem. The agency problem in corporate law turns on the ability of managers to exploit a state's corporate law rules to capture value from shareholders. In corporate law, corporate managers act as "agents" of the shareholders. The agency problem exists because shareholders of a publicly held company face a collective-action problem and cannot effectively monitor opportunistic behavior by corporate managers. Again, this agency problem would not appear to apply to efforts to revise Article 9. Corporate managers are not agents of creditors in a legal sense. This does not mean that an agency problem does not exist. Economists do not use the term "agency" in the same way that lawyers do. A corporate officer need not be an "agent" of the shareholders in the legal sense for there to be an "agency" problem in the economic sense. As

81. Bebchuck, Federalism, supra note 45, at 1494-96.
82. See White, Ex Proprio Vigore, supra note 51, at 2131 (describing forces that contribute to nonuniform adoption).
83. LoPucki Letter, supra note 54.
Easterbrook has noted, the reason that shareholders are given the power to control a corporation is that they are residual claimants. The logic is that any action that helps the residual claimant will increase the value of all claims against the enterprise. Where the shareholders can inflict costs on fixed claimants this logic breaks down. Perhaps a more precise way of describing the “agency” problem would be to describe it as a conflict of interest between an empowered corporate constituency (i.e., management) and a disempowered corporate constituency (i.e., minority shareholders or creditors). More precise, but also more jargony, would be to call it a “negative intrafirm externality.” The problem of intrafirm externality exists whenever there is a conflict of interest between corporate managers and one corporate constituency that cannot make its voice heard.

When a uniform law has the effect of enhancing such an intrafirm externality, the drafters will be forced to anticipate a race to the bottom. This will occur any time that a legal rule (even one that does not deal directly with corporate governance) allows one corporate constituency to seize value from a corporate constituency that is either disenfranchised by corporate law or that faces a collective-action problem. As discussed below, the rule of full priority in Article 9 falls into this category because it allows shareholders and managers to alter the risk faced by nonconsensual and nonadjusting creditors.

Similarly, if one state can place the costs of an inefficient rule on the citizens of another state, there is an incentive for that state to benefit home state corporations by adopting that inefficient rule. Delaware benefits from the incorporation, while most of the shareholders who are harmed are residents of other states. The only way for the uniform law process to prevent nonuniform adoption in such a case is to make that inefficient rule part of the uniform law. Again, as discussed below, Article 9 falls into this category because it may allow Delaware citizens to benefit from corporate law rules that harm the citizens of distant states.

D. The Proper Domain of the Uniform Law Process: Towards a Decision Rule for Selective Abstention

This analysis suggests that there are advantages to using the uniform law process to legislate in certain areas. The need to obtain uniform adoption will encourage the drafters to enact a statute that is widely acceptable and may effectuate a race to the top. However, this analysis also suggests a decision rule that may help to decide in advance which questions should be handled through the uniform law process and which questions


85. See infra notes 147-48 and accompanying text.

86. This conflict exists because the shareholders can use secured credit to increase the risk faced by nonadjusting creditors, without paying a corresponding risk premium. See infra notes 143-49 and accompanying text.
can more effectively be dealt with by other lawmaking bodies. Because the
uniform law process appears to have both relative advantages and
disadvantages over the federal and nonuniform law drafting processes, it
might seem wise to self-consciously adopt an approach of selective
abstention.\textsuperscript{87} When there is no reason to expect the uniform law process to fail, it should be allowed to function and do what it does well. However,
when capture, anticipated capture, or an anticipated race to the bottom are
likely to drive the uniform law process, the ALI/NCCUSL should decline to
regulate the area and leave the question to federal law or nonuniform state
law. In the alternative, ALI/NCCUSL could adopt a rule in the absence of a
federal or state rule, but indicate that the matter would better be handled by
nonuniform legislation.\textsuperscript{88}

Thus, there are two types of rules that are likely to lead to failure of the
uniform law process: rules that are likely to cause the drafters to anticipate
and facilitate the capture of state legislatures, and rules that are likely to
cause the drafters to anticipate and facilitate a race to the bottom. In sum,
the uniform law process can be expected to fail when it seeks to create

(1) rules that are distributive between political constituencies,
when either the benefitted or burdened interest group (but
not both) faces a collective-action problem; or

(2) (a) rules that are distributive between corporate
constituencies, when either the benefitted or burdened
corporate constituency (but not both) faces a collective-
action problem or otherwise lacks a voice in the
corporate decisionmaking process; or

(b) rules that allow citizens of, and businesses located in,
one state to impose costs on citizens of other states.

Rules in the first category are likely to be subject to capture or anticipated
capture, while rules in the second category are likely to be subject to an
anticipated race to the bottom. In either case, there is reason to believe that
federal or nonuniform state legislation will produce a better legislative
product.

\textsuperscript{87} Indeed, Steven Nickles argued that it might have made sense to merge the National
Bankruptcy Review Commission and the Drafting Committee for Revised Article 9 so that the
system could be viewed as a whole. Steven H. Nickles, \textit{Consider Process Before Substance,}
\textit{Commercial Law Consequences of the Bankruptcy System: Urging the Merger of the Article 9 Drafting

\textsuperscript{88} The NCCUSL already follows this practice with regard to model acts. These are acts
where the drafters have concluded that the act embodies policy choices that may not be
suitable for all states. If selective abstention is to work, it must be carried out in a forthright
and self-conscious fashion. When certain provisions are excluded from a uniform law for
"selective abstention" reasons, it should be made clear that the decision not to include, for
example, consumer protection provisions in Revised Article 4, does not reflect on the merits
of such proposals, but is driven by the inability of the uniform law process to incorporate such
provisions.
II. EVALUATING THE DECISION RULE: THE ARTICLE 9 REVISION--WHAT IT DOES AND DOESN'T DO

Having articulated the decision rule, the next task is to demonstrate that it has explanatory power. This Part contrasts the response of the Revisers of Article 9 to two different types of proposals: (1) proposals directed at the safety of secured credit (in the form of risk alteration and consumer protection); and (2) proposals that respond to technological change.

A. The Article 9 Revision and Proposals That Respond to the Distributive Consequences of Secured Credit

Professors Warren, LoPucki, Bebchuck and Fried have made a number of proposals aimed at controlling the third-party effects of secured credit. In contrast to the Reviser's reaction to proposals which address technological change, the response has been vehement. Critics have attacked the theoretical and empirical bases for these proposals along with their practicality. The Revisers have proposed no changes to Article 9 to address concerns over the third-party effects of secured credit. This Part develops the argument for the Warren Proposal and describes the Revisers' response. Readers who are familiar with the debate may wish to skip to Part II.A.3.c.

1. Distributive Consequences of Secured Credit: Common-Law Recognition and the UCC's Response

The distributive consequences of secured credit are not a recent discovery. Article 9 is unique among the articles of the Uniform Commercial Code in that it is devoted to facilitating, and indeed encouraging, a practice that both English and American courts viewed first as a felony and later as a civil fraud. Until the advent of the statutory precursors to Article 9 in the late nineteenth century, common-law courts viewed nonpossessory interests in personal property as a fraud upon creditors. These courts took the view that, by separating ownership and possession (thereby creating a secret lien), debtors could deceive future creditors and harm existing creditors. These judges feared that potential

89. See Bebchuck & Fried, supra note 18, at 904; LoPucki, Bargain, supra note 18, at 1908-09; Warren, Proposal, supra note 18, at 1.
90. See infra notes 173-80 and accompanying text.
91. Statute of 13 Elizabeth, 13 Eliz., ch. 5 (1570); Twyne's Case, 3 Coke 80b, 76 Eng. Rep. 809 (Star Chamber 1601).
93. Id.
creditors would look at the assets in the debtor's possession and assume that they would be available (upon levy and execution) to satisfy the creditor's claims. Even more troubling, debtors on the brink of bankruptcy could use nonpossessory property interests to prefer one creditor over another, or to protect their assets from execution by the sheriff.

For example, in *Twyne's Case*, the debtor, Pierce, owed Twyne £400. Pierce also owed £200 to C. C sued Pierce and obtained a judgment. Pending the writ, Pierce conveyed all of his property to Twyne in satisfaction of the larger debt. Twyne continued in possession of the property, however, and remained in business. The Star Chamber found the conveyance to be fraudulent. Thus, the early judicial hostility to nonpossessory security interests, while characterized in terms of fraud, rested on a recognition that nonpossessory security interests in personal property could have undesirable distributive consequences.

Over time, however, a different response developed. Creditors contrived, and courts and legislatures recognized, a number of common-law and statutory security devices, such as chattel mortgages, field warehouses, and trust receipts. Courts would recognize certain nonpossessory property interests so long as the "secured" creditor or debtor took steps to notify other creditors of the property interest. By requiring some form of notice, courts ameliorated the problem of fraud, and to some extent, the risk of debtor misbehavior. Early lenders could protect themselves from later creditors either by insisting on collateral themselves or by insisting on negative covenants, under which the debtor would promise not to incur further secured debt. Though simple in concept, implementation of this principle was far from perfect. A congeries of security devices and notice mechanisms developed that made it difficult for secured creditors to determine how to perfect their property interest and for prospective unsecured creditors to determine which assets would be available to general creditors in the event of default.

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94. Id.

95. 76 Eng. Rep. 809 (Star Chamber 1601).

96. For a discussion of pre-Code security devices, see Grant Gilmore, Security Interests in Personal Property 5-195 (1965).

97. The official comment to section 9-101 provides:

Pre-Code law recognized a wide variety of security devices, which came into use at various times to make possible different types of secured financing.

Differences between one device and another persisted, in formal requisites, in the secured party's rights against the debtor and third parties, in the debtor's rights against the secured party, and in filing requirements, although many of those differences no longer served any useful function. Thus an unfiled chattel mortgage was by the law of many states "void" against creditors generally; a conditional sale, often available as a substitute for the chattel mortgage, was in some states valid against all creditors without filing, and in states where filing is required was, if unfiled, void only against lien creditors. The recognition of so many separate security devices had the result that half a dozen filing systems covering chattel security devices might be maintained in a state . . . .

The growing complexity of financing transactions forced legislatures to keep
The genius of Article 9 was that it identified a simple solution to the problem of the secret lien and to the problem of multiple security devices and filing systems—the unitary security interest and the Article 9 filing system. In one stroke, Article 9 replaced a wide variety of cumbersome devices, filing systems, ad hoc notice requirements, and much of the law of pledge with a relatively straightforward system of notice filing and a simple set of priority principles. Indeed, the basic outline of Article 9 "can be summarized in a few sentences:

A security interest is . . . a priority right that is linked to specific collateral. A creditor who takes a nonpossessory security interest creates an ostensible ownership problem and should presumptively have a duty to cure it by making a public filing. The public filing, however, need only give notice that the secured creditor has or in the future may take an interest in particular types of collateral. There is no duty to record the details of the transaction. Finally, a creditor who acts in good faith and cures the ostensible ownership problem has the right to take a security interest in the personal property of the debtor.

By devising this straightforward mechanism for curing the ostensible

piling new statutory provisions on top of our inadequate and already sufficiently complicated nineteenth-century structure of security law. The results of this continuing development were increasing costs to both parties and increasing uncertainty as to their rights and the rights of third parties dealing with them.

The aim of this Article is to provide a simple and unified structure within which the immense variety of present-day secured financing transactions can go forward with less cost and with greater certainty.


98. Of course, simplicity is in the eyes of the beholder. While certainly an improvement over what came before, the filing of notice to perfect a security interest remains an expensive and cumbersome part of any secured transaction. In a report to the Uniform Commercial Code Article 9 Filing System Task Force to the Permanent Editorial Board's Article 9 Study Committee, Meredith Jackson analyzed over 100 legal bills generated by the law firm of Bingham, Dana and Gould, and concluded that in a typical transaction the legal fees associated with the filing system would constitute 5.52% of the bill. Thus for a transaction where the legal fees were $467,100, $25,000 would be attributable to the filing system. Alces, supra note 17, at 691-92.

99. Again, simplicity is in the eyes of the beholder. While the basic principle of priority is that the first to file properly, or to take possession, takes priority over those who perfect their security interest later in time, U.C.C. § 9-312(5) (1995), there are a number of parties who may take priority over the first to file, such as holders of purchase money security interests, id. §§ 9-312(4) & (5), or parties who have filed improperly but whose interests are known to the first to file, id. § 9-401(2). These rules can create circular priorities and other uncertainties. As a result, Professor White has advocated limiting many of these exceptions to the first-in-time rule. White, supra note 33, at 535 ("As a touchstone against which to measure proposals for priority and in the face of our ignorance about the state of the parties' motivations and intentions, I start with the hypothesis that the first to file should defeat all others, both those coming before and those coming after.").

