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Explaining Creditor Priorities

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EXPLAINING CREDITOR PRIORITIES

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AS a matter of both theory and doctrine, Article 9 of the Uniform Commercial Code may be the most difficult part of the American scheme for ordering claims with regard to an insolvent debtor's property. In this scheme, bankruptcy law, Article 9, and real estate and other state law often combine to produce two kinds of creditors: unsecured creditors, who share pro rata in the debtor's assets regardless of when these creditors appeared on the scene, and secured creditors, who have priority over unsecured creditors as to particular assets and gain priority among themselves according to several racing rules, the most important of which can be characterized as "first in time is first in right."[1] This general description is subject, however, to several exceptions. Bankruptcy law permits certain unsecured creditors to take ahead of the pack,[2] and Article 9 (together with bankruptcy law) allows certain secured creditors to

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1 The three "priority principles" have been summarized as follows: (1) unsecured creditors share pro rata, (2) a later creditor beats an earlier one only when the later alone is secured, and (3) an earlier secured creditor generally beats later creditors. Alan Schwartz & Robert E. Scott, Commercial Transactions: Principles and Policies 609 (2d ed. 1991); Alan Schwartz, A Theory of Loan Priorities, 18 J. Legal Stud. 209, 209 (1989). The second and third rules are stated in U.C.C. §§ 9-201, -312(5) (1990). Pre-Code law was mixed as to whether the first lender had to file or merely lend in order (sometimes) to prevail. James J. White & Robert S. Summers, Uniform Commercial Code 1131 (3d ed. 1988). The Code generally requires filing or possession. Id. at 1131-32.

2 A variety of unsecured claimants enjoy high priority under the rules found in the Bankruptcy Code, 11 U.S.C. § 507 (Supp. 1994). Other claimants, such as buyers in the ordinary course of business, prevail over earlier (even secured) lenders under the rules of Article 9 and might themselves be thought of as unsecured lenders. See U.C.C. §§ 9-301(1)(c), -307(1); see also White & Summers, supra note 1, at 1127-28 (putting these Code sections in historical perspective).

prevail over earlier-in-time peers with respect to particular assets.[3] This combination of first-in-time and late-in-time priorities is the central subject of this Article.

These rules have proved to be difficult material from which to generate positive theories of creditor priorities. One puzzle arises from the observation that, when one creditor gains priority, other creditors must normally lose in corresponding fashion. Reductions in interest costs obtained from creditors who expect priority must be offset by increased charges from those who can see they will be in a subordinate position. It is thus mysterious why a debtor would engage both secured and unsecured credit. Furthermore, additional costs of organizing the race, such as the price of maintaining the various recording systems, confound the mystery. This coexistence puzzle, often known as *the* secured financing puzzle, is flanked by as many other puzzles as there are rules. For example, even if we can explain why certain first-in-time creditors are offered priority, why is this priority keyed to specific collateral rather than to a debtor's estate as a whole? And why do certain late-in-time lenders enjoy a superpriority with which to defeat all who preceded them?

There are several promising approaches to the coexistence puzzle. One theory looks at secured financing as a means of encouraging some creditors to monitor the debtor in a way that benefits other creditors and solves a recurring collective choice problem among the numerous creditors who seek similar information and behavior from the debtor.[4] Another theory views the secured creditor, whose prior claim extends (in the American system at least) to after-acquired property,[5] as a long-term financial counselor that

[3] See, e.g., U.C.C. §§ 9-107, -312(3), (4) (granting priority to purchase-money lenders). Specific late-in-time priorities are taken up in Part IV, infra.

[4] See Thomas H. Jackson & Anthony T. Kronman, Secured Financing and Priorities Among Creditors, 88 Yale L.J. 1143, 1159-60 (1979) (linking monitoring tasks and incentives to priorities); Saul Levmore, Monitors aud Freeriders in Commercial and Corporate Settiugs, 92 Yale L.J. 49, 71 (1982) (identifying secured credit as solution to problem of freeriding among potential monitors); Randal C. Picker, Security Interests, Misbehavior, and Common Pools, 59 U. Chi. L. Rev. 645, 661-62 (1992) (identifying secured credit as solution to problem of common pool of creditors).

[5] U.C.C. § 9-204(1) enables the parties to a security agreement to include after-acquired collateral.

stakes a claim through the recording system.[6] But these and other theories[7] make progress on one puzzle only by highlighting the mysteries of another, in this case the priority offered to some lenders who come late rather than early in time. A purchase-money lender—that is, one who enables a debtor to acquire a particular asset—is one example of a creditor who can gain priority over earlier lenders, including perfected secured parties.[8] Existing theories of secured financing do advance some explanations of the purchase-money priority, but most observers regard these explanations as unsuccessful, half-hearted attempts.[9] More generally, most theories of secured financing do not even attempt to explain the success of assorted late-in-time creditors. For example, no explanation of the secured-financing puzzle has attempted to explain the priority granted to purchasers of commercial paper (including negotiable instruments, documents of title, investment securities, and chattel paper)[10] and to sureties, who regularly defeat the claims of earlier perfected secured lenders.[11]

In this Article we suggest a fairly simple explanation of much of the law regulating creditor priorities: the law compromises between the advantages and the disadvantages of "new money." Each time a debtor borrows, there is some likelihood that the debtor, with the

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6 See Robert E. Scott, A Relational Theory of Secured Financing, 86 Colum. L. Rev. 901, 932-33 (1986) (arguing that secured credit priority enables lead creditor to earn return on provision of valuable counseling to, as well as monitoring of, debtor).

7 Among other important works in the legal literature, see Barry E. Adler, An Equity-Agency Solution to the Bankruptcy-Priority Puzzle, 22 J. Legal Stud. 73 (1993) (addressing "ubiquity puzzle" of secured debt); George G. Triantis, Secured Debt Under Conditions of Imperfect Information, 21 J. Legal Stud. 225, 234-55 (1992) (claiming that secured debt mitigates information imperfections in debt markets).

8 See U.C.C. § 9-312(3), (4). As for real property, see Philip G. Terrie, Note, Priority of Purchase-Money Mortgages, 29 Va. L. Rev. 491, 494-98 (1943) (discussing conflict between purchase-money mortgages and various other liens). Note that when we refer to secured parties in this Article, we are often referring to perfected secured parties who have done everything possible under Article 9 to gain priority.

9 See F.H. Buckley, The Bankruptcy Priority Puzzle, 72 Va. L. Rev. 1393, 1442 (1986) (noting that purchase-money lenders are not necessarily better monitors than are trade creditors in general); Levmore, supra note 4, at 56-57 (observing the puzzling distinction between financing buyers and financing sellers); Scott, supra note 6, at 961-62 (arguing that purchase-money priority undermines the Code's policy of giving one creditor exclusive control over a debtor's financing opportunities and noting problematic exception for construction financing).

10 See infra Part IV.B.

11 See infra Part IV.D.

help of the most recent lender, has added value to its estate and has engaged in an efficient, profitable investment, but there is also some danger of "risk alteration"—the debtor may behave in riskier fashion as a result of the additional obligation. This risk alteration can generate inefficiency, or social cost, and certainly harms earlier creditors who did not perfectly plan for this level of risk. The risk alteration problem is familiar to students of corporate finance and commercial law,[12] but we offer novel connections between this problem and the structure of creditor priority systems. We develop this new theory of priorities in Part I, where we describe the first-in-time rule as a solution to the risk alteration problem.

In Part II we turn to the important exceptions to the familiar race in which the first-in-time creditor is first in right. Put simply, the latecoming lender sometimes will be in a better position to make judgments about the profitability or even efficiency of the debtor's plans, and in these cases priority for the later lender may be desirable. We suggest that the Article 9 system essentially balances the advantages of a first-in-time rule as a solution to the risk alteration problem with priority for various late-in-time lenders who may enjoy decisionmaking advantages.

Our focus on the various late-in-time priorities also illuminates the important question of why loan priority systems are in large part not debtor based but asset based. The races that are run under the rules of Article 9 (and real estate and other law) enable certain creditors to emerge from the pool of claimants who share in bankruptcy and to remove specific assets from the debtor's estate. A security interest "attaches" to specific collateral or its proceeds, not to the debtor's estate as a whole. Professor Alan Schwartz stands almost alone among commentators in endorsing a debtor-based sys-

12 Adler, supra note 7, at 78-79 (citing asset substitution as one form of risk alteration); Levmore, supra note 4, at 52 (noting asymmetry of debtor's assumption of risk). Perhaps the best discussion of the relationship between risk alteration and (its subset) asset substitution is found in Buckley, supra note 9, at 1426-39. Indeed, the first step in our argument, understanding first-in-time rules as an antidote to risk alteration, is taken with an affirmative nod to Professors Buckley and Adler. Although Buckley does not attempt to explain the law's late-in-time exceptions in connection with the risk alteration problem, his later work suggests that he has come to thiuk that risk alteration concerns provide the best means of understanding the puzzle of secured financing. F.H. Buckley, Optimal Personal Leverage and Fresh Start Policies 43-44 (Sept. 12, 1993) (unpublished manuscript, on file with the Virginia Law Review Association).

tem in which the earliest (substantial) lender would simply prevail over all later lenders.[13] Schwartz proposes that this priority depend neither on notice nor on the identification, or mortgaging, of particular collateral.[14] Subsequent creditors would need to protect themselves by bargaining with the debtor and gathering information as they wished. There is much to be said about this approach and about the specific idea that bankruptcy law should not make priority contingent on disclosure, but for now we focus on the possibility that, whatever the reasons for a race among creditors, it need not be conducted in stages organized around specific assets. We explore this choice between asset-based and more global, or debtor-based, priority systems in Part III.

Previous theories have portrayed debtor-based races as concerned with risk alteration, and asset-based contests as marred by one form of risk alteration, namely, asset substitution.[15] In this Article we advance the idea that in fact a great deal of the law of creditor priorities addresses not asset substitution but risk alteration of a more general kind, even as the law seeks to preserve the gains from late-in-time, marginal borrowing. This view not only

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[13] See Schwartz, supra note 1, at 212.

[14] Id. at 218-24 (arguing that notice requirements not needed to protect secured creditors).

[15] Thus, the tension between the bondholders (who often do not contract for security interests with respect to specific assets) and the shareholders of a corporation has been described as turning in large part on the inclination of shareholders and their agents to undertake risky operations with creditors' funds. The bondholders, meanwhile, have contracted for a fixed return and therefore prefer their funds to be deployed in a conservative manner; they wish to maximize the probability of receiving interest and principal and may be indifferent to returns beyond these obligations. See Michael C. Jensen & William H. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 J. Fin. Econ. 305 (1976); Hideki Kanda, Debtholders and Equityholders, 21 J. Legal Stud. 431, 432 (1992) (arguing that "directors and officers should owe fiduciary duties only to common equityholders"); Levmore, supra note 4, at 60 (noting that managers, owning only a small interest in the firm, have substantial incentives to misbehave).

As for collateralized financing, the tension between secured creditors and debtors is said to center on asset substitution, or the possibility that debtors will trade or dispose of the specific assets claimed by creditors and use instead other assets that entail more risk, prove more difficult to monitor, or weaken the legal claim of secured parties. See Picker, supra note 4, at 664 (identifying asset substitution as a form of debtor misbehavior); Clifford W. Smith, Jr. & Jerold B. Warner, Bankruptcy, Secured Debt, and Optimal Capital Structure, 34 J. Fin. 247, 250 (1979) (identifying secured debt as a means of precluding asset substitution by borrowers).

permits us to explain the coexistence puzzle of secured financing in novel terms, but also explains the priorities available to such diverse claimants as buyers in the ordinary course of business, purchasers of various kinds of commercial paper, purchase-money lenders, certain setoff claimants, sureties, and statutory lienholders. These priorities are explored in Part IV, where we emphasize that the puzzle we seek to solve involves not simply the practice of secured financing, but also the existence of certain exceptions to the first-in-time priority rule.[16]

I. Risk Alteration and Creditor Priorities

In this Part we begin with the idea that the first-in-time rule responds to the problem of risk alteration. Section A sets out the risk alteration problem and shows why debtors might engage in socially inefficient investments. The discussion in Section B considers various solutions to the risk alteration problem and develops the idea that secured financing may be a practical solution to the risk alteration problem.