100. Baird, supra note 17, at 2249.

101. Id.
ownership problem, Article 9 improved the lot of both secured and unsecured creditors. Article 9 reduced the secured creditor's cost of perfecting a nonpossessory interest in personal property, and it eased the unsecured creditor's task of learning about existing interests in collateral by reducing the number of files to be searched. By paying a small filing fee and filing a half-page form in a public office, a secured creditor could put prospective lenders on notice of an ownership interest in the debtor's asset(s). By searching those files, potential creditors could learn of any existing encumbrances.

Having "solved" the so-called "problem of ostensible ownership," the debate over the distributive consequences of secured credit moved to the background and lost both its urgency and force. Solution of the notice problem allowed the uses and forms of security interests to be determined under a regime of freedom of contract.

2. Concerns Persist

"b. Misgivings Expressed in Article 9"

The discussion, however, did not go away completely. The drafters of Article 9 themselves articulated some reservations about the wisdom of floating liens on inventory and equipment. In the Official Comment to section 9-204, Gilmore and Dunham attributed the common law suspicion of the floating lien to the view that any debtor should maintain a cushion of unencumbered assets to satisfy unsecured claims. Article 9 rejected this position, "not on the grounds of policy, but on the ground that it was not effective." Commercial reality had overtaken the law. Demand for secured

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102. Id.
103. Although it was still necessary for the debtor to determine which state's files to search, Article 9 sought to limit the number of state files to search by adopting the uniform choice-of-law rule contained in section 9-103. While this section has engendered a fair amount of confusion, it was still an improvement over having to search the chattel mortgage files, trust receipts files, fixture files and other files in any of a number of jurisdictions with widely divergent filing systems.
104. Baird, supra note 17, at 2249.
105. The current debate over the Warren Proposal might be viewed as a re-emergence of the debate over the need for just such an equity cushion. Cf. Warren, Proposal, supra note 18, at 1 ("As I recall the debate [at the Council meeting of December 1996], the operative metaphor was that the new proposals permitted the secured creditors 'to plow the corners of the field.' The Article 9 drafting committee was unwilling to draft a proposal that insured that some assets would remain for unsecured creditors in the event of the debtor's failure.").
106. U.C.C. § 9-204 cmt. 2 (1995). That comment provides:
This Article accepts the principle of a "continuing general lien." It rejects the doctrine--of which the judicial attitude toward after-acquired property interests was one expression--that there is reason to invalidate as a matter of law what has been variously called the floating charge, the freehanded mortgage and the lien on a shifting stock. This Article validates a security interest in the debtor's existing and future assets, even though . . . the debtor has liberty to use or dispose of collateral without being required to account for proceeds or substitute new collateral.. . .
financing had found a way over or around each attempted road block. Gilmore and Dunham decided to give in to the inevitable. Their hope was that the filing system would reduce the risk of harm by putting potential creditors on notice of a security interest in future as well as present collateral. The potential creditor could then choose whether or not to extend credit with a more accurate picture of the assets that would be available in the event of default. By solving the notice problem, Article 9 eliminated the need for an "equity cushion."

b. Gilmore's Challenge

Even with the filing system in place, however, Professor Gilmore continued to worry that notice did not eliminate all of the problematic consequences of secured credit. In 1981, not long before his death, Gilmore mused:

"[T]here was something worth thinking about in the limitations that the nineteenth-century courts had placed on the mortgagee's claim to after-acquired property: does it make any sense to award everything to a secured party who stands idly by while a doomed enterprise goes down the slippery slope into bankruptcy?"

Gilmore was troubled by the power of the device he and his colleagues had created. Although Article 9 took the rule of full priority for secured claims from pre-Code law, it institutionalized the ability to take a security interest in after-acquired property and allowed the priority of future advances to relate back to the date of an earlier filing. As a result, a secured creditor

The widespread nineteenth century prejudice against the floating charge was based on a feeling, often inarticulate in the opinions, that a commercial borrower should not be allowed to encumber all his assets present and future, and that for the protection not only of the borrower but of his other creditors a cushion of free assets should be preserved. That inarticulate premise has much to recommend it. This Article decisively rejects it not on the ground that it was wrong in policy but on the ground that it was not effective. . . . In almost every state it was possible before the Code for the borrower to give a lien on everything he held or would have. There have no doubt been sufficient economic reasons for the change. This Article, in expressly validating the floating charge, merely recognizes an existing state of things. The substantive rules of law set forth in the balance of the Article are designed to achieve the protection of the debtor and the equitable resolution of the conflicting claims of creditors which the old rules no longer give.

Id. (emphasis added).

107. Id.

108. The principal substantive rules mentioned in the last sentence of the official comment to section 9-204 are the perfection rules contained most notably in sections 9-302 to 9-305, and the filing rules contained in sections 9-401 to 9-403. Under Article 9's priority rules, a security interest does not take priority over the claims of third parties (unsecured creditors) unless the creditor has perfected the security interest by taking possession, or by filing a notice of the security interest in the appropriate place. U.C.C §§ 9-301, 9-312.

109. Or, so it was hoped.

110. Gilmore, Good Faith Purchase, supra note 6, at 627.

could perfect a security interest in virtually all of the debtor's property. Moreover, this could be done cheaply and with confidence. The harsh consequences of the rule of full priority on certain types of creditors were the source of Gilmore's concerns. These consequences can best be understood through an example.

Farginkles, a department store, files a bankruptcy petition. At a hearing, on or shortly after the petition date, the lawyer for the debtor-in-possession reports to the bankruptcy judge that the debts of the estate total $40,000,000. Furthermore, the debtor's principal secured creditor holds $20,000,000 of those claims and has a perfected, unavoidable, first priority lien on all of the debtor's real and personal property. The attorney states that the assets of the corporation are valued at $19,000,000. Therefore, says the attorney, "there will be no distribution to unsecured creditors." Accordingly, he requests the court's permission to abandon the debtor's assets to the secured creditor for the purpose of liquidation. The court, after an evidentiary hearing, concludes that the lawyer's estimate of the value of the debtor's assets is, if anything, generous, and grants the debtor's motion to abandon. At the end of the day, the secured creditor is paid 95% of its claim out of the sale of its collateral, and the other claimants receive nothing. These claimants include trade creditors, suppliers, employees with pension claims, retirees with medical benefits and others. These creditors may also include tort claimants such as employees injured on the job (to the extent that their injuries are not covered by workers' compensation), customers injured on the premises, and so on.

For Gilmore, these consequences mandated a second look at secured credit. Until recently, however, Gilmore's misgivings about the harm caused by cheap and easy secured credit remained just that—a gut reaction that something was amiss, without a theory to explain the scope or dimension of the problem. With the notice problem solved, the consequences of Article 9—that secured creditors received more in bankruptcy than unsecured creditors—could be defended on grounds of freedom of contract. The rule

112. Id. § 9-302.
115. This would be subject to nonuniform real estate law, but in every jurisdiction could be accomplished by recording a mortgage in the appropriate land records.
116. Under § 544, the trustee in bankruptcy has the status of a hypothetical lien creditor as of the date of the petition. As such, property enters the estate subject to any property interests that were perfected prior to the date of the petition. 11 U.S.C. § 544. Therefore, if the value of perfected liens against the debtor's property exceeds the value of that property, all property will be used to satisfy the secured claims and no property will be left over to satisfy unsecured claims.
117. "After notice and a hearing, the trustee may abandon any property of the estate that is burdensome to the estate or that is of inconsequential value and benefit to the estate." 11 U.S.C. § 554(a) (1994).
118. $19,000/$20,000=0.95
119. $20,000>$19,000.
of full priority merely held the unsecured creditor to the terms of his or her bargain.\textsuperscript{120} Gilmore’s concerns could be dismissed as mere soft-heartedness.\textsuperscript{121}

3. Explaining Secured Credit: The Efficiency v. Inefficiency Explanations

Gilmore’s question had two components: (1) what social policy is served by secured credit; and (2) is anybody harmed by secured credit? Lurking in the background was the question of whether the social costs of secured credit outweighed the benefits. Because freedom of contract, coupled with notice, seemed on its face to eliminate any significant costs, the search for an answer focused on identifying the policy served by secured credit.

\textit{a. Benefits? The Puzzle of Secured Credit}

So long as freedom of contract provided a complete response to concerns about the costs of secured credit, relatively weak rationales could be tolerated; and weak explanations were all that emerged.

(1) The Puzzle

Even before the search for an answer to Gilmore’s question began in earnest, it ran into trouble. Alan Schwartz looked to finance theory and articulated what has become known as the “Puzzle of Secured Credit.”\textsuperscript{122} He looked to the work of economists Ando Modigliani and Merton Miller\textsuperscript{123} and argued that the prevalence of secured credit was a mystery. Modigliani and Miller argued, in the late 1950s, that altering the capital structure of a corporate entity should not change its value. Creditors will simply adjust the interest rate charged for debt and the amount they will pay for an equity interest in the company to reflect the riskiness of the investment. These adjustments thereby offset any benefit. Put another way, a firm cannot not alter its average cost of capital by altering its capital structure.\textsuperscript{124}

Again an example may be useful. Assume that General Amusements

\begin{itemize}
  \item \textsuperscript{120} See generally Thomas H. Jackson, The Logic and Limits of Bankruptcy (1986).
  \item \textsuperscript{121} Indeed, the Revisers have sought to caricature Gilmore and others who raise concerns about the rule of full priority by suggesting that they are part of a movement that they call “Sympathetic Legal Studies,” driven by misguided compassion for those who lose out under Article 9’s priority scheme. These latter-day followers of Gilmore are collectively, and somewhat uncharitably, referred to as “symps.” Harris & Mooney, supra note 3, at 2045-47.
  \item \textsuperscript{124} See id. at 268 (arguing that “the market value of any firm is independent of its capital structure”).
\end{itemize}
ARTICLE 9

makes Whoopie Cushions®. Whoopie Cushions® sell for $5.00 each. General Amusements can produce 1000 Whoopie Cushions® per week (fifty weeks per year as the factory closes for a week at Christmas, and for a week during the summer), and Whoopie Cushions® cost $4.00 each to produce. General Amusements presently carries $100,000 in unsecured debt on which it pays five percent annual interest.

Vinyl Products offers to sell General Amusements a new Whoopie Cushion®-making machine for $100,000. The machine will have a useful life of ten years and will allow General Amusements to produce an extra 200 Whoopie Cushions® per week at a cost of $3.50 per Whoopie Cushion®. General Amusements does not believe that this increase in production will affect the market price.

If the machine is treated as a bond producing an income stream totaling $150,000 over ten years on an investment of $100,000, and General Amusements can borrow at a rate of five percent, this is a bad investment. Assuming that a balloon payment is due at the end of the period, the company would have had to spend approximately $163,000 to make an investment that produced only $150,000.

Further assume, however, that General Amusements has an opportunity to borrow at a lower interest rate, say four percent, on a secured basis. At first blush this would appear to alter the economics of the deal, reducing the total outlay to approximately $148,000 over the same period. However, under Modigliani and Miller's irrelevance hypothesis (known simply as MM to finance graduate students), this ability to borrow, however, at a lower interest rate would not turn a bad investment into a good one. By charging certain assets to pay the equipment lender, General Amusements would increase the riskiness of the investment of its existing unsecured creditors. As a result, assuming perfect information and costless immediate adjustment, the firm's other lenders would no longer be willing to lend at five percent and would require a risk premium. Under Modigliani and Miller's calculus, the risk premium would offset the reduction in interest rate made possible by borrowing on a secured basis. The company's average cost of capital would remain five percent, and the bad investment would remain a bad investment.

Modigliani and Miller offer the analogy to milk. A farmer cannot increase the amount in the bucket by dividing whole milk into skim milk.

125. Over 10 years, the machine will produce an extra 100,000 Whoopie Cushions (200(cushions)*50(weeks)*10(years)). The profit on each cushion will be $1.50 (100,000*$1.50=$150,000).

126. The formula for compound interest is: \( V_n = P(1+i)^n \), where
- \( V_n \) = value at the end of \( n \) years,
- \( P \) = principal amount deposited or invested,
- \( i \) = interest rate per year, and
- \( n \) = number of years.

Therefore, \( $162,889.46 = $100,000(1 + .05)^{10} \).

127. \( $148,024.43 = $100,000(1 + .04)^{10} \).
Finance graduate students like to use pizza, pointing out that one cannot increase the size of a pizza by cutting it into smaller pieces. If the so-called "Modigliani and Miller Irrelevance Hypothesis" is correct, argues Schwartz, debtors have no interest rate based reason to offer security to their lenders.

From the perspective of social policy, this is troubling. Secured credit is a common form of lending and one that entails certain costs to both the lender and the borrower. The lender must take the trouble to perfect its security interest. The borrower may limit its access to credit in the future by encumbering assets. Why do debtors and creditors choose in such great numbers to bear these costs? Two possibilities present themselves. Either secured credit produces efficiencies, in which case it should be encouraged, or it imposes costs on third parties, in which case it is an institution that should be discouraged.