A. *Risk Alteration*

A creditor that is approached by a debtor needs to contract for an interest rate that reflects the cost of capital and the risk of nonpayment. Other things being equal, the more the debtor has already borrowed, the more risk is present. The debtor (or the agent who manages the debtor firm) can be expected to work harder when more of its own wealth is at risk—and increased debt, like equity obtained from outside investors, makes the debtor's own investment in the enterprise less substantial. More importantly, increased debt gives the debtor an incentive to engage in risk alteration because the debtor receives a return only after fixed credit obligations are satisfied.[17] This proclivity for taking increased risks

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[16] Because other theories explain the basic first-in-time rule for perfected secured parties, the success of a theory in this area hinges on its ability to explain the late-in-time exceptions to the first-in-time and pro rata rules.

[17] On the problem of risk alteration, see, e.g., William A. Klein & John C. Coffee, Jr., Business Organization and Finance 324-66 (5th ed. 1993); Michael C. Jensen & Clifford W. Smith, Jr., Stockholder, Manager, and Creditor Interests: Applications of Agency Theory, *in* Recent Advances in Corporate Finance 93, 102-11 (Edward I. Altman & Marti G. Subrahmanyam eds., 1985); Kanda, supra note 15, at 432-35.

with other people's money can easily cause the debtor to prefer investments with lower expected returns (but greater upside potential for the debtor) than other, more conservative projects.

This point is by now a familiar one in the literature, but because it is at the very heart of what follows, a numerical example is useful. An entrepreneur who has $100 to invest will prefer project A, with which there is a 50% chance that the $100 will turn into $130 by year's end and a 50% chance that it will shrink to $98, over project B, with which there is a 50% chance that the investment will mature into $170 and a 50% chance that it will dwindle to $20. The expected value of A is 0.5($130) + 0.5($98) = $114, and that of B is 0.5($170) + 0.5($20) = $95. We might think of this as a one-year investment with expected returns to the entrepreneur of 14% for A and –5% for B. In this example, A's expected return exceeds B's, so we can be fairly certain that an entrepreneur will prefer A to B.

If these $100 investments are partially financed with $10 of money borrowed at 10% interest, A will return either $119 or $87 (after the entrepreneur repays the debt plus $1 interest), and B will return either $159 or $9 on the debtor's $90 investment. The expected returns to equity invested in these projects, after paying credit costs, are now $103 for A and $84 for B, and the expected rates of return on the debtor's $90 investment are 14.4% for A and –6.7% for B. Debt has modestly magnified the upside and the downside results, and the entrepreneur plainly (still) prefers A to B.

If the bulk of the $100 investment is instead financed with $80 of borrowed money, the magnification in both directions will increase, and A will then yield either $50 or $18 after the principal is repaid. If the interest rate adjusted for risk is, for instance, 20%, the debtor will be left with $34 or $2, for an expected value of $18, or a return of –10% on the $20 investment. Put simply, it does not pay to borrow at 20% in order to invest in a project that yields 14%. Turning to project B, however, we find a 50% chance of its yielding $170 less $80 interest costs on the debtor's $20 investment, and an equal chance that the project will end in bankruptcy (because if the project yields $20 the debtor will be unable even to repay most of the principal). It is thus easy to see why the debtor will prefer B to A in this case; so long as the upside of B exceeds $36 (that is, so long as the interest rate on the $80 loan is less than 67.5%), B is preferred. This preference for B is due, of course, to the protection afforded the debtor, by bankruptcy or some other version of limited liability, when things go poorly; the debtor's own fortunes are made asymmetric, and the debtor may therefore prefer a riskier project with a relatively low expected value.

Project B, it should be noted, is socially inefficient. As a social matter, with other things held constant, we would prefer investment in A to investment in B. Nevertheless, the indebted entrepreneur will be inclined to borrow money and hope for the rosy side of B. This risk alteration can take many concrete forms. A heavily indebted entrepreneur might be more inclined to invest in large inventories, bid on projects with uncertain costs, spend large sums seeking to attract potential customers, or take any of a number of context-specific steps that enable those who manage firms to increase (or diminish) the riskiness of their enterprises.

There is one obvious objection to this argument that debt can encourage risk alteration and, in turn, inferior investments: Creditors do not wish to bear downside losses and will therefore adjust their interest rates (to something more than 67.5% in the case of project B!), attach covenants forbidding their borrowers from investing in projects like B, or simply decline to finance certain risky projects. But information is imperfect and costly to acquire, and precise constraints are expensive to draft and enforce. It may be economical to bar debtors from investing in new (and riskier) lines of business or new assets and to monitor or charge for breaches of such contractual terms, but it is much more difficult to control for risky methods of doing business. Debtors can adopt risky but fairly latent strategies regarding such things as pricing, advertising, marketing, stocking inventories, and maintaining assets. We might think of project B in the example above not as a new and different project, requiring identifiably new assets, but rather as a risky strategy that uses the same assets as project A. Creditors prefer strategy A and can not easily specify (and then monitor) a ban on the pursuit of strategy B.

In short, the risk alteration problem stems from the likelihood that increased debt will lead the debtor to embark on riskier projects. This behavior is a social problem[18] to the extent that it

[18] There is an obvious social cost associated with the need for specifying contracts, but here we emphasize the social problem posed by the investment decision itself.

leads entrepreneurs to undertake projects with lower expected returns than other, available projects. Risk alteration also presents a private problem (with social ramifications, if unsolved) in that creditors can not perfectly anticipate their debtors' behavior.[19]

B. Risk Alteration and First-in-Time Priority

It is apparent that a debtor's first creditor ("C1") can be made worse off by the debtor's subsequent borrowing from later creditors ("C2," and so on) because the additional debt may encourage the debtor to invest in riskier projects.[20] It is useful to imagine the contract to which the debtor and C1 would agree in the face of this risk alteration problem but in the absence of various transaction costs. C1 could, of course, try to bar the debtor from further borrowing, but enforcing such an agreement is difficult. Present law does not entirely facilitate negative pledges,[21] and even in a debtor-based

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19 See Stewart C. Myers, Determinants of Corporate Borrowing, 5 J. Fin. Econ. 147, 149 (1977) (costs of negotiation, monitoring, and contract enforcement determine amount of firm's debt). For discussion of bond contracts, see Fischer Black & John C. Cox, Valuing Corporate Securities: Some Effects of Bond Indenture Provisions, 31 J. Fin. 351 (1976); Avner Kalay, Stockholder-Bondholder Conflict and Dividend Constraints, 10 J. Fin. Econ. 211 (1982); Clifford W. Smith, Jr. & Jerold B. Warner, On Financial Contracting: An Analysis of Bond Covenants, 7 J. Fin. Econ. 117 (1979).

20 Of course, additional (nonsubordinated) claimants can make the first creditor worse off even without risk alteration. If there is a downturn in the debtor's fortunes, additional creditors take added slices out of the debtor's property. But this fairly straightforward possibility generates the secured financing puzzle; if an earlier creditor can be offered priority, then later creditors will surely demand higher interest rates. The discussion in the text thus focuses on another fear of earlier (or all) creditors, the problem of risk alteration, in order to explain the first-in-time and late-in-time priorities that are available. More generally, the argument developed in the text does not emphasize the possibility that a hypothetical bargain among creditors might yield priority for non-risk-altering creditors, precisely because additional creditors, even if they bring no risk alteration problem, can make earlier creditors worse off simply by adding mouths to feed. Thus, the theory we develop may be better understood as including an element of social efficiency.

21 Generally speaking, one can imagine an agreement between the debtor and C1 that the debtor will simply not borrow at all after borrowing from C1. C1 could thereby minimize the risk alteration problem. Alternatively, the debtor could be allowed to borrow from C2 only in a manner that subordinated C2's claim to C1's (or perhaps gave the claims equal priority). If Article 9 offered no purchase-money security priority, we might have a system resembling, or offering, this alternative. A third and still weaker variety of the agreement would allow C1 to specify and gain priority regarding "all assets" save those that later purchase-money lenders specified and enabled the debtor to acquire. Article 9, if viewed as reflecting a hypothetical bargain between the debtor and C1, contains something close to this last option; it will come still closer if the Code is revised to permit C1 to indicate a claim on "everything" rather than on specific assets and types of collateral. The

system (where a priority rule that put C1 ahead of C2 with respect to all the debtor's assets could enable such a negative pledge) C1 may receive priority over subsequent creditors but still may be injured by risk alteration.

One interesting contract between C1 and the debtor—for whom pleasing C1 translates into lower interest costs—could require the debtor to pay further compensation to C1 in the event of subsequent borrowing. We can think of this compensation as a variable interest rate that begins relatively low and is adjusted upward according to a specified schedule each time the debtor increases the risk alteration problem by borrowing from subsequent creditors. Note that the ex ante specification of the schedule removes the situational monopoly that C1 would enjoy if the debtor were required to renegotiate with C1 and if, for instance, interest rates had generally risen.[22] The payments to C1 can be thought of as coming either from the debtor, who has in some sense "breached" the original contract by increasing the level of risk, or from subsequent creditors, who have "interfered" with the first contract. Because efficient breaches generally will be promoted by a system that extracts either damages from breachers or payments (for interference) from the parties with whom these breachers subsequently contract, payments to C1 can come from either source but are more directly and conventionally charged to the breacher, or debtor.

This variable interest rate arrangement presents, however, a high transaction cost solution to the risk alteration problem. The parties need to bargain over many interest rates rather than one. There is also a problem of design and execution. The debtor might borrow from additional creditors without paying or notifying C1, who then might be unprotected even if the presence of these particular arrearages afforded C1's entire claim the highest priority in bank-

term "negative pledge" is, however, normally taken to mean the second alternative enumerated here: a pledge that the debtor shall promise no other security interests. See Douglas G. Baird & Thomas H. Jackson, Security Interests in Personal Property 882 (2d ed. 1987) (noting unclear enforceability of negative pledge clause under current law); see also U.C.C. § 9-311 (defeating an agreement to prohibit the debtor's subsequent transfer of collateral).

[22] Cf. Jackson & Kronman, supra note 4, at 1167-75 (arguing that after-acquired property clause creates situational monopoly in favor of C1 and explains antidote of superior purchase-money interest).

ruptcy.[23] In short, a variable interest rate scheme is theoretically interesting, but likely impractical.[24]

A first-in-time priority system is a more practical means of solving the risk alteration problem. First-in-time priority for C1 can be understood as a proxy for the (high transaction cost) variable interest rate arrangement described above. In a pro rata system, which prevents earlier creditors from enjoying enforceable promises of extra compensation in return for subsequent increases in the level of risk by their debtor, creditors will prefer not to lend early in the life of the debtor.[25] But a remarkably simple way to foster such early lending is to offer priority to C1. This incentive is a large part of what Article 9 and other priority systems arrange. Indeed, we might say that the solution to the puzzle of secured financing is that priority for the early lender solves the risk alteration problem.[26]

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[23] Even if C1's claim for the interest rate surcharge is given priority, C1 will be undercompensated because C1 will collect this money only when the debtor fails (even assuming there is enough in the estate to satisfy this priority). C1 will be made whole only if payments can be ensured when the bankruptcy risk does not materialize (or if a correct multiplier is used in bankruptcy). C1 is like an insurer who requires annual premiums to insure against some loss. If the premiums are never paid and then a loss materializes, it will not do to require the insurer to pay the loss in return for receiving the unpaid premiums.

[24] The debtor and C1 might try to simplify the problem by agreeing that, in the event the debtor promises a higher interest rate to any subsequent creditor, C1 shall be entitled to that rate as well. But even this "most favored creditor" clause undercompensates C1, who must take into account situations where the debtor fails to pay this "most favored interest rate" and is insolvent by the time C1 learns of the underpayment. More generally, financial instruments such as convertible bonds have much in common with the variable, or sliding-scale, interest arrangement described here, but they are imperfect substitutes and leave room for priority arrangements to perform as described in the text.