(2) Attempted Efficiency-Based Solutions to the Puzzle

The principal efficiency-based responses to Professors Gilmore and Schwartz turn on monitoring costs. In many instances, it is very costly for a creditor to monitor the activities and creditworthiness of a debtor's entire enterprise. It is cheaper simply to monitor a single asset. In addition, because creditors will face a collective-action problem and the resulting incentive to free ride, a suboptimal level of monitoring will occur. Secured credit, it is argued, provides a mechanism for creditors to divide up the monitoring task in an efficient way. Creditors simply choose the assets that they are in the best position to monitor and worry about those assets alone. For this reason, the cost savings associated with reduced monitoring costs will benefit all of the debtor's claimants. The free rider problem is thus conquered, as is the problem of duplication of effort.
Although secured lending creates monitoring efficiencies for certain creditors, it does not benefit those creditors who have not bargained for priority. Dean Robert Scott, however, carries the monitoring cost argument even further, focusing on the relationship between a debtor and its lead lender. He seeks to show that the monitoring efforts of the secured creditor may also benefit the debtor's unsecured creditors. He points out that a floating lien creditor expects to be repaid out of the proceeds of the business, rather than out of the collateral per se, and that its monitoring efforts will look at the same things as would an unsecured creditor. In so doing, the debtor saves money because the unsecured creditors are freed from their monitoring burden. This efficiency benefit does not come at the expense of the unsecured creditors.

In comparison to the variety of monitoring cost arguments, James White offers an answer of a slightly different type: secured credit is necessary because it compensates for lender risk aversion. Commercial lenders, he argues, are by nature risk averse. If this is the case, then secured credit is necessary to create the efficient amount of lending. Kanda and Levmore have made a related argument that secured credit operates to control risk alteration, by balancing the interests of early and late lenders. If an early lender takes collateral, the security prevents the debtor from altering the riskiness of the loan by borrowing more money. By contrast, late money priorities, such as the purchase money security interest, give

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> the leverage obtained by holding the debtor's assets hostage empowers the secured creditor to influence the debtor's business decisions, thus ensuring that new projects are properly developed. Most significantly, this relationship induces the creditor to provide valuable financial coordination and control, with resulting benefits accruing to all participants in the venture.

Id.

136. Id. at 933 ("The global monitoring required of the relational creditor releases other creditors from the focused monitoring tasks that they would undertake in the absence of the relational creditor. The resulting cost savings thus provides additional economies that are unlikely to be achieved where such security arrangements are not permitted.").


138. Id. at 502-06. Schwartz argues that this argument is implausible because risk averse financiers will lose out in the Darwinian struggle for survival to financiers who are not risk averse. See Schwartz, Continuing Puzzle, supra note 122, at 1062-63 ("Corporate managers who maximize share values will not act as if they are risk averse, for risk aversion follows from the diminishing marginal utility of money theory. This theory does not describe the behavior of a person who seeks to maximize share values."). White also argues that trade creditors look to cash flow and do not actually expect to be repaid out of the debtor's assets. As such, unsecured creditors should be indifferent to the existence of secured credit. White, supra note 137, at 476. This argument seems implausible. Increasing the indebtedness of a debtor increases the risk that it will fail. As such, a trade creditor who cannot adjust its credit terms will not be indifferent to the capital structure of the debtor.

priority to lenders who may be in a better position to determine the profitability of certain investments, and whose loans are not likely to harm the position of earlier creditors.

Finally, Professor Ronald Mann has done some extremely important work. He has taken the radical step of asking secured creditors themselves to “explain” the reasons they engage in secured and unsecured lending. He notes that the creditors themselves do not explain their desire for security in terms of the “risk shifting” effect of secured credit, but instead focus on the enhanced leverage it gives the creditor to enforce payment. Even this hostage value explanation, however, turns on, and results in, risk alteration. Absent some undemonstrated positive externality, any measure that increases the likelihood that one creditor will be repaid, either inside or outside of bankruptcy, increases the riskiness of the investments of other creditors. Indeed, it is not surprising that the creditors interviewed focused on the benefit to themselves from secured credit rather than the harm that it does to others.

Although these theories are helpful, none is completely satisfactory as an explanation for the prevalence of secured credit and the persistent demand of debtors and creditors for asset-based financing. Even if the inadequacy of these explanations is not particularly troubling, their weakness suggests that academics have not found the true answer to the puzzle. Perhaps the most convincing of these explanations is Mann’s leverage explanation. Yet while this may explain the reason why creditors think that they lend on a secured basis, this leverage is not an unalloyed benefit. One creditor’s leverage increases the risk faced by other creditors.

b. Explaining Secured Credit: The Inefficiency Concerns

In this regard, Mann’s “solution” to the puzzle provides a link to another set of explanations for secured credit. These lie on the cost side of the equation—in the failure of the notice system to eliminate certain externalities of secured credit. Concern about the externalities of secured credit was first articulated by Professor Paul Shupack.


141. See Schwartz, Continuing Puzzle, supra note 122, at 1068 (“The secured debt puzzle remains: firms issue much debt on a secured basis, yet the causes and effects of this practice are largely unknown.”); Schwartz, Theory, supra note 122, at 247 (“[T]he question of why some debtors offer security in lieu of or in addition to loan covenants remains puzzling.”). Ronald Mann has suggested that the pattern of secured credit can be explained based on the creditor’s attempt to balance the increased security of a collateralized loan against the increased costs of obtaining security. Ronald J. Mann, Pattern, supra note 140, at 671-74.

142. See Shupack, supra note 133.
(1) Nonadjusting Consensual Creditors

First, Shupack noted, many creditors cannot adjust their interest rate when the riskiness of the investment changes. For example, an unsecured lender who lends before the debtor gives collateral for a second loan may not be able to adjust the interest rate of its loan prior to maturity. Similarly, employees often lack the bargaining power to alter the credit terms that they give to the company with regard to accrued but unpaid wages, vacation pay, sick leave or other benefits. Suppliers who enter into individual transactions may not find it cost-effective to customize the credit terms of each transaction and may simply choose to do business on an open account.

Thus, once one relaxes the assumption, implicit in Modigliani and Miller, that all creditors can adjust their interest rates in a cost-free and relatively instantaneous fashion, secured credit will have some costs. Some creditors may recognize their inability to adjust and may in fact charge a higher interest rate, or higher price, at the outset. Others may insist on a negative covenant prohibiting future secured lending. Some creditors may not, however, be in a position to do either. Employees are the obvious example here.

(2) Nonconsensual Creditors and Inefficiency

When nonconsensual creditors are involved, the existence of a subsidy is more plain. Article 9's solution to the problem of "safety" was one premised on voluntary investment. The Article 9 filing system would protect widows and orphans through a simple disclosure mechanism that would allow potential investors to determine whether the assets of the debtor are encumbered. Tort claimants, by contrast, do not make a voluntary investment decision based on credit risk. They do not, therefore, benefit from the system of notice filing. Indeed, when a company engages in a risky activity, it may nonetheless be able to raise capital on a secured basis and place the risk of insolvency on nonconsensual tort claimants. The shareholders receive all profits realized as a result of the gamble, while the

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143. Id. at 1094.
144. This inability to adjust may not harm suppliers and other sophisticated unsecured lenders who have the ability to spread risk. While many sellers extend 30 days credit as part of a sales transaction without charging additional interest, they may roll interest and the risk of business failure into the price they charge. For the most part, however, these merchants do not adjust the price that they charge based on the creditworthiness of a particular debtor. Bebchuck & Fried, supra note 18, at 898-99. Leveraged firms may thus have the ability to raise the costs of their unleveraged competitors.
145. Id. at 887-91.
146. In this description of tort claimants, it may be necessary to distinguish the products-liability claimant from the claimant who is run over by the debtor's delivery truck. The products-liability claimant has entered into a consensual relation with the debtor, and, as such is (at least in theory) in a position to make a decision based on credit risk. The same cannot be said of the accident victim.
tort claimants bear the costs. Under this understanding of secured credit, the availability of secured credit, coupled with limited liability, may severely undercut the effectiveness of the system of tort liability. Entities that face substantial tort liability may, in effect, render themselves judgment-proof through the use of secured credit.  

No empirical study has measured the size of this subsidy, and it is likely to vary significantly with the nature of the business involved. Nonetheless, when an entity can predict that it will have a large number of nonconsensual creditors relative to assets, the subsidy will be greater, and the entity could be expected to borrow heavily on a secured basis.

Having identified the subsidy of secured credit, it is now clearer why secured credit exists. An important question remains, however: do the costs of secured credit outweigh its benefits? This empirical question arises because the existence of a negative externality does not necessarily compel the conclusion that security interests are undesirable. When a corporation

147. This ability is not absolute. Under the Uniform Fraudulent Transfers Act, courts may invalidate as fraudulent conveyances security interests where the debtor received little or no consideration in return for conveyance of the lien and the debtor was insolvent or rendered insolvent by the transaction. See, e.g., United States v. Tabor Court Realty Corp., 803 F.2d 1288, 1296-1301 (3d Cir. 1986) (affirming district court's finding of fraudulent conveyance and invalidating security interest where issuer of junk bonds was aware that the transaction would render the leveraged corporation insolvent); In re Greenbrook Carpet Co., Inc., 722 F.2d 659, 660 (11th Cir. 1984) (refusing to find fraudulent conveyance where debtor corporation transferred proceeds of a secured loan to principal owners in exchange for security interest in financial securities because debtor received "reasonably equivalent value" for the loan). But see Kupetz v. Wolf, 845 F.2d 842, 850 (9th Cir. 1988) (refusing to find fraudulent conveyance in case involving leveraged buyout where no evidence was presented of intent to defraud creditors and selling shareholders were unaware of leveraged buyout). But fraudulent conveyance law will only capture a relatively small number of these "judgment proofing" security interests. A court will only find the secured transaction fraudulent if the creditor did not receive "reasonably equivalent value," and such value may include cancellation of a preexisting debt. LoPucki, Death, supra note 30, at 10 n.26. Moreover, secured credit is not the only mechanism that a debtor may use in order to render itself judgment proof. See generally LoPucki, Death, supra note 30. Debtors may also use ownership strategies, id. at 19, asset securitization, id. at 23, bankruptcy exemptions, id. at 30, and foreign debt havens, id. at 32, to accomplish the same objective.

148. Theory and reality may collide here because of the inefficiency of the tort system. While Posner and other law and economics scholars have praised the efficiency of common law tort rules, Posner, Economic Analysis, supra note 58, at 163-216, many others believe that the tort system has run amok. See Note, "Common Sense" Legislation: The Birth of Neoclassical Tort Reform, 109 Harv. L. Rev. 1765, 1765 (1996) (noting a strong popular consensus over tort reform).

149. According to Harris and Mooney, "whether the benefits of secured credit outweigh its costs in a few, many, or most of the circumstances in which security interests are granted is an empirical question that cannot be answered with any certainty using existing information." Harris & Mooney, supra note 3, at 2036. Moreover, because systematic empirical work remains to be done, scholars can still argue that the costs of secured credit are trivial when compared to the benefits or at least that the data is inconclusive. Harris and Mooney raise an important question about LoPucki's use of bankruptcy data to draw conclusions about the efficiency of Article 9. They point out that looking only at bankruptcy data may obscure the efficiency benefits of the vast majority of secured obligations that are repaid. Id. at 2028-37.
engages in an activity that is socially desirable and the corporation is solvent, the subsidy created by secured credit and limited liability may be the incentive necessary to encourage investors to invest their funds in the enterprise. Furthermore, when the entity is solvent, the effect of secured credit and limited liability on shareholders' incentives to take reasonable care is likely to be minimal or at least tolerable.

To illustrate this point, imagine that General Amusements' business, discussed above, has grown. Its assets are now valued at one million dollars. It has secured debt of $250,000, unsecured debt of $250,000, and shareholder equity totaling $500,000. Imagine further that Whoopie Cushions® have a useful life of one year, and in any given year there is a one in five probability that a Whoopie Cushion® manufactured that year will explode and injure a Whoopie Cushion® user. On average, the tort liability for each Whoopie Cushion® explosion is $100,000. On the corporate balance sheet, this should be treated as a $100,000 liability payable over five years. This would reduce shareholder’s equity by $100,000 discounted over five years (say, $80,000).

If a change in the design of Whoopie Cushions® could eliminate this risk for a cost of $50,000, then the change is socially desirable. Under this example, the shareholders would choose to make the change because making it would increase the value of their investment in the company. A charge against equity of $80,000 could be eliminated for a price of $50,000. Because the debtor makes the same decision with or without secured credit, the effect of secured credit is ambiguous.