[25] Again, early creditors may raise interest rates in order to be compensated for the average expected level of risk. But note that as this preemptive interest rate rises, debtors will drop out of the market. Those that remain will be adversely selected to engage in a great deal of risk alteration. A kind of "lemons problem" ensues, in which the interest rate that will satisfy creditors must increase indefinitely as conservative debtors continue to drop out of the market in the face of rising interest rates. Moreover, whatever the level of the initial interest rate, creditors still will be worse off each time the debtor borrows and threatens risk alteration.

[26] Note that we do not claim that all secured financing is otherwise puzzling. Secured financing is not at all puzzling when the debtor offers collateral to C1 and expects to borrow relatively little from subsequent creditors. The collateral encourages C1 to offer a lower interest rate, and there are no offsetting high rates from unsecured creditors because these creditors are not engaged by the debtor. A typical consumer's home mortgage provides a mundane example. Additional, unsecured borrowing rarely will approach the magnitude of the real estate mortgage, and there is therefore nothing puzzling about the popularity of most real estate financing. The secured financing puzzle arises only when the debtor knows

This point does not on its own explain much of the structure of Article 9—that is, why the first-in-time priority is limited to specific assets and occasionally displaced by later-in-time superpriorities. We turn now to some theoretical and preliminary observations about these late-in-time winners, and then consider in Part III the asset-based nature of familiar secured financing schemes.

II. Risk Alteration and Priority for "New Money"

A. *The Potential Advantage of (and Problem with) Late-in-Time Priority*

As a debtor's business plans and behavior unfold, the debtor may approach successive creditors, C1 and C2, for capital. Clearly, there is more information available later in time, and, to the extent that the debtor seeks capital for a new project, an up-to-date look at the debtor will be especially valuable to potential lenders. Some debtors will not seek out C2 but will instead return to C1 for additional funds in the later time period. Indeed, C1 normally will have a first-mover advantage over other creditors in learning about the debtor's latest plans. Other debtors, however, will choose to use multiple sources of capital, which may result in priority conflicts. It therefore is useful to focus on the stark case where the debtor first borrows from C1 and then turns to C2 for additional funds. C2 may well be the more informed lender, or more efficient decisionmaker, in many of these situations. The priority rules applicable to the debtor's potential insolvency are obviously relevant—in both private and social terms—to this bargain between the debtor and C2.

From an efficiency perspective, we might want bankruptcy or other priority rules to encourage C2 to consider the expected return from the debtor's planned investment. Put differently, one cost of a legal system that gives C1 priority over C2 is that C2 may decline to lend even when the debtor proposes to use new capital profitably

that it will borrow amounts much in excess of that represented by the available collateral, because the savings passed on by C1 are then offset by the higher charges from the subsequent unsecured creditors. The argument in the text is that mixed financing (that is, borrowing from lenders, only some of whom are offered security) can be explained as a solution to the risk alteration problem.

(in expected value terms).[27] Knowing that revenues must first satisfy C1, C2 may decline to lend unless there is either a fairly substantial margin of safety or a promise of a substantial interest rate—in which case the debtor may decline to borrow. A better rule therefore might be one that granted C2 priority over C1 in return for injecting new money, if only to encourage all investments that are passably profitable and marginally efficient. Put simply, it may be desirable to give the incentive to lend to the most recent lender, who is likely to be in the best position to assess the profitability of the debtor's present business plans.

If C2 is instead made last in right, this "marginal creditor" sometimes will be inclined not to support plans that are profitable, socially efficient, and even in the aggregate interest of all creditors. Such reasoning might explain the priority commonly granted to purchase-money lenders—that is, to certain C2's—and to various other injectors of new money.[28] On the other hand, if the late-in-time decisionmaker, or injector of new money, is given priority over

27 The argument assumes, of course, that transaction costs prevent C1 and C2 from sharing perfect information about the debtor's past and future projects and from negotiating with one another so as never to miss a profitable project.

28 Scott, supra note 6, at 961 (associating purchase-money status with the bringing of new money into a "faltering enterprise"). For the classic statement of the idea, see 1 Grant Gilmore, Security Interests in Personal Property 777-79 (1965) (observing that purchase-money priority solves the problem of financing new equipment free of earlier creditor's after-acquired property clause). A more recent article discusses risk alteration in the form of concerns about underinvestment and overinvestment and comes to a conclusion close to that of our (less formal but less restrictive) argument explaining the priority accorded to late-in-time decisionmakers. Elazar Berkovitch & E. Han Kim, Financial Contracting and Leverage Induced Over- and Under-Investment Incentives, 45 J. Fin. 765 (1990) (arguing that, with symmetric information, the optimal rule is one that gives marginal lender first priority on new assets but low priority on previously acquired assets).

What becomes of the argument developed in the text if we relax the assumption that the later creditor is better informed than the earlier creditor? As we will see, this Article suggests that the decisionmaking advantage of the later creditor is in tension with the risk alteration problem facing the earlier creditor. Article 9 resolves this tension by favoring the earlier creditor except where the later creditor is not risk altering. If we *completely* relax the assumption that the latecomer has better information, then it might be sensible to adopt either a pure first-in-time rule to combat the risk alteration problem or a more limited set of late-in-time exceptions to encourage the *earlier* lender to be a better decisionmaker. But if the assumption is only partially relaxed, so that latecomers are sometimes or even rarely seen as worth cultivating for their informational advantages, then the theory developed in the text is robust, although we might expect fewer late-in-time priorities than are presently offered by legal rules. Put simply, the more we think that C2 plays a role better than C1, the more we will be sympathetic to priority for C2.

previous lenders, the cushion of earlier money will inefficiently encourage lending with too little concern for the debtor's use of these marginal funds. In some situations it may be possible to limit the late-in-time claim, or superpriority (if it is that), to the very project that the debtor undertakes with the new funds. But it normally will be difficult to trace profits and losses in the manner necessary for such a scheme. A first-in-time priority rule will therefore squander the better information often available to the late-in-time lender, whereas a late-in-time priority rule, rather than encouraging efficient marginal decisionmaking, will encourage the latecomer to view old money as a cushion that forgives overlending.

When the problem is framed this way it becomes apparent why most preferred late-in-time lenders are given priority only with respect to a particular asset and not with respect to the debtor's estate as a whole. A late lender is an inefficient decisionmaker only when there is a cushion (formed by funds provided by other creditors) for a marginal project financed by this creditor that proves disappointing. The cushion problem is largely mitigated, however, to the extent that the prevailing scheme gives some late-in-time lenders priority only for a given asset, such as equipment that the lender finances[29] or payments received from an account debtor after a surety completes its obligation under a performance bond.[30] The optimistic explanation is that late lenders have more information than their predecessors and are thus encouraged by the priority system to consider the marginal profitability of the undertaking enabled by the new funds.[31] In short, late lenders are likely to be better decisionmakers if given priority (only) with respect to the project or asset they decide to finance late in time.

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29 See infra Part IV.C.1.

30 See infra Part IV.D.

31 Asset value may be the best available proxy for the profitability of the marginal project. Note that in evaluating the debtor's marginal project, later lenders may appreciate clues about earlier lending. The rules calling on earlier creditors to provide notice therefore are sensible because such notice permits efficient decisions by later creditors, however much they may gain priority. We also suggest that notice permits the earlier creditors to withdraw their capital or to take other steps to protect themselves against risk alteration. See infra text accompanying note 95. Notice also can inform later creditors of the "ordinariness" of a given transaction. See infra text accompanying note 65. In short, notice plays many roles in the Article 9 scheme.

B. Risk Alteration Revisited

We have seen that late-in-time creditors might be given limited priority in order to encourage better marginal decisionmaking on their part. But each bit of additional credit still increases the risk alteration problem. A scheme that gives priority to C2 will disadvantage C1 and bring on the risk alteration problem discussed in Part I. There is thus a tension between risk alteration, which suggests a first-in-time rule, and the later creditor's information advantage, which suggests at least occasional late-in-time priority.[32]

A pro rata rule would not solve this tension between first-in-time and late-in-time advantages. Under such a rule we would still expect C2 to charge a higher interest rate than C1, and we might again expect the credit market to unravel as creditors avoided (or charged for) the position of C1. Both C1 and C2 would fear further borrowing and risk alteration by the debtor after their advances. But C2 would be likely to have more or better information about C1's previous commitment than C1 would have about C2's.[33] C2

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[32] Note that a debtor's interest costs would not decrease under a regime that always gave C2 priority, even if C2 always had better information than C1, because C1 would raise interest rates in response to the risk alteration danger.

[33] The amount of knowledge a party has regarding the circumstances of its loan can have a striking effect on that party's expected returns. The problem is very much like that found in the well-known Monty Hall (host of the television program "Let's Make a Deal") puzzle, in which a television game-show host places a new automobile behind one of three doors and places goats behind the other two doors. An uninformed player is invited to select one of the doors and to keep the prize found behind it. After the player chooses a door, the host first opens one of the remaining doors to reveal a goat, then gives the player the option to switch from the still-unopened first-choice door to the third door. Most observers reason that the player's decision is unaffected by the host's having opened a door because the great prize must lie, after all, behind one of the two unopened doors, so the player enjoys a 0.5 chance of success regardless of whether she stays or switches. But because the host has provided a valuable piece of information—that is, by deliberately choosing which door to open so as to reveal a goat (when there is a two-out-of-three chance that the host needed to choose carefully between the two unchosen doors)—the player should now see that switching is the better strategy. There is a 0.67 chance that the player has been offered valuable information, so switching doubles the chance of success. See John Tierney, Behind Monty Hall's Doors: Puzzle, Debate and Answer?, N.Y. Times, July 21, 1991, at A1, A20.

Similarly, from the perspective of an earlier creditor, new information changes optimal decisionmaking even though this information seems at first to have been anticipated. It might seem at first that an earlier creditor knows of the possibility of later creditors and therefore takes this possibility into account, but it is again the case that more information is useful. Both C1 and C2 fear some level of future borrowing by the debtor from C3, but C2 can find out about C1 with more precision than C1 can guess about the potential for C2.

therefore would seem to occupy a more enviable position than C1 even though the hypothetical pro rata rule would apply to both claims. This perspective is obscured, however, because C1's relative disadvantage is one of uncertainty, and C1 might be compensated for this uncertainty through a higher interest rate.

Another way to think of the relative positions of C1 and C2 is to focus on the fact that C1 is likely to be worse off each time the debtor takes on more debt from C2 or other lenders. At its extreme, the debtor's behavior presents a "lemons problem": spiraling adverse selection forces C1 to charge an infinitely high interest rate because debtors drop out of the credit market as rates rise, until those who remain are those who plan to borrow and alter risk to the hilt.

C. *Non-Risk-Altering, Late-in-Time Lenders*

We have described early lenders as concerned with risk alteration and later lenders as enjoying informational advantages about the debtor's likely inclination toward risk and sometimes about the debtor's prospective investments. These factors alone suggest that the ideal priority system must balance first-in-time and late-in-time priorities. The balancing act becomes more precarious once we recognize that new money does not always generate a risk alteration problem for the early creditor.

Consider, for example, a creditor quite outside of Article 9, the salvor who rescues a vessel in distress. Admiralty law recognizes the monopoly (or perhaps bilateral monopoly) problem that would infect any bargain between a potential salvor and the master of a vessel in distress, often in a location far from other entrepreneurs who may wish to compete for the rescue task. The salvor's reward is therefore determined after the fact and is designed to encourage an efficient level of entry into the field.[34] As for the priority of this reward in the event of the vessel owner's insolvency, all admiralty schemes of which we are aware give the salvor's claim priority over those of other creditors, including registered mortgage holders, who

Much as Monty Hall's contestant can take a useful step after seeing one open door, C2 gains from observing the presence of C1.

[34] See William M. Landes & Richard A. Posner, Salvors, Finders, Good Samaritans, and Other Rescuers: An Economic Study of Law and Altruism, 7 J. Legal Stud. 83, 100-02 (1978).

look to the vessel for security for their earlier advances.[35] The conventional view of this priority is that but for the salvage operation there would be no vessel for other creditors to feast on. But this is only a partial explanation because other late-in-time claimants also might show, with the benefit of hindsight, that but for their contributions all other creditors would have been worse off. Similarly, the argument that the salvor can retrieve his money ahead of earlier claimants because he injected new money is insufficient; virtually all latecomers provide new money, yet very few can emerge from the ranks and defeat even prior, secured creditors.

Note that the salvor does not generate a risk alteration problem. Once the vessel is saved, the owner-debtor does have a new debt in the amount of the salvage award (and thus some temptation to increase the riskiness of future projects), but the salvor's advance does not enable the debtor to do anything new or unexpected. Although we have described first-in-time priority as a solution to the risk alteration problem, it seems plausible (but unconventional) to connect the late-in-time exception for salvors to the fact that these particular claimants do not create risk alteration problems for the creditors that have preceded them. Indeed, the connection is even closer if there is reason to think that earlier creditors would prefer to be subordinated to the later salvor, for in that case our argument is of the hypothetical-bargain variety.[36] If, for instance, a

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[35] For American law, see Grant Gilmore & Charles L. Black, Jr., The Law of Admiralty 738, 752 (2d ed. 1975) (noting that salvage claims have high priority, defeating even mortgage liens). Civil law jurisdictions normally recognize late-in-time priority for salvage claims and other maritime liens. Under the Japanese Commercial Code, for example, a salvor obtains such a lien by operation of law and gains priority over earlier secured parties. Shōhō (Commercial Code), Law No. 48 of 1899, as amended, ch. VII, §§ 842(5), 849 (Japan), *reprinted in* 2 E.H.S. L. Bull. Series, at JA234-36 (1994). Indeed, there is a kind of double late-in-time rule applied to salvage claims, as well as to claims for pilotage dues and towage fees, general average claims, and claims arising from the necessity of continuing a voyage—all of which avoid the risk alteration problem. Claims arising from the most recent voyage have priority over those from an earlier voyage, and within a given voyage the last-in-time rule is adopted for these claims. Shōhō (Commercial Code), Law No. 48 of 1899, as amended, ch. VII, §§ 842(4)-(6), 844 (Japan), *reprinted in* 2 E.H.S. L. Bull. Series, supra, at JA234-35.

[36] More technically, even where C2's arrival causes no risk alteration problem, the expected advantage to C1 from C2's superior ability to screen the debtor's potential projects must more than offset the disadvantage to C1 from having another claim on the debtor (and on whatever cushion C1 anticipated) in the event of a downturn in the debtor's business and, perhaps, a decline in the value of C1's collateral.

potential salvor knew that there were substantial liens against a vessel, a first-in-time rule might deter the salvor from investing in a salvage operation. A court might be convinced to apply a multiplier to salvage awards based on the risk of both the salvage operation and the collection of the salvage award in bankruptcy. This award, however, is an ineffective incentive if its hypothetical low priority causes the potential salvor to stay away.

The salvor therefore may be a "better-informed" C2. He is both better situated and better equipped than earlier creditors, and the project funded by the salvor does not alter risk in a way that harms earlier creditors. And, as already noted, it is possible that the salvor would decline to act if not granted high, and of course late-in-time, priority. The salvor is thus a near-perfect example of a late-in-time creditor that is both non-risk-altering and a superior marginal decisionmaker.

It is interesting but perhaps less useful to add that another advantage of giving priority to salvors and to other non-risk-altering latecomers is that priority discourages them from investing in information about the debtor's creditworthiness. Low priority, combined with whatever premium or multiplier is necessary to encourage potential salvors, will cause these actors to inquire into the debtor's history. Because this inquiry produces no social gain, it is arguable that high priority is more efficient.[37]

Although the case of the salvor neatly illustrates the interaction between risk alteration (or the lack thereof) and late-in-time, superior decisionmaking, few transactions are this uncluttered. We suggest that Article 9 and related law seek to balance the advantages of first-in-time and late-in-time priority. The more a lender exhibits the qualities of a salvor, the more likely an exception to the first-in-

[37] The reason this argument may be more interesting than useful is that it succeeds only if there is some connection between latecomers who gain priority—not simply most latecomers—and creditors who would, in the absence of priority, invest in socially useless information. It is certainly the case that some favored latecomers, including improvers identified in U.C.C. § 9-310 and buyers in the ordinary course, might be given priority as a means of removing the incentive to invest inefficiently in information. But other, nonfavored latecomers, such as buyers not in the ordinary course, are no different—except in risk alteration terms. Put differently, the theory developed here seeks to explain why some latecomers gain priority and others do not. The risk-altering versus non-risk-altering distinction is helpful in this regard, but this distinction probably does not help identify those who would, in the absence of priority, invest in socially useless information.

time solution (to the risk alteration problem) will be made. Moreover, Article 9 attempts to work with categories rather than with case-by-case instructions. The scheme that emerges, then, is almost necessarily peppered with close (but plausibly correct) calls. We will explore these categories in Part IV.

Because it may be useful to get a sense of what lies ahead, we now touch on the Code's treatment of purchase-money lenders.[38] Some purchase-money lenders may threaten the interests of earlier lenders, but others do not present a risk alteration problem (in the extreme, they may simply replace damaged equipment) and may have access to superior information about the debtor's plans. We suggest in Part IV.C that the Code tries to realize the advantage of late-in-time purchase-money priority while minimizing the risk alteration problem through a variety of notice rules. Details aside, it is important to see that there is a tension between solving the risk alteration problem and encouraging efficient marginal lending. This tension explains Article 9's treatment of purchase-money security interests. Some purchase-money lenders are much like salvors, and the Code's rules enable these latecomers to gain priority in a way that is then socially efficient and privately desired.

III. Asset-Based Versus Debtor-Based Systems

A. Asset-Based and Late-in-Time Priorities

The positive version of the theory set out thus far is that the law governing creditor priorities reflects (private or public) concern about the risk alteration problem and attempts to encourage efficient marginal decisionmaking. These considerations explain in part why Article 9 does not establish a simple pro rata rule (that is, a system that recognizes neither priority claims nor private contracts for priority in the event of insolvency), but rather provides a first-in-time rule with substantial late-in-time exceptions. We discuss how these late-in-time priorities comport with this theme in

38 These are lenders who enable the debtor to acquire specific collateral. Generally speaking, Article 9 offers these lenders the opportunity to gain priority over earlier lenders who have taken all possible steps to stake a claim on all collateral of the type that includes the specific collateral financed by the purchase-money lender. The latecoming purchase-money lender must file (and if the collateral is inventory there is a requirement of written notice to the earlier lender), but the point is that this latecomer can gain priority over earlier lenders. See U.C.C. §§ 9-107, -312(3), (4).

Part IV, but already we have seen that at least one non-risk-altering injector of "new money," the salvor in admiralty law, may be encouraged to engage in efficient marginal decisionmaking by late-in-time priority. Purchase-money lenders and other favored latecomers may be described in similar fashion.

A complete theory of creditor priorities must also explain the pro rata treatment of other claimants and the asset-specific nature of the priorities themselves. The pro rata rule governing unsecured creditors is best explained as creating a residual pool of claimants who can efficiently share in the cost of both employing agents and making decisions about the (insolvent) firm's future. The pro rata rule facilitates the sharing of administrative and legal expenses and also permits the creditors to be served by a common agent with limited conflicts of interest.[39] Other explanations are possible,[40] but this Article emphasizes the tension between first-

[39] Note that these explanations for the pro rata, residual rule in bankruptcy do not point to a single scheme. For example, a system that gave many unsecured creditors priority according to a first-in-time rule but then formed a residual (pro rata) category with the rest of the unsecured creditors could also be rationalized as providing the advantages of a first-in-time scheme while saving transaction costs associated with a class of similarly situated claimants. A complete explanation for the unique system found in Article 9 and bankruptcy law might therefore claim that a convenient way to organize the first-in-time and pro rata groups is along the lines of secured and unsecured, or perfected and unperfected (and unsecured), parties. Alternatively, we could merge this explanation with that offered by another theory of Article 9. Monitoring theory, for example, might be used to explain the boundary between the first-in-time and pro rata groups, while risk alteration could explain the very existence of first-in-time priorities and the various late-in-time exceptions (to the two other categories).

The explanation offered in the text has the advantage of providing a means of understanding the nearly universal presence of (pro rata or other) sharing rules, as opposed to ancient rules such as those based on equal sharing of contested amounts and outright assignment of "uncontested amounts." Perspectives offered by game theory, strategic behavior concerns, and intuitive fairness notions suggest that there is much to commend these ancient rules, but the pro rata rule is more conducive to economies of scale in collection and litigation. For an interesting discussion of nonproportional rules, but with no mention of the gains from forming a class of creditors to pursue assets or employ agents, see Robert J. Aumann & Michael Maschler, Game Theoretic Analysis of a Bankruptcy Problem from the Talmud, 36 J. Econ. Theory 195 (1985).

[40] There is, first of all, the idea developed in Thomas H. Jackson, The Logic and Limits of Bankruptcy Law (1986), that a pro rata rule saves the costs associated with many creditors' rushing to be the first to reduce claims to judgment or to take whatever other steps the rules of the race require. Id. at 12-13, 29-31. It is also possible that the residual, pro rata category forms a kind of filler material, or cushion, such that there is a reward to those creditors that have priority and take some positive steps of benefit to other creditors. If, for instance, notice from the first lender is useful to other creditors, then the pro rata rule for

and late-in-time priorities. We therefore turn to the asset-based nature of these races, which is closely related to the very reason late-in-time priority is occasionally granted.

An important characteristic of all priority systems is that priority is granted with regard to specific assets, most commonly the subjects of security agreements. One can imagine a system that favored a first-in-time lender by satisfying its claim out of the debtor's estate before satisfying the second-in-time lender and so forth. Instead, most first-in-time priorities, and certainly all late-in-time priorities, are limited to the value, or the repossession, of particular assets. Thus, a real estate mortgage lender has priority only on the real estate regarding which a mortgage has been recorded; a salvor's priority is limited to a fraction of the salvaged vessel and does not extend to the vessel owner's other assets; a surety's priority over earlier perfected lenders is limited to the payments coming in from the account debtor; and a winner under Article 9 has priority only on the assets covered by the security agreement and perfection process.

Put differently, the priority afforded secured lenders could be, but is not, similar to the priority enjoyed by creditors of a corporation compared to its shareholders. In the corporate case, even unsecured creditors have a prior claim to the estate as a whole in the sense that their claims must be satisfied before shareholders can extract their pro rata residual interests. In contrast, priority under Article 9 and similar systems is limited to the value of specified collateral that, once exhausted, relegates the balance of the creditor's claim to the level of the unsecured creditors'.[41]

Note that this asset-based characteristic of Article 9 is found in real estate law, non-Article 9 common law, and the priority schemes of other legal systems. We are unaware of any jurisdiction with a

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unsecured creditors indirectly gives this first creditor a straightforward incentive to provide notice. After all, the failure to provide notice will drop the first lender into the pro rata pool, whereas a purer first-in-time rule would offer no such simple penalty because the first-in-time lender might be entirely satisfied with its collateral.

Other incentives to notify (or monitor) are, of course, available. The nonperforming first-in-time creditor might, in a purer first-in-time scheme with no pro rata rule at all, simply be demoted to the very bottom of the list. But, as suggested in the text, one problem with this sort of hierarchical scheme is that every creditor would need separate representation.

[41] U.C.C. § 9-504.

complete debtor-based priority system—that is, a system that allows a private creditor priority over all of the debtor's assets—with respect to (or in order to generate) competition among creditors.[42] One might insist that a shareholder in a corporation is a kind of claimant, and perhaps even a kind of creditor, who *loses* to other creditors in such a debtor-based fashion. But the primary tool for distinguishing among claimants (that is, among all creditors and shareholders) is priority with respect to given assets. Whatever view one takes of the shareholder-creditor relationship, asset-based systems of priority govern conflicts among creditors.[43]

In terms of the risk alteration theme stressed in this Article, the asset-based character of creditor priority systems is especially important to understand because the simplest way to protect early lenders against risk alteration would be to protect earlier advances with a prior claim on all of the debtor's assets.[44] In fact, we argue that the asset-based nature of creditor priority systems is not an integral part of a system for protecting early lenders against risk alteration (because that protection is indeed best accomplished with debtor-based priority) but rather follows the justification offered for the late-in-time exceptions to the first-in-time rule.