(3) Leverage and Moral Hazard

By contrast, if the company is insolvent or close to insolvency, the effect on incentives is greater. Shareholders, officers, and managers have a significant incentive to engage in opportunistic behavior. Imagine that General Amusements' assets are still worth $1,000,000, but now secured claims against the company total $600,000, and unsecured claims total $360,000. The probability of an accident remains the same. Therefore, the shareholders' equity, taking the $80,000 charge into account, is now worth negative $40,000. If the corporation can eliminate $80,000 of the risk at a cost of $50,000, it is socially desirable. However, on these facts, the shareholders remain underwater even if the investment is made. As a result, the only hope for the shareholders to receive a return on their investment is to gamble that during the next several years no Whoopie Cushions® will explode, and that this will allow the company to return to profitability. The shareholders will bear none of the cost, but will receive a portion of the benefit if the gamble pays off. The secured creditors bear none of the risk either. Even under the worst-case scenario they will probably be paid in full out of the proceeds of the sale of their collateral. The costs are borne

150. At an interest rate of five percent, compounded annually, an $80,000 investment in year one would be worth $102,102.52 at the end of five years.
instead by the unsecured creditors (including employees and tort claimants) who will share pro rata in the value of the company's unencumbered assets.

This moral hazard is in part a product of limited liability (the shareholders cannot lose more than their investment), and in part a product of the existence of secured credit (the secured creditors will be paid regardless of the riskiness of the debtor's behavior). However, the almost inevitable conclusion is that, other things being equal, the priority of secured credit over claims of involuntary creditors will lead to more secured lending than is efficient or desirable.

Notwithstanding the absence of systematic empirical work, history has borne out some of Shupack's concerns. Indeed, Article 9 may be a victim of its own success. Gilmore and Dunham created a mechanism through which it was possible and relatively inexpensive for a secured creditor to take a security interest in virtually all of a debtor's assets. Because it was possible, it was done. During the 1980s, Wall Street developed and refined the leveraged buyout, a technique through which an investor could purchase a company by putting up a limited amount of money, borrow the rest, and offer her financiers security in the form of the assets of the target company. These transactions took corporations with substantial unencumbered assets and replaced them with highly leveraged and much riskier companies. When a significant number of these leveraged companies failed or reorganized during the early 1990s, the effect of these leveraged corporate capital structures on unsecured creditors became painfully obvious. Indeed, even in the absence of a leveraged buyout, lifetime employees found themselves unsecured claimants against underfunded pension plans, and tort claimants found themselves in possession of almost worthless claims.

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151. The bankruptcies of Federated Department Stores and Southland fall into this category. See Suzanne Bilello, Year Makes Huge Difference for Federated, Newsday, Mar. 9, 1993, at 35 (“When Federated sought protection from creditors in January, 1990, it was sinking under the weight of debt from the biggest leveraged buyout in retail history.”); Southland in Exit From Bankruptcy, N.Y. Times, Mar. 6, 1991, at D4 (explaining that Southland Corporation's bankruptcy followed the founding Thompson family's efforts to take the company private through a leveraged buyout).

152. For a graphic example of the effect of bankruptcy on retirees, see LTV Steel Co. v. United Mine Workers of Am. (In re Chateugay Corp.), 945 F.2d 1205, 1210 (2d Cir. 1991), and for examples of the treatment of tort claims, see A.H. Robins Co. v. Piccinin, 788 F.2d 994 (4th Cir. 1986) (holding that Chapter 11 debtor was entitled to preliminary injunction staying plaintiffs' suits). See also In re Johns Manville Corp., No. 82B11656-11676 (Bankr. S.D.N.Y. 1982); Lee Ann Flyer, Comment, Will Financially Sound Corporate Debtors Succeed in Using Chapter 11 of the Bankruptcy Act as a Shield Against Massive Tort Liability?, 56 Temp. L.Q. 539, 542-43 (1983) (discussing the ramifications to tort claimants if two asbestos corporations succeed in shielding themselves from tort liability by filing for Chapter 11 protection); Christopher M.E. Painter, Note, Tort Creditor Priority in the Secured Credit System: Asbestos Times, The Worst of Times, 56 Stan. L. Rev. 1045, 1046 (1984) (“[U]nder either liquidation or reorganization rules tort claimants go uncompensated because of their low priority in a bargaining system despite the fact that they are inherently unable to bargain.”). Although the LTV, Robins and Manville bankruptcies were not leverage driven, highly leveraged capital structures increase the risk of business failure and reduce the likelihood that retirees and tort...
Article 9, at least in part, made possible the creation of a new type of corporate entity: the judgment-proof, yet asset-laden, corporate shell. Thus history lends plausibility to the externality-based story of secured credit.

(4) The Subsidy of Secured Credit

The desirability or undesirability of secured credit cannot be completely assessed in the absence of empirical work that has yet to be done. In Professor LoPucki’s view, however, even without such empirical work, it is possible to demonstrate that secured credit is less efficient than it could be: “That subsidy may or may not account for the prevalence of security. But, as with anything subsidized, there will tend to be more of it than is economically efficient.”

The subsidy for secured credit, he argues, will encourage debtors who are sliding into insolvency to encumber their assets up to and (if they can) beyond the liquidation value. Having made this logical connection between the subsidy of secured credit and the tendency of a financially troubled debtor to encumber all or substantially all of its assets, LoPucki looks to recent bankruptcy statistics to show that only a very small fraction of bankruptcy filings result in any distribution to unsecured creditors. For LoPucki, these statistics provide all the empirical support necessary for a call to reform the Article 9 priority scheme.

Having demonstrated that the reasons for the popularity of secured credit may lie in the subsidy obtained by secured creditors and debtors at the expense of nonadjusting and involuntary creditors, Professors Lucian Bebchuck and Jesse Fried carry the argument one step further and identify the specific types of inefficiency costs associated with full priority for secured credit. Like LoPucki, Bebchuck and Fried argue that full priority will cause the excessive use of security interests. In addition, they argue that full priority will distort the investment and precaution decisions of the debtor, and will lead to suboptimal use of covenants to suboptimal claimants will be paid.

153. LoPucki, Bargain, supra note 18, at 1920-21. As LoPucki has noted elsewhere: [The UCC drafters] largely succeeded in their effort [to simplify secured credit]. The effect was to increase dramatically the proportion of encumbered assets in the American economy. The change appeared first in bankruptcy liquidations. Early bankruptcy liquidations produced at least some distributions to creditors in the majority of cases. By 1976, the percentage of bankruptcy liquidations in which there was a distribution to unsecured creditors had fallen to twenty percent; by 1991-92 it had sunk to five percent. In 1926-27, unsecured creditors recovered over twenty-seven cents on the dollar in assignment liquidations . . . . By 1976, the average recovery in all bankruptcy cases had fallen to less than one cent on the dollar.

Lopucki, Death, supra note 30, at 18-19.

154. See LoPucki, Bargain, supra note 18, at 1931-38 (“As every bankruptcy practitioner knows, security tends to expand to the liquidation value of the collateral as a debtor sinks into financial distress.”).

155. Id. at 1935.

156. Bebchuck & Fried, supra note 18, at 896-98.

157. Id. at 898-900.

158. Id. at 900-02.
Most commentators have already recognized that, at some level, secured credit in its present form creates perverse incentives to engage in unreasonably risky behavior. Although nobody argues that secured credit should be abolished, there are compelling arguments that altering the

text

creditor monitoring, and to suboptimal enforcement of covenants.159

On some level, LoPucki's and Bebchuck and Fried's arguments prove too much. If they are right, then one would expect that debtors would encumber as many of their assets as they could in order to obtain an interest rate savings at the expense of non-adjusting and non-consensual creditors. A number of scholars have recently recognized that there are costs associated with issuing secured credit that may balance the prospect of an interest rate savings. These costs include (1) additional costs of closing the transaction (such as filing); (2) additional costs of administering the loan (such as monitoring the collateral); (3) reputational costs associated with borrowing on a secured basis. See Mann, Pattern, supra note 140, at 658-67 (arguing that a borrower will not borrow on a secured basis unless the value of the security in terms of increased likelihood of repayment exceeds these costs); Steven L. Schwarcz, The Relatively Easy Case for the Priority of Secured Claims in Bankruptcy: A Response to Professors Bebchuck and Fried, 47 Duke L.J. 425, 447 (1997) [hereinafter, Schwarcz, Easy Case]. As Professor Schwarcz noted:

Simply stated, a debtor incurs costs when it encumbers its assets . . . . The existence of [a measure of these costs] explains why debtors—other than those that can only obtain credit on a secured basis—typically obtain financing on an unsecured basis even though the interest rate may be higher than for secured credit.

Indeed, Professors Douglas Baird, Hideki Kanda and Saul Levmore, and Robert Scott have all acknowledged in recent articles that secured credit creates such incentives. See Baird, supra note 17, at 2251 (concluding that "[A]t the end of the day, there is no perfect plan for how to design an efficient system that allows the greatest freedom for debtors to shift to riskier projects without harming creditors."); Kanda & Levmore, supra note 159, at 2103 (stating that additional obligations may induce a debtor to engage in riskier behavior that may generate inefficiencies and harm creditors who did not plan on this level of risk); Scott, supra note 38, at 1783 (arguing that one form of "debtor misbehavior" is "asset substitution," which occurs when a debtor proceeds to a riskier project after being issued secured debt for a venture with less risk). Schwarcz too agrees that while new money secured loans may reduce the risk of insolvency, transfers of collateral that secure existing debts are more likely to cause harm to existing creditors. Schwarcz, Easy Case, supra note 159, at 433-36.
Article 9 priority scheme would make secured credit more efficient.

c. Proposed Solutions and the Revisers' Response

Towards that end, Professor LoPucki has argued that the appropriate response is to eliminate at least part of the subsidy for secured credit by creating a priority for tort claimants superior to that of the secured creditor. A priority for tort claimants would force secured creditors, who, after all, are consensual creditors, to consider the true riskiness of the debtor's enterprise and to adjust the interest rate to reflect the fact that they might be forced to bear the burden of the debtor's torts. This in turn would cause the debtor to internalize the true riskiness of its behavior.

Bebchuck and Fried's suggestions go farther than LoPucki's. Bebchuck and Fried have suggested limiting the priority of secured claims, turning secured claimants into partially unsecured claimants, and thereby giving them an incentive to monitor the activities of the debtor. They argue for a form of equity cushion: either (1) the secured creditor's priority should be limited to eighty percent of the value of the collateral, or (2) the secured creditor's claim should be subordinated to the claims of both involuntary and nonadjusting creditors. Professor Warren's proposal to amend section 9-301 embodies Bebchuck and Fried's first proposal.

By contrast, the Revisers appear to object to any proposals for change to the priority scheme based on concern about externalities. As Professor Warren has noted, at its December 1995 meeting, "The Article 9 drafting committee was unwilling to draft a proposal that insured that some assets would remain for unsecured creditors in the event of the debtor's failure ... ." The Revisers argue in response that the costs of fixing any problem

161. There is a compelling logic to LoPucki's suggestion. As discussed above, the drafters of Article 9 recognized that a secret lien was fraudulent as to creditors and would not be enforced against third parties. They solved this problem by creating a system of notice, which allowed consensual creditors an opportunity to loan, not to loan, or to seek more information. The notice solution does not justify giving secured creditors priority over nonconsensual creditors. Nonconsensual creditors are not harmed because they were deceived. They are harmed because they are injured by an entity that is unable to compensate them for the harm caused. Thus, the policy question with regard to tort claimants is fundamentally different in type. It is not a question of notice, but a question of what constitutes an unreasonably risky capital structure. Once the problem of nonconsensual creditors is viewed this way, the terms of the discussion shift. Rather than speaking in terms of freedom of contract, the terms of the discussion turn to questions of who is the least cost avoider of the harm. Is the tort victim in a better position to avoid the costs of being injured by an insolvent, or is the tortfeasor's secured lender in a better position to monitor its debtor? The answer seems relatively clear. The lender who enters into a consensual relationship is in a far better position to encourage prudence than the unidentified tort victim.


164. Warren, Proposal, supra note 18, at 1. Indeed, Professor Warren notes that the Warren proposal "followed extensive debate over the efforts of the current Article 9 drafting committee to extend the reach of security interests to lock up all the property of a debtor." Id.
that might exist will likely exceed the costs of the problem itself. Even once Professor Warren took it upon herself to draft a proposal, it received no support and virtually no discussion in the Drafting Committee.

B. Proposals Aimed at Protecting Consumers

In addition to proposals aimed at risk alteration, a number of proposals were made by consumer advocate Gail Hillebrand to protect consumers from some of the harsher effects of secured credit. These proposals were aimed principally at Article 9's remedy provisions. Hillebrand's concern was not based on risk alteration, per se, but instead on the view that secured consumer credit transactions are largely the result of contracts of adhesion. An automobile purchaser rarely negotiates the terms under which her car may be repossessed when she takes out a loan secured by the car. Even more problematic, many store credit cards create purchase money security interests with language on the back of the charge slip. In these instances, the consumer may not even be aware that a security interest has been created and perfected.