Article 9 itself can be understood as leaning toward a debtor-based regime for the first-in-time lender and an asset-based regime for late-in-time (non-risk-altering) favorites. An early lender can create a security interest in virtually all of the debtor's assets by

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42 It is arguable that the universality of asset-based priority rules is nothing more than an outgrowth of efforts by private parties to create priorities, or even to take advantage of earlier creditors, through private agreements such as those providing for retention of title. Article 9 and other asset-based systems may have evolved in the shadow of such private contracting. Similarly, a debtor-based real estate system might have been difficult to establish in a world in which private parties could lease real estate. We do not, therefore, mean to infer too much from the popularity of asset-based systems, but we do argue that there are affirmative advantages to such systems.

It is also noteworthy that the law of security interests in personal property has evolved separately from corporate law, and indeed the two areas are rarely analyzed together even though it is arguable that they are seamlessly joined. Thus, commentators may ask whether security interests arising under Article 9 ought to be characterized as property rights but rarely ask similar questions about corporate debt instruments.

43 Somewhat similarly, parties under current law can create a debtor-based priority system with subordinated debt or even with senior debt, so long as all other creditors consent.

44 Put differently, if risk alteration rather than asset substitution is the critical problem, one might think that debtor-based rather than asset-based priority is the solution.

specifying and filing appropriately for all categories of collateral. This security interest can cover future advances and extend to after-acquired property.[45] This arrangement, although nominally asset based, comes close to the fractional debtor-based scheme favored by Alan Schwartz, namely, automatic priority (that is, with no notice requirement) for the first substantial financer.[46] Such priority is both in some sense efficient and at some relatively low cost (Schwartz asserts) discoverable by later creditors, who can adjust the terms of their credit contracts.[47]

We suggest that the asset-based nature of secured financing follows from the explanation of late-in-time exceptional priorities; the advantage of an asset-based system is precisely its ability to incorporate priorities for selected latecomers and to do so in a way that encourages the marginal creditor to focus on the marginal project engaged in by the debtor with this creditor's injection.[48] In the case of purchase-money lenders, for instance, we already have suggested that late-in-time priority favors these claimants because they may sometimes be efficient marginal lenders while not contributing to a risk alteration problem.[49] But in a debtor-based system this priority would be so vast that it is difficult to see how the purchase-money lender would have any incentive to focus on the profitability of the marginal investment opportunity facing the debtor. Moreover, a

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[45] U.C.C. § 9-204(3) (future advances); id. § 9-204(1) (after-acquired property).

[46] Schwartz, supra note 1, at 211-12.

[47] It is fractional because Schwartz suggests not that any earlier lender beat a subsequent lender in debtor-based fashion, but only that the first substantial lender enjoy this priority. Id. at 212. Presumably, one reason for this half-step is that, although it is plausible that a later creditor can discover at low cost whether any substantial prior creditor exists, it would be quite costly for the later creditor to discover how far down the list he is located.

It is, of course, the offering of exceptional priorities, or superpriorities, to certain late-in-time lenders that keeps Article 9 from amounting to the debtor-based system sketched in the text.

[48] An alternative means of explaining the asset-based character of the system is that monitoring by creditors might be efficiently apportioned through such a system—either because creditors can keep track of specific assets at lower cost than they could monitor an entire enterprise or because collective action problems among monitors can be avoided. Because our aim is to make the most of risk alteration (and marginal decisionmaking), and not to rely heavily on other theories of secured financing posited elsewhere, we do not explore whether the choice of the scope of priority (between asset and debtor) can be explained as a matter of monitoring theory alone. We suspect that this choice can be explained only with dramatic assumptions about the relative costs of different inquiries.

[49] More precisely, the decisionmaking benefits they bring may exceed the risk alteration costs they impose.

debtor-based priority system for purchase-money lenders surely would generate a risk alteration problem.

In short, the very reasons why we might expect or wish for exceptional late-in-time priorities suggest that they be constrained, or asset based rather than debtor based.[50] Conversely, the easiest way to understand why the system as a whole is asset based rather than debtor based is to see that this regime enables occasional late-in-time priorities.

It also may be the case that limiting late-in-time exceptions to specific assets cleverly limits the damage that such exceptions can wreak. If C2's injection turns out to be risk altering, perhaps because of the rule of thumb that distinguishes risk-altering injectors is overbroad, the specification of assets limits the "error." C1 accordingly will charge a lower interest rate under an asset-based system than in a system that sometimes mistakenly grants C2 a more complete, debtor-based priority.

Finally, the linking of asset-based priorities to the judgment that certain latecoming lenders should be granted priority leaves open whether the first creditor's priority should also be asset-based. There is little doubt that the first-in-time rule is generally desirable or at least explicable,[51] but the narrow issue is whether this first-in-time priority should attach to specific assets or to the debtor's estate as a whole. Reasonable observers could dispute this question.

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[50] Indeed, we might expect a legal system to limit late-in-time priority to those creditors that agreed that their claims on particular assets were either without recourse to the debtor's estate as a whole or at least subordinated to all other creditors' claims to the extent that the specified assets did not satisfy the claims they secured. In other words, the fact that late-in-time creditors do not lend in nonrecourse fashion more often may seem at odds with the theoretical notion developed in this Article.

One possible explanation is that there is little to gain from this nonrecourse arrangement between the debtor and C2 because the latter loses to C1 anyway, and C1 is the other important player. Another possibility is that it is more efficient to have C2 share costs (without conflicts) with other unsecured creditors than it is to use the threat of subordination (to these other creditors) to encourage accurate marginal decisionmakiug by C2. Finally, a nonrecourse scheme might *discourage* efficient monitoring by a creditor with collateral of marginal value. Though this Article aims to explain creditor priorities without relying on monitoring arguments, we simply note that debtors might pay (in the form of higher interest rates) for nonrecourse arrangements with some creditors in order to enjoy lower interest charges from other creditors.

[51] As already discussed in note 25, supra, without a first-in-time rule all creditors would fear later creditors and a kind of lemons problem would drive interest costs up to that appropriate for the riskiest debtor.

It is precisely the closeness of this question that explains in part the variety found in diverse areas of law and in different jurisdictions. For example, Article 9 recognizes a virtual blanket-type security interest, particularly appropriate for a primary lender claiming various types of present and future collateral to secure present and future advances. In contrast, real estate law in the United States does not enable the first lender to come so close to staking a debtor-based claim.[52] We can explain why all systems use asset-based priorities for exceptional (non-risk-altering) late-in-time lenders, but because these priorities can be structured as exceptions either to first-in-time asset-based priorities or to first-in-time debtor-based priorities—and because there is no strong reason universally to prefer an asset- or debtor-based approach for the priority afforded the *early* lender—we find a multiplicity of priority systems.

B. Priority Tied to Notice

Both asset-based and debtor-based systems may condition all priorities on the provision of notice (sometimes through public recording systems) to past or potential creditors. We will argue in Part IV that such notice requirements reflect a judgment that rules of thumb identifying non-risk-altering latecomers may be overinclusive and that much can therefore be gained from notice to past or

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[52] The reason that real estate law, with its emphasis on recorded mortgages, is even more asset based than personal property law may have less to do with the choice between asset and debtor than with the desire for homogeneity and liquidity so that real estate mortgages can be traded easily in a secondary market. Real estate mortgages can, in turn, provide the debtor with cheaper credit. Put differently, there may be no reason for the law to prohibit blanket-type security interests to favor asset-based interests, but such interests may have evolved to promote tradability. Note that increased securitization (that is, capital market financing of a specified subset of a firm's assets) may have diminished the use of nearly blanket interests under Article 9.

Japanese law provides additional evidence of variety in the asset-based character of creditor-priority systems. Japanese law enables the first real estate lender to enjoy a blanket-type security interest with respect to future advances. Minpō (Civil Code), Law No. 89 of 1896, as amended, ch. X, § 398-2 (Japan), *reprinted in* The Civil Code of Japan 80 (Ministry of Justice trans., 1972). It does not, however, recognize such a nearly debtor-based claim for the first lender on personal property. Note that Japanese law recognizes a blanket-type security interest in all of the debtor's assets for bondholders (and only bondholders), but this interest is subordinated to any security interest created in asset-based fashion—even if the asset-based interest is created later in time. Kigyō Tanpo Hō (Firm Collateralization Act), 1958, as amended (Japan).

potential lenders. For the present it is useful to begin with the converse of this proposition.

When a late-in-time lender has the right incentives to make efficient advances to the debtor and does not encourage risk alteration with these advances, there is no reason to require notice to earlier or later creditors. Salvors, as we have seen, fit this description, and, in fact, their priority does not depend on the provision of notice. In other settings, as already noted, the non-risk-altering character of late-in-time financing is a less tidy question. It is in these cases that notice may be useful.

In terms of the choice between an asset-based and a debtor-based priority system, the utility of a notice requirement may be a function of the nature of the priority system. If there is no notice requirement, parties may discover and provide information on their own. But the costs of such private information gathering, as envisaged by Schwartz,[53] are likely to be greater if priority is asset based than if an earlier creditor simply has a powerful, debtor-based priority. In the latter case, a potential creditor can inspect accounting books and other records for evidence contrary to the debtor's assertions about its sources of capital. An asset-based system, however, requires costly sleuthing to uncover superior claims to specific assets. A public filing system and a set of notice requirements for those seeking priority will likely go a long way toward creating a less costly alternative to a laissez-faire system.[54] This suggests that asset-based systems will come with notice obligations, but debtor-based systems vary. Put quite differently, an argument for a debtor-based system may depend on the potential savings in (social and private) notice costs.

Finally, note that a completely debtor-based scheme also should be associated with public notice requirements. Schwartz contemplates a system in which only the first (important) lender has a strong, debtor-based priority with no attached requirement of

[53] Schwartz, supra note 1, at 218-24.

[54] See Douglas Baird & Thomas Jackson, Information, Uncertainty, and the Transfer of Property, 13 J. Legal Stud. 299 (1984) (discussing costs and benefits of the public filing system); see also Douglas G. Baird, Notice Filing and the Problem of Ostensible Ownership, 12 J. Legal Stud. 53 (1983) (noting that public filing system under current Article 9 is meaningful for secured creditors but not for unsecured creditors).

notice.[55] But imagine a more complete debtor-based system in which C2 also beats C3 and so forth, such that potential creditors will want more precise information about the number or amount of earlier credit extensions. A recording system most economically conveys this information and resolves later disputes.

Moreover, even in a debtor-based system the first creditor may want information about later creditors because these creditors may stimulate risk alteration sufficiently severe to cut into C1's security. We will return in Part IV to situations where notice may be efficiently excused, but for the present a complete abolition of priorities contingent on notice is plausible only if the system both grants a debtor-based priority to one or two early creditors and declines to offer priority to injectors of new money even when these latecomers do not motivate risk alteration on the debtor's part.

In sum, the choice between an asset-based and a debtor-based priority system may best be understood by focusing on the available late-in-time priorities. The advantages to some asset-based priorities indicate that a notice requirement (and a transaction-cost-reducing notice system) also may be advantageous. Other consumers of these notices include early-in-time creditors in search of information about the arrival of latecomers who have been overincluded in a category of otherwise non-risk-altering, value-adding lenders.

IV. Late-in-Time Priorities

A. *Parties in the Ordinary Course*

Article 9 offers late-in-time priority to certain, but not all, parties who transact with the debtor in the "ordinary course of business."[56] The most important, common, and perhaps uncontroversial of these

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[55] Schwartz, supra note 1, at 211; see also supra note 47 and accompanying text (describing Schwartz-based system as fractionally debtor based).

[56] The U.C.C. provides:

> (1) A buyer in the ordinary course of business . . . other than a person buying farm products from a person engaged in farming operations takes free of a security interest created by his seller even though the security interest is perfected and even though the buyer knows of its existence.
>
> (2) In the case of consumer goods, a buyer takes free of a security interest even though perfected if he buys without knowledge of the security interest, for value and for his own personal, family or household purposes unless prior to the purchase the secured party has filed a financing statement covering such goods.

parties is the buyer in ordinary course, such as a law school that purchases computers from a retailer. If, for example, the retailer has borrowed from a bank or supplier that has created a security interest in the inventory held by the retailer, the law school purchasing out of this inventory takes free of the security interest, even if it is perfected and earlier in time and even if this buyer had knowledge of its existence.[57]

Our explanation of this latecomer's victory is rather straightforward. In order to enjoy this priority available to buyers "in the ordinary course," the purchase must be "from a person in the business of selling goods of that kind."[58] This requirement ensures that the debtor, or retailer, is engaging in a normal business transaction that can hardly surprise earlier lenders. These lenders are better off when their debtor engages in value-enhancing transactions, and the ordinariness requirement protects them against risk alteration. Put

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> (3) A buyer other than a buyer in ordinary course of business . . . takes free of a security interest to the extent that it secures future advances made after the secured party acquires knowledge of the purchase, or more than 45 days after the purchase, whichever first occurs, unless made pursuant to a commitment entered into without knowledge of the purchase and before the expiration of the 45 day period.

U.C.C. § 9-307.

[57] A buyer in the ordinary course of business must be "without knowledge" that the purchase violates the rights of a secured party (as opposed to knowledge of the existence of the security interest). Id. § 1-201(9). This superficially puzzling requirement effectively allows C1 to decide whether sales by D are really ordinary, or value enhancing. If C1 does not wish to authorize these sales, C1 can so provide in the security agreement, and if the purchaser has knowledge of this agreement, the purchaser will lose to C1. See infra note 77 and accompanying text for a parallel (and fuller) discussion of chattel paper.

An interesting question is whether the rule in § 9-307(2), usually understood to deal with a purchase by a consumer from another consumer, can also be understood in risk alteration terms. In contrast to § 9-307(1), which addresses a purchaser in the ordinary course, § 9-307(2) requires the consumer to be without knowledge of the existence of the security interest. It is at least arguable that in these consumer-consumer settings, as opposed to consumer-dealer settings, purchases are less often value enhancing, so C1 would not agree to be subordinated to the purchaser.

Note, in passing, that this distinction may also explain why ordinary buyers of real estate are not given the same priority as ordinary buyers of personal property under Article 9. Alternatively, in both the real estate and the Article 9 contexts, the important variable may be the likelihood that subsequent sales are implicitly authorized by C1.

A similar inquiry can be made regarding the priority allowed holders in due course under § 9-309. Here, priority may reflect the judgment that the benefits of encouraging the secondary market for commercial paper outweigh the costs of possible risk alteration. See also infra note 68 (discussing purchase of stolen goods).

[58] U.C.C. § 1-201(9).

more intuitively, everyone involved will welcome the markup paid by the law school, and the ordinariness requirement ensures that this premium does not reflect the debtor's sudden adoption of a riskier business strategy.

The markup paid by the ordinary buyer also suggests that a later lender is often a better marginal decisionmaker regarding the debtor's plans. It probably is not enough to show that one who enjoys a late-in-time priority has not created a risk alteration problem, because without some affirmative reason to prefer the latecomer, even a non-risk-altering latecomer might be subordinated to (or sometimes treated the same as) the earlier lender.[59] Here, the latecoming ordinary buyer gets priority because there is little if any risk alteration and the arm's-length transaction between the debtor and the buyer adds substantial value. More generally, the Code balances the advantages of first-in-time and late-in-time priority and therefore considers both the danger of risk alteration and the advantage to all concerned of encouraging transactions with latecomers. To the extent that arm's-length transactions might generally be regarded as efficient, the emphasis is on the risk alteration problem.[60]

A sale by a debtor to a customer who is not a buyer in the ordinary course does, in contrast, raise the possibility of risk alteration. In this case, the first-in-time priority rule for prior perfected secured parties may be appropriate; it is less clear that the nonordinary sale improves the position of previous lenders. The Code's intricate rule is that this nonordinary buyer beats an earlier secured party to the extent that the latter's advances were made forty-five days after the buyer's purchase (or after the secured party learns of the purchase), unless the secured party commits to making these

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[59] A non-risk-altering latecomer makes the earlier lender worse off to the extent that there is a new claimant on the debtor's equity. Moreover, each late-in-time exceptional priority adds transaction costs, so a solution to the secured financing puzzle requires some affirmative explanation for each late-in-time priority. On the other hand, priority for the non-risk-altering latecomer might generate better decisionmaking by earlier lenders. See infra note 84 and text accompanying notes 84-89.

[60] In the case of salvors, there is no voluntary transaction, so the focus is on both the likelihood of risk alteration and the efficiency of encouraging the salvor. In both cases, however, priority prevents overinvestment in information; priority makes the ordinary buyer unconcerned about the seller's credit history. See supra note 37 and accompanying text.

future advances within this time period and lacks knowledge of the purchase.[61] Some debtors' businesses include such sales, whereas others' do not, so these sales may or may not reflect the likelihood of risk alteration.

The Code's rule, with respect to future advances, effectively allows an earlier secured party to act upon a fear of risk alteration by perfecting the security interest every forty-five days.[62] If such an affirmative step discourages buyers or lowers the purchase price buyers will pay, the debtor may convince the prior lender not to reperfect. In short, the Code gives latecomers priority when they are virtually certain to be both value enhancing[63] and non-risk-altering. Furthermore, the Code gives prior perfected secured parties a chance to avoid the risk alteration problem (by declining to make a future advance or by perfecting every forty-five days) when there is a real likelihood that the late-in-time injector may provoke risk alteration.[64]

The preceding argument emphasizes the connection between ordinary-course buying and the expectations of earlier lenders (who are not therefore surprised by risk alteration) rather than the markup that is often associated with most buyers in the ordinary course. This observation prompts us to ask whether *all* ordinary

61 See supra note 56 (setting out text of § 9-307(3)).

62 This view suggests that the knowledge requirement in U.C.C. § 9-307(3) ought to be interpreted narrowly, but we do not claim to offer a general answer to the interesting question of the role knowledge ought to play in priority systems. See Baird & Jackson, supra note 54, at 312-18.

63 This Article's earlier analysis described the value-enhancing step as a function of the superior information available to the marginal lender. See supra text accompanying notes 27-28. In the case of the ordinary buyer the social utility is not limited to superior information, but rather concerns the higher valued use reflected in the premium paid by this buyer. Note that fraudulent conveyances to such a buyer are dealt with by other laws.

64 Under U.C.C. § 9-301(4), however, a lien creditor can beat a prior secured party when the secured party chooses to make advances more than 45 days after the lien materializes and with knowledge of it. When the claim in question is a judgment lien, note that the lien alone does not pose a risk alteration problem. A less generous rule would discourage an unsecured creditor from pursuing its claim to judgment. If the claim itself serves some useful signaling function, then the case for priority is complete (because there is net value added with no risk alteration) even though there is no injection of new money by a superior marginal decisionmaker. Other liens require a slightly different analysis.

More generally, this Article has focused on the question of when late-in-time injections benefit or harm earlier lenders or the system as a whole. Section 9-301(4), however, reminds us that some latecomers do not inject assets or new money. The most important of these is surely the tort claimant, discussed in note 98 infra.

interactions with the debtor are or should be given priority over earlier secured lenders. We might, for example, expect the law to provide late-in-time exceptions to the pro rata and first-in-time rules for the buyer who materializes in the ordinary—that is, expected or non-risk-altering—course as well as for the supplier who regularly sells to the debtor and then lines up to collect unpaid bills when the debtor becomes insolvent. In fact, such a supplier often gains priority as a purchase-money lender, although this priority comes with more conditions than the priority for the buyer in ordinary course.[65] It is apparent, however, that some asymmetry exists between ordinary buyers and sellers.

Everyday examples reveal at least one explanation for this asymmetry. An automobile dealer enhances its value to existing creditors when it makes ordinary sales from its inventory. Such sales (and the corresponding injections by buyers) are unlikely to be risk altering. In contrast, the dealer's decision to add to inventory by purchasing vehicles or spare parts, or to alter showroom space, easily can be risk altering. The presence of debt-financed inventory can affect the dealer's decision about how much inventory to acquire and how to sell inventory in stock because the debtor-dealer must now bring in more revenue before enjoying any upside return. Risk alteration thus explains why the dealer's supplier is less likely to emerge as a late-in-time winner than is the dealer's retail customer. Similarly, an automobile manufacturer surely enhances its value when dealers purchase out of its inventory, but the decision to buy additional supplies in order to manufacture may be risk altering.[66]

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[65] See infra Part IV.C.

[66] On the other hand, some ordinary suppliers generate only a minor risk alteration problem. Arguably, as long as these suppliers are dealt with in arm's-length (value-adding) fashion, priority should be available. This explains most statutory lienholders. See U.C.C. § 9-310. Their priorities are generally limited to claims based on work done to preserve or improve existing assets, and in these cases risk alteration is unlikely.

Because statutory lienholders gain priority only up to some amount, or ceiling, specified by state law, the availability of the priority even when there is no filing may be viewed in risk alteration terms. The Code effectively places certain lenders in a category where there is limited risk alteration and speculates that these lenders are indeed efficient marginal decisionmakers. Moreover, priority advantageously removes the supplier's incentive to acquire information about the debtor that is only privately useful. Of course, the category is by its nature imperfect. Some creditors who qualify as statutory lienholders will have taken part in a risk-altering injection, as in the case of a creditor who customizes a van

In sum, not all of the parties who interact with the debtor in the ordinary course are non-risk-altering value enhancers. The Code's special treatment of the buyer in the ordinary course neatly reflects the likely bargains regarding risk alteration with respect to the debtor's venture. This approach to the buyer in the ordinary course is especially interesting in American law, where the buyer in the ordinary course can lose if he unknowingly purchases stolen goods.[67] Conventional wisdom describes the buyer's success in Article 9 as a political or administrative matter, or as necessary to prevent markets from unraveling because ordinary buyers are unwilling to bear the costs of uncertainty. These arguments may have some merit, but the absence of risk alteration is a useful, if not superior, distinguishing feature of those ordinary buyers who prevail.[68]

B. Purchasers of Paper

When accounts or certain other property claims are "paperized" in the form of chattel paper,[69] negotiable instruments, investment securities, or documents of title, commercial law allows the "purchasers" of such paper to enjoy priority as to underlying property rights over earlier perfected security interests in these underlying properties. Readers unfamiliar with the advantages and pitfalls of paperization may find it easiest to consider three cases drawn from a leading casebook.[70]

(already subject to a security interest) with idiosyncratic features. This example emphasizes the categorical, as opposed to case-by-case, approach of the Article 9 scheme.

Alternatively, the priority offered statutory lienholders can be viewed as a response to interest group pressures; the price of politics is limited by the modest risk alteration problem. Finally, some statutory lienholders might be seen as purchase-money lenders that need not provide notice because the risk alteration problem is so minor. See infra Part IV.C.

67 White & Summers, supra note 1, at 173 & n.12.

68 An interesting possibility is that the rule governing the ownership of stolen property in the hands of a good-faith purchaser cau also be understood in risk-altering terms. It is at least arguable that a victory by the buyer might encourage the market for stolen goods (and therefore for theft itself), in which case the buyer's victory is (in a sense) risk altering.

69 The Code describes "chattel paper" as paper that represents "both a monetary obligation and a security interest in . . . specific goods." U.C.C. § 9-105(1)(b); see Robert C. Clark, Abstract Rights Versus Paper Rights Under Article 9 of the Uniform Commercial Code, 84 Yale L.J. 445 (1975); Thomas H. Jackson, Embodiment of Rights in Goods and the Concept of Chattel Paper, 50 U. Chi. L. Rev. 1051 (1983).