Unlike the Warren Proposal, the efforts of Gail Hillebrand initially met with some success. A Consumer Task Force was formed, and a number of proposals suggested by Hillebrand were included in the draft.

165. See Harris & Mooney, supra note 3, at 2023-24 ("Although the efficiency literature may be interesting and useful, we conclude that it is largely free of cogent support for materially modifying the current legal regime for secured transactions.").

166. Woodward, supra note 26, at 1512.

167. The stated goals of the consumer representative were relatively modest-to prevent the Revisors from eroding protections available under current law. Memorandum from Gail Hillebrand to ALI Council 3 (Nov. 14, 1996) [hereinafter Hillebrand Memorandum] (on file with Iowa Law Review). As Hillebrand noted:

The new Article 9 draft . . . moves quite far toward facilitating secured credit . . .
Those very changes in the . . . draft make the inclusion of separate consumer rules essential to preserve some elements of current law for consumers, and to rebalance the statute for consumers in light of the many changes being made to it.

Id. For example, the consumer representatives objected to: (1) creation of a bona fide error defense to statutory damages where a creditor violates Article 9; (2) broadening the definition of purchase money to include a refinance of a purchase money security interest; (3) broadening the scope of a purchase money security interest to include "mixed" collateral; and (4) elimination of the doctrine of constructive strict foreclosure. Id. at 4-7. They also sought to have "price" included as a term that must be "commercially reasonable," when price is used to calculate a deficiency. Id. at 9.


169. The Reporters' Prefatory Comment to the Proposed Final Draft states with regard to consumer transactions:

Background. In 1995, NCCUSL appointed a subcommittee of the Drafting Committee to consider whether and to what extent Article 9 draft should contain consumer-protection provisions. The subcommittee made several recommendations that the Drafting Committee considered during its meetings in 1996 and 1997. Many of the provisions that the Drafting Committee adopted, and which the ALI membership discussed at its 1997 annual meeting, remained highly controversial.
However, in response to these efforts to include consumer-protective language in the remedial provisions of Article 9, representatives of the automobile financing and consumer credit industry withdrew angrily from discussions, arguing that consumer interests had captured the process. Only after heroic efforts to mediate the dispute led by Marion Benfield and assisted by Neil Cohen, Gerald Bepko, and others, was the dispute resolved at the very last scheduled meeting of the Article 9 Drafting Committee. This peace treaty was viewed by representatives of both the consumer groups and the consumer credit industry as largely a return to former law. The compromise eliminates certain changes that would have been harmful to consumers, but does not expand protection of consumers beyond that afforded by current law.

The draft that emerged proved unsatisfactory to many representatives of both consumers and consumer creditors. Proposed Final Draft, supra note 12, at xxx.

170. Id.; Hillebrand Memorandum, supra note 167, at 3. At the time of the “walk-out” the draft of Revised Article 9 contained the following provisions that could be viewed as favorable to consumers: (1) exclusion of consumer deposit accounts from Article 9 for consumer transactions; (2) limited rights of reinstatement that arose after 60% of the principal has been repaid and could be used once during the life of the loan; (3) reciprocal rights to attorney’s fees; (4) a restriction on the power of consumers to waive certain rights provided by Article 9; and (5) exclusion of consumer transactions from the ten-day safe harbor for a notice of disposition, from a special bare bones safe harbor notice of disposition, and from the addition of partial strict foreclosure. Id.

171. The Reporters’ Prefatory Comment to the Proposed Final Draft states:

Proposed compromise solution. In 1997, the Chair of the Drafting Committee initiated a renewed effort to reach a consensus solution that would not be actively opposed by consumer or consumer-creditor interests. After many rounds of discussions and much “shuttle diplomacy,” a tentative solution was reached during the February, 1998, meeting of the Drafting Committee. During that meeting, the Drafting Committee approved in principle, and asked the Reporters to incorporate in the next draft, a list of proposed revisions relating to consumer transactions. Most of the proposals, but not all, related to Part 6, Default. The Chair of the Drafting Committee presented the proposals as a compromise, explaining that if the package of proposals were accepted by the Drafting Committee and its sponsors, representatives of consumer creditors involved in the process would actively support, and advocates of consumer interests involved in the process would not oppose, enactment of revised Article 9. The Chair explained further that the alternative could be widespread opposition, with pitched battles in the various legislatures during the enactment process. This controversy could delay or inhibit enactment of the revisions.

Proposed Final Draft, supra note 12, at xxxi (emphasis added).

172. The Reporters’ Prefatory Comment to the Proposed Final Draft describes the discussions, and is set forth at length, as follows:

Deleted provisions. Under the proposal, several consumer-protection provisions in the January, 1998, draft, which had been approved by the Drafting Committee, would be deleted:

(i) Section 9-104(d) and (e) (allocation of payments for determining purchase-money status in consumer-goods transactions);
(ii) Section 9-613(b)(3) (notice of disposition containing minor errors not seriously misleading is sufficient);
(iii) Section 9-622 (reinstatement rights of consumer debtor or secondary obligor);
(iv) Section 9-624(d) and (e) (reduction of secured party's liability for statutory damages by amount of loss of deficiency or actual damages awarded to consumer);
(v) Section 9-625, Alternative A (absolute bar of deficiency alternative for secured party noncompliance in consumer transactions);
(vi) Section 9-627(d) (good-faith error defense to statutory damages);
(viii) Section 9-627(e) (limitation on recoveries in class actions); and
(vii) Section 9-628 (reciprocal attorney's fees in consumer transactions).

Revised provisions. The proposal also called for revision of several other provisions.

(i) In addition to deleting Alternative A of Section 9-625 (absolute bar rule), the rebuttable presumption rule in Section 9-624 would be made applicable only to transactions other than consumer transactions. The draft would remain silent as to the effect of a secured party's noncompliance in consumer transactions, leaving that issue to the courts. (During its March, 1998, meeting the Drafting Committee decided that the draft should contain a statutory statement that no implications for consumer transactions should be drawn from the statutory rebuttable presumption rule for non-consumer transactions. See Section 9-625(b) of this draft.)

(ii) Sections 9-104(f) and (g) (approving "dual status" rule for purchase-money security interests (i.e., rejecting "transformation" rule) and setting burden of proof) would be applicable only to non-consumer-goods transactions. (During its March, 1998, meeting the Drafting Committee decided that the draft should contain a statutory statement that no implications for consumer-goods transactions should be drawn from the statutory treatment of non-consumer-goods transactions. See Section 9-104(f) of this draft.)

(iii) Either the definition of "buyer in ordinary course of business" would not be revised to provide that BIOCOB status depends on a possessory right as against the seller, or certain proposed provisions in revised Article 2 would accompany revised Article 9 to provide protection for a prepaying buyer. (During its March, 1998, meeting the Drafting Committee adopted the latter approach, reflected in this draft. See Appendix I.)

(iv) The comment to Section 9-111 would contain no examples of sufficient collateral descriptions in consumer transactions (e.g., the previous approval of "all jewelry" in the Reporters' Comments would be deleted).

(v) Sections 9-403 and 9-404 would be expanded to make effective the FTC's anti-holder-in-due-course rule (when applicable) even in the absence of the required legend.

(vi) Section 9-614A (post-disposition notice) would be revised to provide for a somewhat more refined statement of how a deficiency or surplus was calculated.

(vii) The comments would be modified to delete any explicit statement that "price" is not a term of a disposition which is required to be commercially reasonable, and an explanatory comment would be added to the effect that a low price mandates enhanced judicial scrutiny of the terms of a disposition.

(viii) Section 9-618 would be revised to prohibit partial strict foreclosure for consumer goods.

Drafting Committee resolution. During its March, 1998, meeting, the Drafting Committee considered the Reporters' efforts, incorporated in the March, 1998,
C. Proposals Aimed at Simplicity

1. The Article 9 Revision and Proposals That Respond to Technological Change

By contrast to the fate of the Warren Proposal and the proposals of consumer advocates, the Revisers have welcomed amendments that seek to take modern technology into account. A wide variety of proposals have been made, and many have been included in the current draft. For example, current section 9-402 has been amended in order to make the filing system “media neutral,” and to eliminate the signature requirement. These changes have been made to facilitate electronic filing. The Revision also amends section 9-103 so that the choice of law governing perfection for virtually all collateral would be the law of the jurisdiction where the debtor is located. If the debtor is a corporation, the location of the debtor is the state of incorporation. Under current section 9-103, the law of the jurisdiction “where the collateral is located” governs perfection and the effects of perfection and nonperfection for ordinary goods. This rule made sense where most lending was local, and the lender and the collateral were likely to be located in the same jurisdiction, even when the debtor did business on a national basis. These conditions are not as likely to hold today. More important, today, because of computer technology, it is feasible and inexpensive for a prospective California creditor to search the UCC draft, to implement the proposed solution. The Drafting Committee gave its general approval to the proposed solution. It also considered a number of specific issues that had been raised by the consumer and consumer creditor representatives. The Drafting Committee resolved all remaining material issues. This draft reflects that resolution. However, we should note three caveats. First, inasmuch as less than two weeks were available for us to revise the draft following the March, 1998, meeting, this draft has not been reviewed by anyone other than the Reporters. Second, several elements of the proposed solution for the consumer-related issues implicate the language of the Official Comments that will accompany the final revised text of Article 9. While substantial progress has been made in formulating these comments, they have not yet been finalized. Finally, the proposed solution of the consumer-related issues has been recognized by all concerned as a compromise. The statutory text that has emerged is less than ideal in substance and approach. It represents a balance struck in the hope that it will enhance the opportunities for prompt and uniform enactment of revised Article 9. Proposed Final Draft, supra note 12, at xxxi-xxxiii.

173. These changes are reflected in sections 9-502 (contents of financing statement), 9-503 (name of debtor and secured party), 9-506 (effect of minor errors and omissions), 9-504 (indication of collateral), and 9-508 (persons entitled to file) of the Proposed Final Draft, supra note 12.

174. These changes are reflected in sections 9-301 (choice-of-law provision), 9-307 (location of debtor) and 9-314(a) (continued perfection following change of law) of the Proposed Final Draft. Under proposed section 9-301(3), the effect of perfection or nonperfection is governed by the law of the jurisdiction where the collateral is located. Id. § 9-301(3).

175. Id. § 9-307.
records in Delaware to determine whether an Arkansas creditor has perfected a security interest in collateral located in Florida. Indeed, UCC filings can now be searched electronically from virtually anywhere in the country.

Amendments to current sections 9-302\(^{176}\) and 9-304\(^{177}\) increase the importance of the filing system by allowing perfection of a security interest in instruments by filing,\(^{178}\) and by clarifying the rules for taking "control" of instruments.\(^{179}\) These changes are also driven by modern technology. The ability to perfect a security interest in instruments by filing would appear to reflect the fact that much commercial paper is handled through clearinghouses and that the "holder" never takes delivery of the instrument itself.\(^{180}\) On the whole, these changes appear to be for the good. They allow Article 9 to react to and grow with changes in technology and financial practice.

2. Proposals That Enhance the Certainty of Secured Credit

In addition to proposals aimed at technological change, the Proposed Final Draft of Revised Article 9 contains a number of proposals that aim at the goal of simplicity, but which, in the process, suggest fundamental disregard for the inefficiency concerns discussed above. First, the Revisers have expanded the scope of Article 9. The Article 9 Revision amends current sections 9-102\(^{181}\) and 9-104\(^{182}\) to bring security interests in deposit accounts (in nonconsumer transactions),\(^{183}\) payment intangibles (principally loan participation agreements), and letters of credit within the scope of Article 9.\(^{184}\) The Proposed Final Draft also expands the scope of Article 9 to include healthcare insurance receivables,\(^{185}\) and (commercial) tort claims.\(^{186}\)

\(^{176}\) Id. § 9-108 (control over investment property); id. § 9-309(a) (when filing required).

\(^{177}\) Proposed Final Draft, supra note 12, §§ 9-310(a), 9-311(a), 9-327, & 9-328.

\(^{178}\) See id. § 9-310(a) (allowing perfection by filing of security interest in instruments, chattel paper, investment property, or negotiable documents); id. § 9-311(a) (allowing security interest in goods, instruments, money, negotiable documents, or tangible chattel paper to be perfected by taking possession of the collateral); id. § 9-327 (defining priority of purchaser of chattel paper vis a vis holder of certain security interests); id. § 9-328 (describing priority of holder of negotiable instrument over perfected security interest).

\(^{179}\) Proposed Final Draft, supra note 12, § 9-311.


\(^{181}\) Proposed Final Draft, supra note 12, § 9-112(a) (scope).

\(^{182}\) Id. § 9-112(d).

\(^{183}\) Id. § 9-112(d)(13).

\(^{184}\) Id. § 9-112(a).

\(^{185}\) Id. § 9-112(d)(8)(A).