70 Schwartz & Scott, supra note 1, at 655-59.

Case 1: C1 has a perfected security interest in the accounts receivable of the debtor ("D"). This may be a "direct" interest or one that arises because C1 has a security interest in D's inventory and these accounts receivable are the proceeds from the sale of inventory. If D sells the accounts to C2 (with no explicit paper transformation other than a contract between D and the purchaser of the accounts), C1 retains priority over C2.[71]

Case 2: C1 has a perfected security interest in D's chattel paper (or other paper) because C1 had an interest in D's inventory and this chattel paper arises as proceeds of the sale of this inventory. If D sells the paper to C2, C2 now prevails over C1 even if C2 has actual knowledge of C1's interest.[72]

Case 3: C1 has a perfected security interest in D's chattel paper (or other paper), not as proceeds but as a result of having taken a direct interest in this paper.[73] If D sells the paper to C2, C2 beats C1 unless C2 has actual knowledge of C1's security interest.[74]

This is not the place to review the literature on these rules, but it is useful to note that the legal distinction between Case 2 and Case 3 is generally regarded as puzzling, whereas the outcome of Case 1 is treated as unremarkable. Thus, Case 2 has been explained as the product of the bargain between D and C1 (because this contract left room for the sale to C2), and in this view Case 3 is puzzling.[75] Alternatively, C2's victory in Case 2 has been ascribed to C2's injection of new money, but again the Case 3 exception for a knowledgeable C2 then seems inexplicable. In any event, we must not rely too heavily on a new money explanation because virtually all latecomers inject new money. The question is why some gain priority and others do not. Finally, it has been suggested that C1 might agree to C2's priority when C2 makes the credit market deeper or "thicker."[76]

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[71] U.C.C. § 9-312(5).

[72] Id. § 9-308(b).

[73] In the case of a negotiable instrument or an investment security, the direct interest can be created only by taking possession of the paper. The conflict described in Case 3 will then arise only to the extent that the security interest is created temporarily under U.C.C. § 9-304(4). A direct security interest can, however, be created by filing as to chattel paper and documents of title. Id. § 9-304(1).

[74] Id. §§ 9-308(a), -309.

[75] See, e.g., White & Summers, supra note 1, at 1179-84.

[76] Schwartz & Scott, supra note 1, at 658-59.

The risk alteration theme suggests a very different view of these cases. Case 2 involves ordinary-course purchasers of chattel paper and is therefore subject to the analysis offered in Section A. Purchasers of chattel paper materialize on a regular basis, and C1 should not be surprised by their injections of money, or substitutions of new cash for old promises of regular payments. The marginal evaluations performed by potential purchasers of chattel paper might even benefit D and C1.

In Case 3, in contrast, C1 creates a direct security interest in the chattel paper, which suggests that the sale of this paper is not intended to be in the ordinary course of D's business. C1 may recognize that the sale of this paper can cause risk alteration, as D will have more money in hand.[77] If so, the question is why C2 should ever win in Case 3. We suggest that earlier creditors are offered choices, or means of guarding against risk alteration threats, when there is not only some possibility of risk alteration, but also a decent chance that the latecomer is creating value and not provoking risk alteration.[78]

In Case 3, C1 can make use of the actual knowledge exception by marking the paper to guarantee that C2 cannot prevail even after purchasing the paper for fair value. C1 might take this precaution if C1 thinks that the money available to D from a later purchaser's acquisition of the paper will be risk altering in a way that negatively

77 When the purchase of paper represents a cash-for-cash transaction, it in a sense provides no more of an opportunity for risk alteration than the normal sale of a good. In one case a set of promises is exchanged for cash, and in the other a set of services is exchanged for cash. When these transactions are at arm's length, there is reason to think that they are value enhancing—and the more they enhance value, the more earlier creditors might be expected to discount the increase in risk alteration that is threatened by the debtor's receipt of the present value of a cash-flow. This reflects the explanation for priority accorded to the consumer who makes an ordinary purchase out of the debtor-retailer's inventory. See supra text accompanying notes 56-60. In theory the cash received by the retailer might lead to risk alteration, but this possibility seems overwhelmed by the fact that the buyer pays a (value-enhancing) premium and that such buyers are expected (and wished for) by earlier creditors.

If the purchaser of paper injects too little, however, there plainly should be no priority. And current law does provide, for example, that a purchase is not in "good faith" if C2 pays for a promissory note with an amount less than its present value; C2 in that case would neither enjoy the status of a holder-in-due-course nor gain priority over C1.

78 The explanation from a risk alteration perspective that the Code offers choice when there is a gray area is thus another version of the idea offered in Part IV.A, supra, with respect to U.C.C. § 9-307.

affects C1's interest.[79] Failure to mark the paper may indicate that C1 does not regard sale of the paper as risk altering. Similarly, if C1 does not create a direct security interest in the chattel paper, this may indicate that the parties expect later sales of paper to be in the ordinary course of this debtor's business, and that C1 agrees to be subordinated to such purchasers. Because C1 has the most to lose from risk alteration, this choice and these tasks are put in C1's hands.[80]

Explaining Case 2 and Case 3 in this manner makes the outcome of Case 1 appear puzzling. The explanation for the straightforward first-in-time rule in Case 1 must now reflect the more general argument in the literature about paperized claims.[81] Perhaps (unpaperized) accounts of the kind at issue in Case 1 simply are not generally traded in a secondary market. The debtor who sells these accounts therefore may be forced to accept a discount so steep such that

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79 Note that this "private" notice to C2 is required along with "public" notice in the form of a filing statement by C1. The public notice is of no concern to C2 because of the last sentence of U.C.C. § 9-309, which provides that "[f]iling under this Article does not constitute notice of the security interest to such holders or purchasers." Id.

80 Permanent Editorial Board Commentary No. 8 on § 9-308 reflects this argument in an interesting way. PEB Commentary on the Uniform Commercial Code, Commentary No. 8 (Final Draft Dec. 10, 1991). The Board distinguishes between two types of financing. "Type A" inventory financing is largely item-by-item (as is typical for automobiles); each item secures a precise loan that must be paid off when the item is sold or soon thereafter. "Type B" financing is a general floating lien secured by inventory and receivables, and this "availability loan" is accessible to the debtor subject to some ceiling based on the value of the inventory or the state of the receivables. Id. at 3-4. The point of the distinction is that a type B financer may have a more direct interest in any chattel paper generated by the sale of inventory than a type A financer. See id. at 4.

Under § 9-308(b), reflected in Case 2 and Case 3 in the text, a direct interest in the chattel paper permits an early lender to prevail over a later purchaser that has knowledge of the earlier interest. Thus, the type B lender can stamp the paper and prevail, but the type A lender loses to the purchaser, as illustrated in Case 2 in the text.

The distinction between the two types of financing seems consistent with our risk alteration theme. In type B circumstances the debtor can most easily engage in risk alteration because of the sale of paper. We might therefore say that C1's ability to block C2's ascension is useful (when C1 feels threatened or, more accurately, when the bargain struck between C1 and D contemplates a level of risk that does not include the sale of this paper to a prevailing purchaser). Type A financing substitutes one cash-flow for another in a way that might be value enhancing (because of tradability or collection) without significant risk alteration.

81 See Clark, supra note 69, at 447-49; Dan T. Coenen, Priorities in Accounts: The Crazy Quilt of Current Law and a Proposal for Reform, 45 Vand. L. Rev. 1061, 1075-77 (1992).

there is insufficient value enhancement to offset the possibility of risk alteration raised by the new cash in hand.

In any event, the rules governing priority with respect to paperized claims permit C1 to assess and then respond to the risk alteration problem posed by particular debtors. If an account is not paperized, C1 maintains first-in-time priority unless C1 explicitly agrees to exclude that account, through description or subordination, from the scope of C1's security interest. If, on the other hand, the account is paperized, C1 loses to the arm's-length purchaser of the paper unless C1 creates a security interest in the paper and provides purchasers with direct, or "private," notice (normally by stamping the paper itself). These rules may have evolved as a means of enabling the collection of accounts. As a matter of positive theory, however, it is arguable that paper sold in secondary markets creates little risk alteration. Viewed from C1's perspective, the choices and burden shifting embedded in these rules seem quite sensible.

C. Purchase-Money Lenders

1. Interpreting the Code's Rules

The persistence of the new money idea is greatest in the context of the Code's (and other law's) treatment of purchase-money lenders that finance the acquisition of identifiable assets. These latecomers gain priority over earlier lenders with claims on such after-acquired property that result from blanket-style interests in the relevant type of collateral. Where the debtor offers noninventory collateral, the latecoming lender need only perfect its security interest within ten days of the debtor's receiving possession of the collateral.[82] In the case of inventory, the purchase-money lender can also prevail over an earlier and perfected secured lender with an interest in inventory if the purchase-money interest is perfected at the time the debtor receives possession (there is no ten-day grace period) and if the latecomer gives advance notice in writing to the earlier lender.[83] The familiar question is how to explain the priority available to these purchase-money lenders while preserving an explanation for the fundamental race, which rewards not new

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[82] U.C.C. § 9-312(4).
[83] Id. § 9-312(3).

money but first money provided by the lender who is first to file or perfect.

We already have suggested that the law's treatment of purchase-money lenders strikes a difficult balance between the danger of risk alteration and the advantage of late-in-time decisionmaking. One way to think of this balance is to ask why the Code's priority is limited to credit used to acquire a specific asset. When funds are not linked to assets, such as when a latecomer simply advances money to a debtor, the instinct to reward new money vanishes, the risk alteration problem is apparent, and the first-in-time rule (for those who have taken security) offers an antidote. In contrast, the acquisition of certain classes of specific assets is unlikely to create risk alteration. For example, replacing an unreliable but critical piece of equipment may add value and create no risk alteration danger to the debtor's estate. Note also that creditors are more likely to consider the marginal profitability of an investment in a particular asset or associated project when funds are linked to the asset or project. The Code's rules effectively recognize this gray area in which there may or may not be risk alteration. The rules intimate that the acquisition of new inventory and its associated debt is more threatening to earlier creditors than the debt-financing of new equipment, but that debt tied to new inventory is still less threatening than new money unlinked to particular assets. When the purchase-money lender on inventory informs earlier lenders that a purchase-money interest is soon to be formed, the earlier lenders have the opportunity to withdraw (or to take other steps, including renegotiation).[84] These lenders may be able to point to generic "insecurity clauses" in their contracts, which permit a lender to regard the debtor as in default if the lender regards its loan as insecure.[85] More cautious lenders will know that they may be followed by purchase-money lenders and will simply draft contracts permitting the creditor to withdraw its capital or to change

[84] The informed lender might also step up its monitoring efforts, but the aim of this exercise is to stress nonmonitoring explanations.

[85] Some difficulty may arise in convincing courts that the insecurity clause has been triggered in good faith. See, e.g., McKay v. Farmers & Stockmens Bank, 585 P.2d 325, 327 (N.M. 1978).

interest rates[86] when informed of new inventory financing. Code section 9-312(3), with its specific notice provisions for purchase-money inventory lenders, can therefore be understood as offering the earlier creditor a chance to do something when it regards itself as surprised and disadvantaged by the new debt.[87]

Earlier creditors have the same option where the financing of new equipment is concerned. In this case, however, the Code essentially requires creditors to keep themselves informed by checking the records for a filing by a new purchase-money lender. In the case of inventory, the information comes to the earlier lender, but in the case of noninventory collateral, the earlier creditor must go looking for the information. Reasonable people can disagree whether the Code draws these lines in the right places. A legal system might give no special priority to purchase-money lenders,[88] give priority only where notice is affirmatively provided to earlier lenders, or even give latecomers priority if their funds are linked to specific assets. Our theory therefore does not point to the current rules in the Code as uniquely sensible, although these Code rules surely reflect our theoretical expectations.[89]

Somewhat similarly, a legal system might diverge from Article 9 by judging after the fact whether a particular latecomer's advance was risk-altering or advantageous to earlier creditors. When all is said and done, however, Article 9's category-oriented compromise, as it were, begins to look fairly clever. The rules reflect a supreme confidence in ordinary-course buyers as compared to ordinary-course seller-suppliers but regard the equipment-financing subset of these suppliers as somewhat likely to be non-risk-altering and value enhancing. The rules assume that the inventory financer is less likely to be welcomed by earlier creditors (who are therefore given information and an opportunity to bow out before this new priority

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[86] See supra text accompanying notes 22-24 (noting that variable interest rate might compensate earlier creditor for later increases in debt and risk alteration).

[87] U.C.C. § 9-312(3).

[88] Civil law countries generally do not offer special priority for purchase-money lenders. There is a limited vendor's lien, but this priority may be better appreciated as part of a contractual regime that uses specific performance (and hence repossession rather than a suit for damages after a buyer's breach) as its centerpiece.