\(^{186}\) Proposed Final Draft, supra note 12, § 9-112(d)(12) (providing that tort claims for personal injury are still excluded from Article 9, but that other types of tort claims may be used as collateral). The prior exclusion of these types of collateral from Article 9 did not mean
In addition to expanding the scope of Article 9 to cover new types of collateral, the Revision simplifies the process of perfecting a security interest in these new types of collateral. The Revisers have amended section 9-402 to make it possible for a financing statement to recite that a creditor has taken a security interest in "all" of the debtor's assets.\textsuperscript{187}

One might surmise that the Revisers view changes to the priority scheme as more troubling than these other types of changes. However, the Revision also includes modifications to the priority scheme. Moreover, these modifications, if anything, compound rather than ameliorate the externality problem. One group of changes reflects the inclusion of deposit accounts into the Article 9 scheme.\textsuperscript{188} A second set of changes corrects uncertainties in the law of purchase money security interests.\textsuperscript{189} Each of these enhances the certainty of a secured creditor's investment. Thus, the Drafting Committee has proved willing to make changes that make secured credit cheaper and its priority more certain. No changes were made to protect involuntary or nonadjusting creditors, and consumers were, at best, able to negotiate for a standstill.

III. EXPLAINING THE REVISERS' RESPONSE TO THE PROBLEMS OF PRIORITY AND CONSUMER PROTECTION

The preceding Part demonstrates that, even though original Article 9 and Revised Article 9 do an excellent job of simplifying and regularizing the law of secured credit, neither Gilmore and Dunham nor Harris and Mooney have been able to make it "safe."\textsuperscript{150} The Proposed Final Draft does nothing to address the third party effects of secured transactions, and does nothing to soften the effect of secured transactions upon consumers. To the

\textsuperscript{187} Id. §§ 9-502(a), 9-504. In the Proposed Final Draft, a financing statement may cover "all" personal property, but a security agreement must specify the type of collateral. Id. §§ 9-111 (sufficiency of description), 9-203 (enforceability of security interest).

\textsuperscript{188} See id. § 9-325 (defining priority of security interests in deposit accounts).

\textsuperscript{189} See id. § 9-322 (expanding on current sections 9-312(3) & 9-312(4)). In early drafts, a second priority applied to production money security interests, secured by an interest in crops. However, no consensus emerged on this issue within the Task Force, the Drafting Committee, or the agricultural financing community. For this reason, the Drafting Committee has included the production-money provisions in an Appendix. Under this approach, the UCC sponsors would make no recommendation one way or the other. In contrast to Section 9-321 of Discussion Draft No. 2, which presented the production-money priority rule as proposed uniform statutory text, Appendix II presents the rule as a "model."

Proposed Final Draft, supra note 12, at xxv (Reporters' Prefatory Comments).

\textsuperscript{190} This is not to say that secured credit is necessarily socially undesirable, or that it should be abolished, but only to say that there is a problem that may need to be fixed and that the problem cannot be fixed through the uniform law process.
contrary, the Revision expands the scope of Article 9 to *reduce* the cost of taking a security interest and to *facilitate* the creation of security interests in all of a debtor's assets.\footnote{The Reporters are quite forthright about this, saying: 
[We] think that the transfer of an effective security interest ought to be as easy, inexpensive, and reliable as possible. For the most part, the current version of Article 9 reflects our position: The law should not impair the ability of debtors to secure as much or as little of their debts with as much or as little of their existing and future property as they deem appropriate. 
Harris & Mooney, *supra* note 3, at 2021-22.}

In this Part, I use the decision rule developed in Part I to explain the Revision's successes and its failures. First, I explore the possibility that secured creditor interests have captured the drafting process. Second, I explore the possibility that anticipated capture may have led the Revisers to act like a captured legislature, and that anticipation of state competition may have forced the drafters to facilitate a race to the bottom. I conclude that concerns about the anticipated capture of state legislatures and an anticipated race to the bottom contribute significantly to the failure of the *Proposed Final Draft* to address the distributive consequences of full priority. Indeed, these concerns have also dictated the shape of the choice-of-law provisions discussed above. Similarly, anticipated capture appears to have influenced discussions over proposed consumer protection provisions. Conversely, however, the absence of these concerns appears to explain the success of changes that merely address technological change.

**A. Capture of the Article 9 Drafting Process?**

The first question to ask is whether actual capture of the Drafting Committee explains the failure to address the externalities of secured credit. In an important article, Dean Scott has suggested that the Article 9 Study Group process showed signs of having been captured.\footnote{Scott, *supra* note 38, at 1783; see also Schwartz & Scott, *supra* note 47, at 638-43.} First, he notes that the structure of interest groups concerned with Article 9 would give rise to concern about capture:

Where the legal regime regulates the interests of relatively cohesive industries, the U.C.C. lawmaking process is likely to function much differently than where the regulatory effects are diffused. Thus the normative implications of a revision to Article 9 are likely to differ substantially from the implications of a revision to Article 2. Because Article 9 regulates asset-based financiers, a paradigmatic example of well-organized and cohesive interests, the process is susceptible to disproportionate influence by a single active interest group representing particular financing interests. In such a case, I suggest that the law revision process will tend to propose rules that are both transactionally efficient and distributionally favorable to
the dominating interests. Scott does not, however, share the actual discussions of the Article 9 Study Group (of which he was a member). Instead, he examines the substantive treatment by the Article 9 Study Group of proposed changes to choice-of-law rules, filing rules, PMSI priority, the rule on priority in proceeds, agricultural liens, enforcement rules, and the revision to deal with the dual debtor problem. He suggests that amendments with regard to:

[T]he filing system, PMSIs, proceeds, and the treatment of statutory liens . . . tend to show: (1) that many of the key revisions seem to promote the interests of specific classes of secured creditors in contexts where competing interests may well be disadvantaged, and (2) that these effects are largely hidden from public view behind cosmetic efforts to maintain the efficacy of the filing system. [However,] the treatment of enforcement issues and corporate restructuring provide counterexamples that may suggest the presence of competition within the dominant "coalition."

Even though Scott does not discuss it, the rule of full priority for secured creditors created by Article 9 also fits the description of rules that might be viewed as a product of a captured private legislature. Indeed, the argument is particularly powerful because not only are the banking interests concentrated, the interests harmed are diffuse. Trade creditors and employees (in the absence of labor unions) are not well-organized, and tort claimants may not even know that they have an interest to defend.

Curiously, and possibly in contrast to the Article 9 Study Group, the discussions of Revised Article 9 before the ALI and in the Drafting Committee have not lacked substantive participation by people articulating concerns that run contrary to the interests of secured creditors and banks. Professors LoPucki, Warren, Klee, and others have raised the concern about the externalities of Article 9 at meetings of the ALI and NCCUSL.

193. Scott, supra note 38, at 1851.
194. "PMSI" is shorthand for Purchase Money Security Interest.
195. Scott, supra note 38, at 1823-50.
196. Id. at 1825-26.
197. Scott and Schwartz point to the crucial role in the drafting of Article 9 played by Homer Kripke, then affiliated with CIT Credit Corporation. Schwartz & Scott, supra note 47, at 638; see also Grant Gilmore, Dedication to Professor Homer Kripke, 56 N.Y.U. L. Rev. 1, 9, 14 (1981) (stating that Homer Kripke served as the principal draftsman of the 1972 revision of Article 9, which immensely improved the 1962 text by clarifying unintended obscurities, correcting mistakes, and providing solutions to problems that were ignored in the original draft). See also Kripke, supra note 1, at 323-24 (describing the interplay between academics and practitioners in the drafting of the Code).
198. Banks also frequently serve as unsecured creditors and therefore have an interest in ensuring that unsecured creditor interests are properly served by Article 9. However, bank creditors, even in the guise of unsecured creditors, are not the creditors who are harmed by the full priority system. Bank creditors are in a position to check the Article 9 financing system, and can either bargain for loan covenants or adjust their interest rates to account for the possibility of debtor misbehavior.
Similarly, consumer positions were argued forcefully by Hillebrand among others. While the Warren Proposal was rejected out of hand, the initial inclusion of consumer protection provisions undercuts the argument that the drafting committee was captured by secured creditor interests. For these reasons and the reasons discussed below, the failure of these ideas to take hold appears to be less a product of a failure of representation and more a symptom of a process held hostage by concerns about uniformity.199

B. Applying the Decision Rule

Thus, even though the Article 9 Drafting Committee does not appear to be captured and affected groups appear to have participated in the process, it does appear to be constrained. As such, anticipated capture and anticipated state competition may provide a better explanation for the Revisers' failure to address secured credit's distributive consequences.

1. Anticipated Capture and Article 9

As discussed above,200 capture is a concern any time a proposed rule has significant redistributive consequences and there is an asymmetry between the strength of the interest group that benefits from the rule and the strength of the interest group that is harmed. Because of the collective-action problem, the strength of an interest group is often inversely related to the size of the affected group.201 Larger and more diffuse groups have greater difficulty organizing, and they tend to be underrepresented in the legislative process. As Professor Scott has noted, an interest group asymmetry exists with regard to Article 9.202 Banks are a relatively concentrated and well-organized group. Employees and tort claimants are comparatively diffuse and disorganized groups. Even assuming that these groups are well-represented in the Article 9 Drafting Committee, this does not mean that they will be well-represented in the legislatures of each of the fifty states. Here, the public choice prediction becomes very important. It may be possible to correct representational problems in one or two state legislatures, but the ALI is not in a position to ensure balanced representation in the legislatures of all fifty states. Thus, a prediction of

199. A legislature may be captured even when all affected groups are represented when one group controls enough votes to consistently win on any disputed issue. Here, however, Gail Hillebrand, for example, had some success in getting consumer issues onto the agenda. See supra notes 167-68. However, most were removed from the final draft in order to ensure adoption of the Revision. See supra note 172 and accompanying text.

200. See supra text accompanying notes 55-58.

201. Olson, supra note 58, at 128 ("The privileged and intermediate groups often triumph over the numerically superior forces in the latent or large groups because the former are generally organized and active whereas the latter are normally unorganized and inactive.")

202. See Scott, supra note 38, at 1838 ("The recommended revisions in PMSI and proceeds rules generally confirm the prediction that special interest legislation is more likely to be adopted when the subject matter of the regulation is confined and invisible to the potentially opposed publics.").
capture (of some subset of state legislatures) turns into a prediction that if the Revisers resist the banking interests at the drafting stage, nonuniform adoption will likely result. Thus, anticipation of capture may have played a role in the decision to reject the Warren Proposal.

Where consumer protection provisions were involved, the anticipation of capture was placed in high relief. Consumer advocates, who were not voting members of the Drafting Committee, were able to influence the drafting process by threatening to oppose a Revision, which did not include their proposed reforms. Similarly, representatives of the consumer credit industry, who were not themselves voting members of the drafting committee, were able to use their own threat to oppose the statute in state legislatures to block the inclusion of these reforms. Both groups used the threat to oppose the Revision in state legislatures as leverage in negotiations. The result was a stalemate. Banking interests were unable to eliminate existing consumer protections, and consumer advocates also were unable to expand them substantially. Concern about enactibility and anticipation of state capture played a major role in the shape of the final agreement. The Revisers were expressly driven by the need to gain support of the consumer credit industry and to prevent consumer opposition.

2. Anticipated State Competition and Article 9

In addition to anticipated capture, anticipated state competition is likely to play a role in the Article 9 Revision. First, Article 9 provides states with an opportunity to compete with each other. If a state can provide favorable rules to creditors, then local businesses may be able to borrow at lower interest rates than businesses in other states. This will in turn increase the level of business activity in the state. In other words, states will compete for loans or for favorable loan terms for local debtors. Similarly, corporations may choose to locate major facilities in jurisdictions where they can take advantage of secured creditor-friendly rules to obtain a reduced cost of capital.

Will the effect of this competition be favorable (a race to the top) or unfavorable (a race to the bottom)? To answer this question, it is necessary to apply the second (agency/intrafirm externality) and third (interstate externality) tests of the decision rule.

a. Intrafirm Externality (Agency Cost)

First, the rule of absolute priority creates the possibility of intrafirm externality. There is a conflict of interest between two corporate constituencies: shareholders, on the one hand, and nonconsensual and nonadjusting creditors on the other.203 Whenever a corporation faces substantial claims by tort claimants, employees or other nonadjusting creditors, the corporate officers can increase the value of the corporation’s

203. See supra notes 143-47 and accompanying text.
stock by borrowing on a secured basis. The debtor obtains a reduction in interest rate, but the nonadjusting creditors do not demand a risk premium to compensate for the increased riskiness of their claims. Because managers owe a fiduciary duty to shareholders and because managers and shareholders (where they can conquer the collective-action problem) control the incorporation decision, corporations would be expected to incorporate in states that have adopted the rule of full priority in order to maximize shareholder wealth. As such, the "agency costs" component of the decision rule would predict that the uniform law process would operate to anticipate and effectuate a race to the bottom with regard to priority for secured creditors.

By definition, consumer protection provisions are unlikely to implicate intrafirm externality. Consumers are not firms, and the hardships that the consumer advocates seek to address are hardships to the debtor him or herself, rather than to their creditors. As such, the "agency costs" component would not likely cause a race to the bottom with regard to consumer protection provisions.

b. Interstate Externality

A race to the bottom is also likely when a state can obtain benefits for its own citizens and place the burden on citizens of other states. The rule of full priority would again seem to fall into this category. For example, Delaware is a small state. Many businesses incorporated in Delaware do business nationwide. Therefore, Delaware citizens will not bear all the costs of torts committed by Delaware corporations. Delaware will therefore have an incentive to compete for loans and for the location of corporate assets by offering a favorable priority rule. With regard to consumer protection provisions, a more balanced result would be predicted. Consumer credit transactions usually involve collateral located in the same state as the debtor. Thus, even in Delaware, the costs of bank overreaching would be borne directly by Delaware citizens.

Thus, if one seeks to predict the behavior of the Article 9 Revisers with regard to priority for secured creditors, the decision rule would predict that anticipated capture and an anticipated race to the bottom would drive the Revisers to adopt a rule of full priority in order to prevent nonuniform adoption. The rule distributes value to banks at the expense of nonconsensual and nonadjusting creditors. The rule of full priority benefits corporate shareholders at the expense of nonconsensual and nonadjusting creditors, and the rule of full priority raises the spectre of interstate

204. As discussed in the next section, under this view, the amendment to section 9-103, as proposed in the July Draft of Revised Article 9, would have created an incentive for states to use Article 9 as a tool in the incorporation game. July Draft, supra note 25. To prevent this problem section 9-301 of the Proposed Final Draft adopts a bifurcated approach, under which the law of perfection (where and how to file) is governed by the law of the debtor's location, but the effect of perfection (priority) is governed by the law of the jurisdiction where the collateral is located. Proposed Final Draft, supra note 12, § 9-301.
externality. By contrast, if the decision rule is applied to consumer protection provisions, anticipated capture would be predicted, and anticipation of capture can be observed.

This application of the decision rule offers a powerful prediction of and perhaps an explanation for the Revisers’ reluctance to alter the Article 9 priority scheme in the ways that Professors Bebchuck and Fried, LoPuck, and Warren have suggested. First, capture is implicated because secured lenders, harmed by any rule that removes the subsidy of secured credit, will likely be in a position to block enactment of that rule because nonadjusting and involuntary creditors are disorganized and diffuse interests. Second, anticipated capture is a concern because corporate managers can obtain a lower cost of capital at the expense of a disenfranchised corporate constituency. Third, a race to the bottom would be likely because states can externalize the costs of adopting a rule that favors secured creditors. For these reasons, the risk of adoption of nonuniform rules would be high if Revised Article 9 contained a rule less favorable to secured creditors than that contained in current Article 9. Similarly, the decision rule helps to predict and explain the fate of the consumer protection proposals, which resulted in an imperfect, but hard-fought compromise, driven by the anticipated capture of state legislatures.

C. Empirical Evidence: The Legislative History

Having shown that the decision rule predicts that both anticipated state competition and anticipated capture would likely play a role in the deliberations of the Drafting Committee over the rule of full priority, and that the anticipation of capture would implicate consumer provisions, the next task is to determine whether those three concern are having the predicted effects. There is some anecdotal evidence that they are playing a role. First, Professor Mooney’s flippant response to the Warren proposal appears to be driven more by concern that it will impair uniform adoption than by an objection to its substance (though he clearly objects to its substance as well). Similarly, Professor James White has raised concerns that the dispute over the Warren Proposal and consumer issues is endangering uniform enactment. He states that the absence of consensus over the issue of absolute priority is creating a substantial risk that it will be impossible to achieve uniform adoption of Revised Article 9.

More importantly, the drafting history of Revised Article 9 demonstrates a fairly sophisticated understanding and response to the problem of state competition, as demonstrated by the evolution of the Revision’s choice-of-law provision. As noted above, under current Article 9, the law of the jurisdiction where the collateral is located governs the perfection (where to file) and effect of perfection (priority) of a security

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205. See supra text accompanying note 24.

206. White, Comments, supra note 15, at 222. White uses the metaphor of a truck caught on the crown of a “deeply rutted road,” unable to go forward, but unable to turn back.
interest in ordinary goods. By contrast for mobile goods, accounts, and general intangibles, the law of the jurisdiction where the debtor is located governs the perfection and effect of perfection. In response to the availability of computers, the Revisers decided that it would be easier to adopt a rule that required the search of only one jurisdiction for all of a debtor's assets. A brief description of how that rule achieved its current form is illustrative.

When it first considered modifying Article 9's choice-of-law rule, the Article 9 Study Committee initially rejected filing in the debtor's state of incorporation in favor of filing at the headquarters of the debtor corporation. Indeed, when Professor LoPucki raised the matter at a meeting of the ALI Conference in May of 1993, the reaction to filing in the state of incorporation was overwhelmingly negative. According to LoPucki, the fear was expressed that filing at the place of incorporation, whatever its merits, was not politically viable because it would shift too much money—in the form of UCC filing fees—to Delaware. Professor LoPucki then undertook an empirical study to estimate the shift in filing fees. LoPucki's study suggested that the amount of fee shift from other states (ignoring local filing, which was being abolished anyway) would be between $1.6 and $3.3 million. Once the problem had been shown to be only a $2-3 million problem, the drafters shifted to filing at the debtor's place of incorporation. The July Draft of the Revision therefore amended section 9-103 to provide that for all collateral, the perfection (where to file) and effect of perfection (priority) would be governed by the law of the debtor's state of incorporation.

This was not the end of the discussion, however. The comment to the choice-of-law provision in the Proposed Final Draft notes that the approach taken in section 9-103 of the July Draft was further criticized. Delaware, for example, might decide to favor its local debtors by adopting nonuniform priority rules. In response to this criticism, later drafts and the Proposed Final Draft further revised section 9-103 (now section 9-301) to provide for a bifurcated approach, stating that the law of perfection (where to file) would be governed by the law of the debtor's location, but the effect of perfection would be governed by the law of the jurisdiction where the collateral is located. This amendment is aimed directly at preventing a race to the bottom. Under the Proposed Final Draft, a creditor knows precisely where to file and where to search, but an individual state can only adopt priority rules that affect collateral located within its jurisdiction.

208. Id. § 9-103(3)(b).
209. LoPucki Letter, supra note 54. According to Professor LoPucki, some people "jokingly suggested" that he was "an agent of the state of Delaware." Id.
211. Id. at 645.
version has the effect of limiting the possibility of the interstate externality noted above, but it does not eliminate it entirely. As in prior law, no bifurcation exists for accounts, general intangibles, and mobile goods. Furthermore, corporations may choose to locate assets where a favorable rule exists. Thus, the amendment does not eliminate the race to the bottom entirely; it simply prevents the Revision from making it worse. Nonetheless, this amendment provides direct evidence that concerns about anticipated capture and anticipated state competition are playing a role in the deliberations over Revised Article 9.

Finally, the debate over consumer protection provisions ended after a year of diplomacy with an agreement to return to prior law. According to the Reporters, the Chair of the Drafting Committee represented that if the package of proposals were accepted by the Drafting Committee and its sponsors, representatives of consumer creditors involved in the process would actively support, and advocates of consumer interests involved in the process would not oppose, enactment of revised Article 9. Indeed, the Reporters offered this sobering assessment:

[ ]he proposed solution of the consumer-related issues has been recognized by all concerned as a compromise. The statutory text that has emerged is less than ideal in substance and approach. It represents a balance struck in the hope that it will enhance the opportunities for prompt and uniform enactment of revised Article 9.

There is no evidence here that the Reporters were anticipating a race to the bottom, but as predicted, anticipation of capture and the desire for uniform enactment appear to have shaped the Proposed Final Draft. This insight is rendered even more powerful when one recognizes that the consumer advocates and consumer credit industry representatives were not themselves members of the Drafting Committee. Even without votes, they wielded substantial influence in the drafting process.

Thus, concerns about uniformity, in the form of anticipated capture and anticipated state competition, appear to be operating. Therefore any NCCUSL-based effort to limit the externalities of secured credit transactions is doomed to fail, either in the drafting process or during the process of enactment, and any efforts to protect consumers will be severely constrained.

214. This bifurcated approach does not eliminate entirely the risk of a race to the bottom with regard to discussions of the rule of absolute priority. As noted above, see supra notes 65-66, 83-86 and accompanying text, anticipated capture and agency problems still remain. Furthermore, if a jurisdiction adopts the rule of partial priority, a creditor may charge a higher interest rate in that jurisdiction and a debtor may therefore choose not to locate assets—a factory, for example—in that jurisdiction. See infra note 218.
216. Id. at xxxiii.
IV. NONUNIFORM AND FEDERAL LAW AS ALTERNATIVES

If the uniform law process is not well-equipped to regulate the externalities of secured credit, or to incorporate consumer protective provisions into Article 9, are nonuniform or federal law equal to the task? In this Part, I explore these questions and conclude that nonuniform state law does not offer a solution, but that federal law might.

A. State Law

As noted above, anticipated state competition is likely to doom any efforts to use Article 9 to address the externalities of secured credit or to protect consumers. An individual state might nonetheless try to enact such a regulation on its own, outside the Article 9 scheme. For example, a state could adopt a priority for tort claimants through a statutory lien, akin to a mechanic's lien, that would have priority over an Article 9 lien. A state could similarly adopt the Warren Proposal through a state law lien or through a nonuniform amendment to current section 9-301.

This nonuniform state law approach has a lot to recommend it. Although secured creditor interests will still have substantial power within individual state legislatures, such interests are, from time to time, overcome by other interests. State legislatures are more public fora than the relatively private meetings of the Article 9 Drafting Committee. In addition, as Justice Brandeis recognized, states can often function as the "laboratories" of democracy where policies can be tried out on a smaller scale. If a few states were to adopt a "tort first" rule or a "partial priority" rule, the Revisers would have an opportunity to evaluate the rule's effects before trying it out on the nation as a whole.

However, there are a number of countervailing concerns that may counsel against such a nonuniform approach. First, in each state, the collective-action problem will operate to the advantage of secured creditor interests and to the disadvantage of trade creditors, employees, and tort claimants. As a result, although efforts may succeed in one state or another, these successes are likely to be isolated, and the amount of regulation provided by nonuniform state law is likely to be suboptimal. If nonuniform enactment of "tort first" or "partial priority" is likely to be isolated, another more fundamental concern arises. "Tort first" and "partial priority" are likely to raise the cost of credit for enterprises whose loan transactions are governed by the law of the nonuniform jurisdiction. Indeed, on some level, that is exactly what these measures are supposed to do. A jurisdiction that adopts one of these rules would likely have affirmatively decided to accept these costs. However, when states use nonuniform enactments, an adopting state would face another cost. Because "tort first" and "partial priority" are

218. If a state adopts a tort-first rule, lenders in that state would begin to require borrowers to purchase liability insurance in order to ensure that no tort claimant took priority.
will raise the cost of capital for in-state corporations relative to out-of-state corporations, state competition would likely operate in reverse. Businesses with mobile assets would flee the adopting jurisdiction in favor of a jurisdiction where they could obtain a lower cost of capital. Once this concern is recognized (and business interests are likely to point it out early on), the likelihood that any jurisdiction will adopt a "tort first" or "partial priority" rule begins to look exceedingly small.\textsuperscript{2} Thus, assuming that either "tort first" or "partial priority" is an efficient rule, the ability of individual states to externalize the costs associated with the rule of full priority is likely to result in an actual, rather than an anticipated, race to the bottom.

With regard to consumer protection, nonuniform law may work somewhat better. Consumers still face a collective-action problem. However, they may be able to organize in individual states. Where the collective-action problem can be overcome, the race-to-the-bottom problem would not seem to exist. Even though consumer protection might lead to higher interest rates or higher prices for consumers in consumer-protective jurisdictions, it is unlikely that many people will alter their decisions on where to live based on such concerns.

over the lender. This requirement would increase the cost of capital for enterprises seeking to secure financing based on collateral located in the tort-first jurisdiction. This would have a number of effects, all of them negative. First, firms in that jurisdiction might find themselves at a competitive disadvantage vis-à-vis firms in a non-tort-first jurisdiction. Second, firms with movable assets and the need to engage in secured financing might seek to move their assets to another jurisdiction in order to avoid the additional financing costs associated with the rule. The end result would be a capital outflow from the state that adopted the efficient rule. To make matters worse, the adoption of tort first in one jurisdiction would not have the effect of increasing safety in that jurisdiction. Torts would still be committed by out-of-state creditors, including those who left to avoid the impact of the law.

219. A similar effect could be expected if a state adopted Bebchuck and Fried's rule of partial priority. First, it would increase the level of monitoring by secured creditors. Some of this monitoring might be efficient, but it is likely that, at least when a firm has multiple secured creditors, some of this monitoring will be duplicative. Second, banks might impose stricter financial covenants on lenders in the partial priority jurisdiction. Third, they would likely increase interest rates to account for these additional costs, plus the additional risk of default. Again, the likely result would be that businesses seeking financing would move assets out of the partial priority jurisdiction, and businesses which could not relocate would be at a competitive disadvantage with enterprises from other jurisdictions.

220. This argument does rest on the assumption that states either have industry and want to keep it or want to get it. Some states may not fit this description. Vermont appears to be a notable example. Lynn LoPucki points out that not all industry would flee a tort-first jurisdiction—only industry that was consciously externalizing its debt. The creditors of an adequately capitalized company lose nothing by putting tort claims first. Lopucki Letter, supra note 54. This may not be true, however. As noted above, the likely result of a tort-first regime is that secured lenders would insist that all debtors carry liability insurance. The requirement of insurance would be imposed on all debtors, not just debtors who were externalizing tort risk.
B. Federal Regulation

If neither the uniform law process nor nonuniform state law can be expected to adopt a rule that addresses the externalities of secured credit, and to a lesser extent consumer protection provisions, does federal law provide a better alternative? For a number of reasons, it may.

1. Competition and Capture

First, and most obviously, concerns about interstate competition and the race to the bottom disappear. A federal law will, by definition, displace inconsistent state law. There would be no concerns about capital flows between and among the states. Second, with regard to questions of capture, by comparison to the uniform law process, the federal lawmaking process, while not perfect, is open and accessible to various interest groups. By comparison to the nonuniform law process, there is a greater likelihood that even diffuse and disorganized interests will have some representation at the federal level. There is some empirical support for this proposition from both the federal Bankruptcy Code and from federal enactments in the payment law area.

2. Interest Groups and the Bankruptcy Code

Although the subject of interest group influence on the United States Bankruptcy Code is too large for any systematic treatment here, unsecured creditor interests as well as other creditor constituencies have tended to fare

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221. There might be some concern about international capital flows. Some businesses might be in a position to insulate their assets from U.S. tort liability by moving the assets offshore or by incorporating offshore. For most businesses, the costs of doing this would be substantial and would likely outweigh the relatively small increase in capital costs occasioned by a change in the priority rule. But see LoPucki, Death, supra note 30, at 2. LoPucki notes:

In recent years, computer technology has dramatically reduced the cost of record generation and, consequently, the cost of keeping chips out of the pot. Major players are reducing their stakes. By doing so, they are breaking down the social norms and cultural barriers that prevent further reductions. The process is feeding on itself. Soon no one will have significant chips in the pot. When that happens the fundamental nature of the game will change. Liability will die.

Id.

222. The Federal Bankruptcy Code already contains a number of priorities for employees. See Bankruptcy Act, 11 U.S.C. § 507(a) (3) (1994) (giving priority to claims for pay earned over 90-day period prior to filing); id. § 1113 (limiting circumstances under which a collective bargaining agreement may be rejected); id. § 1114 (limiting circumstances under which retirees' benefits may be modified). Similarly, section 362 (the automatic stay) contains a long list of exceptions obtained by various special interest lobbies. Id. § 362. Tort claimants, however, do not get the benefit of any special priorities. Tort claimants do get the benefit of two exceptions to discharge: section 523(a)(6) applies to debts relating to willful and malicious injury; and section § 523(a)(9) exempts damages for death or personal injury caused by drunk drivers. While uncontroversial conceptions of morality rather than interest group politics probably account for the first exemption, Mothers Against Drunk Driving provided the impetus for the second.
better under federal law than under state law. In addition, discussions about bankruptcy law have tended to address questions of distributive policy more directly. Indeed, there has been a great deal of pulling and tugging among secured creditor interests, unsecured creditor interests, and debtor interests. On the one hand, the Bankruptcy Code has been criticized by creditors as being too pro-debtor. On the other hand, both the 1984 and 1994 amendments showed signs of heavy creditor influence. As this article goes to press bankruptcy reform bills are pending in Congress (H.R. 3150 and S. 1301). Though both versions show heavy signs of influence by the consumer credit industry, the Senate Bill shows some limited signs of solicitude for consumer interests, and the President has threatened to veto the House Bill if enacted. Only time will tell whether this legislation will ultimately be enacted, and if so, whether it will be more balanced in its final form. In short, both unsecured creditor and debtor interests appear to be represented, with varying degrees of success, at the federal level.

223. The Bankruptcy Code contains numerous group specific priorities and exemptions that favor groups that have been able to convince Congress that they are particularly likely to be harmed by a business failure. A number of these priorities and exemptions favor groups that, while not well organized at the state level, have strong representation at the federal level. These include priorities for employees, §§ 507(a)(3), 1113, retirees, § 1114, alimony and support claimants, § 507(a)(7), and tax claimants, § 507(a)(8). The Bankruptcy Code also exempts from discharge certain support and alimony claims. §§ 523(a)(5), (15).

224. Whether this is a good or a bad thing has been the subject of much debate. See Jackson, supra note 120 (arguing that resolving the collective-action problem associated with a debtor's insolvency is the sole purpose for the federal bankruptcy scheme); Douglas G. Baird, Loss Distribution, Forum Shopping and Bankruptcy: A Reply to Warren, 54 U. Chi. L. Rev. 815, 822, 827 (1987) (arguing rules for distributing losses within and without bankruptcy should be generally the same, with differences following from the reasons for having the two systems). But see Elizabeth Warren, Bankruptcy Policy, 54 U. Chi. L. Rev. 775, 785-89 (1987) (arguing that the purpose of the bankruptcy scheme is to distribute the losses associated with business failure); Elizabeth Warren, Bankruptcy Policymaking in an Imperfect World, 92 Mich. L. Rev. 336 (1993) (same).


226. The amendment to 11 U.S.C. § 550 to eliminate the "Deprizio Problem" is an example. The "Deprizio Problem" arose when courts, beginning with the Seventh Circuit, Levit v. Ingersoll Rand Financial Corp., 874 F.2d 1186 (7th Cir. 1986), allowed bankruptcy trustees to reach back to reclaim preferential payments made within one year to creditors whose debt was guaranteed by an insider of the debtor. David G. Hicks, The October Surprise: The Bankruptcy Reform Act of 1994-An Analysis of Title II—the Commercial Issues, 29 Creighton L. Rev. 499, 503-04 (1996).

227. For a brief but engaging account of the tension between secured creditors and unsecured creditors, characterized as the war between Bankruptcy and Article 9, see Nickles, supra note 87.

228. Unsecured creditors and tort claimants will face collective-action problems at the federal level as well, and there is reason to expect their interests to be somewhat underrepresented. Nonetheless, there is a greater likelihood that they will not be completely overmatched.
3. Interest Groups and Payment Law

Just as the law of debtors and creditors has a state law (Article 9) and a federal law (bankruptcy) component, payment law is divided between Articles 3, 4, and 4A, on the one hand, and a number of federal laws governing check collection and electronic funds transfers on the other.\(^{229}\) We have already seen how the control of the uniform law process by bank interests affected the drafting of Article 4.\(^{231}\) The federal statutes, by contrast, show evidence of a much more balanced tug-of-war between bank interests and consumer interests.\(^{232}\) Congress enacted the Expedited Funds Availability Act ("EFAA") expressly to protect consumers from excessive periods of float allowed by Article 4 and used by banks as an obvious source of profit. Similarly, the Electronic Fund Transfer Act ("EFTA") takes a far more pro-consumer approach to risk of loss in the event that a credit card is stolen than Article 4 of the UCC does with regard to checks.\(^{233}\) Finally, the experience with payment law provides an example of what can happen to a uniform law when it fails to address at the state level the concerns of an interest group that has power at the federal level. The EFAA and EFTA preempt large portions of Article 4.

One final concern about federal regulation bears mentioning. Any lawyer who has spent any time working with the Bankruptcy Code, the EFAA, or the EFTA knows that, although these statutes may reflect a more balanced set of policy choices, they are not examples of finely-honed statutory craftsmanship. The UCC is a model of clarity and craftsmanship by comparison to the federal statutes and may be a better statutory "product."\(^{234}\)

In sum, federalization of the Article 9 priority scheme would likely have certain benefits and some costs. The benefit would be in an enhanced ability to address distributive questions raised by the secured credit system. The cost would likely be a less user-friendly statute. However, when, as with the Article 9 priority scheme, the decision rule predicts that the uniform law process will fail, either because of capture, anticipated capture or an anticipated race to the bottom, the benefits of federalization would appear


\(^{231}\) See supra notes 61-64 and accompanying text.

\(^{232}\) See Rubin, Efficiency, Equity, supra note 3, at 586.

\(^{233}\) See id. For example, the consumer's risk of loss is limited, in most circumstances, to $50. Electronic Fund Transfer Act, 15 U.S.C. § 1693(g) (1994).

\(^{234}\) See Rubin, Efficiency, Equity, supra note 3, at 592. In Rubin's opinion:

The revisions of Articles 3 and 4 are superbly drafted, and represent high levels of technical achievement. Underneath their polished surface, however, they are deeply flawed . . . . The Electronic Funds Transfer Act is a much better statute, which could be readily adapted to cover the checking system as well as electronic funds transfers.

It is a more rough-hewn piece of work, but it is strong and solid on the inside.
to outweigh the costs. The "selective abstention," or even a "selective federal preemption" approach appears to have some merit.\textsuperscript{235}

\section*{CONCLUSION}

The ALI and NCCUSL have generally been successful at identifying talented and experienced practitioners and academics to participate in the drafting process. The ALI and NCCUSL operate on a national scale. Therefore, when technical expertise is required, they have been successful at identifying experts in greater quantity than might be available in individual states. As a result, the uniform law process has been successful at drafting laws that are well-written and that have worked well.

Nonetheless, the uniform law process has a number of problematic characteristics. First, the ALI and NCCUSL are organizations with limited membership and a low political profile. Because of this, the number of groups that are represented in the process may be unduly constricted. Even though it is a national forum, there is reason to believe that the number of affected groups participating in the process is likely to be smaller than the number that would participate in open legislative proceedings at either the state or federal level. Thus when redistributive issues are involved, capture is more likely. Second, even when the ALI/NCCUSL process is not captured, the uniform law drafters must consider the possibility that individual state legislatures may be captured. If uniform adoption is a goal, the uniform law drafters must anticipate and mimic the rule that would be adopted by a captured legislature. Third, the desire for uniform adoption may have perverse effects when a proposed uniform law presents the possibility of a race to the bottom. This is likely when either (1) the rule distributes corporate assets among corporate constituencies, when either the benefitted or burdened corporate constituency (but not both) faces a collective-action problem or otherwise lacks a voice in the corporate decisionmaking process; or (2) the rule allows citizens of, and businesses located in, one state to impose costs on citizens of other states. In either of these situations, the drafters will have one of two options, neither of them attractive. They may seek to mask the distributive choice, or they may anticipate and facilitate the race to the bottom. Indeed, they may do both. For these reasons, when these factors are present, the federal system may provide a better mechanism for making these distributive choices.

On some level, none of this is new. Indeed, Homer Kripke identified, and on some level applauded, many of the dynamics I find troubling in the

\textsuperscript{235} One weakness of the selective abstention approach is that it may not always be easy to differentiate between rules with distributive consequences and rules without distributive consequences. For example, if secured credit is inefficient, and harms involuntary and nonadjusting creditors, anything that makes secured credit easier, it could be argued, facilitates an inefficient institution. However, if a selective abstention approach can lead to an effective resolution of the distributive justice and efficiency questions, a uniform law that effectively reduces transaction costs would be a good thing.
drafting of the original Uniform Commercial Code. As he saw it, enactability was paramount, and rendered the process inherently conservative:

The Code was "lawyers' legislation," largely outside the potential understanding of most members of state legislatures, and too big to be grasped by even the studious lawyer members. Difficult legislation like this without a popular appeal can seldom be passed without a broad consensus of agreement of interested parties. The determined opposition of well-knit groups tends to induce the legislature to do nothing, which is a victory for the opposition. The Code would have been a sitting duck target for any determined special interest or combination of special interests who chose to attack one or more features of the bill persistently. Thus, it was important not to arouse the opposition of banks or finance companies, warehouse companies, railroads, or other private trade groups.\textsuperscript{236}

However, as I have argued, the constraint on the uniform process imposed by this need for consensus can have pernicious effects on the substance of uniform laws.

Where Article 9 is concerned, a selective abstention approach to uniform enactments suggests that, at the very least, the secured credit priority scheme should be regulated on the federal level, and that consumer protection may be more productively sought in state and federal legislatures than through the private ALI/NCCUSL process. Where other uniform enactments are involved, these principles may give guidance as to whether and how to allocate responsibility between federal and state lawmakers.

\textsuperscript{236} Kripke, supra note 1, at 327.