[89] The easiest way to do this is to recognize arrangements that call for the retention of title by the lender. It is therefore arguable that civil law countries are in fact more sympathetic to private agreements to give priority to later lenders.

is created), but place the mere injector of late money (with respect to no particular asset) about as far away on the spectrum as possible from the salvor and buyer (of goods or paper) in the ordinary course.

2. *Financing Buyers*

It is well known that Article 9's purchase-money provisions have not been extended to "financing buyers"[90] who advance funds to enable the debtor to assemble or manufacture collateral. A financing buyer fails to gain priority as a buyer in the ordinary course because he has not yet taken possession of the collateral.[91] He also fails to qualify as a purchase-money lender because, although he has advanced funds to enable the debtor to acquire rights in the collateral, the funds have not directly "in fact [been] so used."[92] The obvious question is whether the financing buyer creates a greater risk alteration problem, provides less useful decisionmaking, or adds less value than the financing seller, who can of course enjoy the status of purchase-money lender.[93]

In fact, the financing buyer and seller appear inclined to make similar marginal decisions (and contributions). Moreover, both the financing buyer and seller increase the level of debt and may therefore similarly promote risk alteration on the debtor's part. The explanation for the disparate treatment of these two lenders may instead derive from the problem of meshing purchase-money priority for the financing buyer with the mechanics of an asset-based system.[94] To match the notice required of the purchase-money seller—a requirement that, as discussed earlier, addresses the risk alteration problem by enabling the earlier lender to withdraw or

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[90] See Thomas H. Jackson & Anthony T. Kronman, A Plea for the Financing Buyer, 85 Yale L.J. 1, 3-5, 32 (1975).

[91] U.C.C. § 9-312(4).

[92] Id. § 9-107.

[93] Note that this is not the same as a buyer in the ordinary course who buys out of inventory and should therefore be appealing (as non-risk-altering) to all earlier creditors. Instead, the financing buyer may well promote an increase in risk because the transaction with the debtor is in a sense an expansion of the debtor's enterprise. Even if it is ordinary in the sense of an arm's-length price for the goods sought by the buyer, the increase in debt that the debtor takes on may itself lead to a riskier business strategy.

[94] If the financing buyer enjoyed priority in a debtor-based system, the first-in-time rule would be eviscerated.

adapt—the financing buyer would need to give notice before the debtor received the funds advanced by this buyer.[95] The buyer's priority would extend to the item created for this buyer, which is part of the inventory now held by the debtor for delivery. But which piece of inventory would be subject to the purchase-money buyer's priority?

A serious tracing problem arises because even when the debtor can isolate and specify work done on a single buyer's project, the debtor may wish (or may respond to a creditor's pressure) to change designations.[96] This tracing problem suggests that a purchase-money priority for the financing buyer may come too close to a debtor-based priority. Put differently, when tracing is difficult, priority generates a risk alteration problem for earlier lenders.

Finally, a debtor-based scheme that offered purchase-money priority would allow the late-in-time exception to swallow up the first-in-time rule. Earlier lenders would then face serious risk alteration problems and credit costs would rise. Viewed from a different perspective, a debtor-based scheme that favored later rather than earlier lenders would generate inefficient overlending by latecoming lenders.

D. *Sureties*

We have shown that almost all of the late-in-time priorities can be associated with limited risk alteration danger and at least some prospect of net gain. We also have argued that some notice requirements reduce potential risk alteration problems arising out of overbroad categories by affording earlier creditors the opportunity to withdraw or to take other protective steps. To understand this char-

95 The quest is for symmetry with the time the debtor receives inventory under present U.C.C. § 9-312(3).

96 Imagine, for example, a debtor that builds yachts or customizes vans. A project, or piece of inventory, in one corner of the factory may be designated as financed by and already sold to a specific buyer, but in the course of business, as other orders are rescinded or as supplies come in at unanticipated times, the debtor may (even in the ordinary course of business) switch and decide that a different work-in-progress should be designated and finished for the first buyer. In some cases there will be no tracing problem at all, such as when the financing buyer encourages the debtor to manufacture a new item that cannot be confused with other buyers' inventory. The risk alteration idea suggests that the Code should answer the plea for the financing buyer in (at least) these situations.

acter of notice, consider the treatment of a non-risk-altering lender that does not serve as a marginal decisionmaker or contributor to value. We might expect such a claimant, when late in time, to lose to an earlier creditor. The absence of a risk alteration problem means that the earlier lender has little to lose, but the absence of superior decisionmaking or marginal contribution also means that there is nothing for the earlier lender to gain through subordination. On the other hand, the earlier lender may itself be a better marginal decisionmaker if it does not enjoy the cushion provided by the non-risk-altering lender.[97]

Sureties, who guarantee completion of a contract, fit this pattern.[98] A governmental entity, for example, may contract with a builder and require the latter to secure a performance bond from a well-established insurer to guarantee completion at the stated cost—albeit slightly swelled by the cost of this insurance. In the event of the insured's default, the surety will complete the project and then compete with the creditors of the insured for payments (such as progress payments or amounts due on completion) owed by the governmental unit, or account debtor. In this contest the surety generally prevails, even when the surety has not filed under Article 9 and even if the contract with the surety was entered into after a secured creditor perfected its interest.[99]

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[97] This calculus should also include some judgment about the optimal size of the residual (pro rata) group. Non-risk-altering lenders that do not perform some service at the margin may be best used to reduce the transaction costs and collective action problem of the residual group of claimants. See supra notes 39-40 and accompanying text.

[98] More generally, latecomers who do not pose a risk alteration problem but do not seem to add value or provide superior marginal decisionmaking are occasionally given priority. Lawmakers might be expected to give substance to other policy preferences when there is no problem of risk alteration. In particular, although the priority of tort claimants in the Article 9 system is much lamented, see infra note 121 and accompanying text, tort claimants who secure a maritime lien can defeat earlier registered mortgages under admiralty law. See, e.g., Preparation and Adoption of a Convention on Maritime Liens and Mortgages, U.N. IMO, arts. 4(1)(e), 5(1), U.N. Doc. A/CONF.162/L.5 (1993). Tort claims surely can pose a risk alteration problem; once such a claim materializes, a debtor may engage in risk alteration to increase the chance of some upside return. Placing the tort claimant behind other creditors does not alleviate this risk alteration problem. Unlike contractual creditors, who can raise their interest charges and thus discourage borrowing by the debtor, the potential tort claimant's priority does not otherwise affect the debtor's marginal decisionmaking.

[99] See, e.g., Finance Co. of Am. v. United States Fidelity and Guar., 353 A.2d 249 (Md. 1976) (discussing contract with surety entered into after contract with account debtor and after contract with the secured party and after perfection by secured party, and insisting

A conventional but again unhelpful way to explain the surety's victory is to say that but for the surety's late-in-time injection the account debtor would owe no additional funds to the defaulting debtor; thus, the earlier creditor is not made worse off by the surety's victory. But other late-in-time lenders also might show that their advances were necessary to preserve an asset of the debtor, and these run-of-the-mill latecomers are not offered an opportunity to gain priority by appealing to this sort of causation argument.[100]

We emphasize that the surety does not simply inject new money—something virtually all subsequent lenders do—but rather completes an ongoing project in a manner that is by nature not risk altering. To the extent that the creditors' (and society's) concern is that increased debt will cause the debtor to gravitate selfishly toward riskier, and even negative-present-value, projects, the surety's injection is not threatening. The surety fails to provide the debtor with the means of risk alteration because funds are not made available for the debtor to invest at will but rather are dedicated to

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that surety's right of subrogation conflicts only with a *simultaneously* perfected security interest because the surety's obligation became retroactive to the date of the contract with the account debtor, which was also the date of attachment and therefore perfection under U.C.C. § 9-303 because the debtor did not have rights in the collateral until that time). For an interesting essay that instead ties the surety's victory to the fact that it derives its power from the owner of the property, whereas the earlier lender derives its rights from the breaching contractor, see Baird & Jackson, supra note 21, at 870-72. Baird and Jackson reason that in the "absence of a special rule" the "derivation principle" suggests that the surety has priority over the earlier secured lender. Id. at 872. Our argument is somewhat more general; we ask, in effect, when the law does and does not provide such special rules.

Note that, consistent with our earlier discussion about the expected treatment of a claimant that is non-risk-altering but nothing more, the rule favoring the surety over the Article 9 winner is not universal. See White & Summers, supra note 1, at 948 & n.4 (summarizing In re Kuhn Constr., 11 B.R. 746 (Bankr. S.D. W. Va. 1981)).

100 A more straightforward if unexciting means of explaining the surety's victory over prior lenders, however secured and perfected, is to argue that, even though the surety does not provide other lenders with notice (and certainly is not the first to file or perfect), other creditors expect a surety to be present (now or in the near future) and therefore act as if there is notice from the surety. See White & Summers, supra note 1, at 948 & n.8. To the extent that reported cases involve governmental units as account debtors (indeed, we have not uncovered cases where prior secured parties compete with sureties who were brought in by private account debtors), other lenders may be regarded as on notice of a surety's likely presence. On the other hand, it is the creditors of the contractor and not the creditors of the governmental unit that must take the surety's presence into account. Thus, the argument that filing is not required because there is de facto notice presumes more information in the hands of creditors than we are inclined to assume for the purpose of a general explanation of the priority granted to sureties.

completing performance on a specific project. Moreover, the surety's involvement most likely corresponds with the debtor-contractor's bankruptcy, so there is little fear of future risk alteration.[101] It does not follow from the surety's non-risk-altering character that earlier lenders would agree to be subordinated to the surety; that step requires a claim of added value or better marginal decisionmaking.[102] But the non-risk-altering character of the surety does explain why there is no need for notice to these lenders; the debtor (and now the surety) is obviously doing the very thing it agreed to do earlier, so there is no risk alteration problem.

E. Setoff Rights

A final late-in-time winner is a creditor who asserts a setoff right as a common-law matter and not under Article 9, which purports to "exclude" setoff claims (perhaps because the drafters found the problem too difficult).[103] Imagine that a debtor owes $1000 to each of three creditors, E, F, and G, and that E and another party, H,

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[101] Put differently, the premium paid by the debtor to the surety is not risk altering because it buys a promise to complete the very project anticipated by earlier creditors.

It is fitting that the surety's priority is limited to the payments received from the account debtor (an asset-based priority). Armed with a more extensive (debtor-based) late-in-time priority, a surety might simply charge a "premium" that amounted to an interest rate tied to the time value of money and to the risk associated with the debtor's enterprise as a whole rather than the prospects associated with a given contract. When the late-in-time priority is limited to a specific asset, however, such as the surety's claim to the account debtor's payments, ouly non-risk-altering injections are encouraged because there is no priority once the given asset proves insufficient to satisfy the late-in-time injector.

[102] If the surety's victory were limited to cases where the surety came on the scene last and then served as a monitor or check on the contract price and terms entered into by the debtor, then such a claim might be made.

[103] A modern, and certainly plausible, view is that the Code's provision that Article 9 "does not apply . . . (i) to any right of set-off," U.C.C. § 9-104, can be explained as the product of political influence and effort on the part of the banking industry. See John C. McCoid, II, Setoff: Why Bankruptcy Priority?, 75 Va. L. Rev. 15, 43 (1989).

The exclusion of setoffs was explained in a much-cited earlier view as

> an apt example of the absurdities which result when draftsmen attempt to appease critics by putting into a statute something that is not in any sense wicked but is hopelessly irrelevant. Of course a right of set-off is not a security interest and has never been confused with one: the statute might as appropriately exclude fan dancing.

1 Gilmore, supra note 28, at 315-16. There may be some linguistic argument that setoffs are not security interests, but surely Gilmore could have predicted that a generation of serious students and users of Article 9 would find the conflicts between Article 9 and setoff claimants difficult to resolve.

each owes $500 to the debtor. The debtor's trustee in bankruptcy will attempt to collect all debts owed to the estate, but E will assert a right of setoff, paying the trustee nothing and claiming $500 from the trustee. The trustee will divide the $500 received from H, paying E, F, and G pro rata shares of $100, $200, and $200, respectively. E's ability to use the right of setoff to retain $500 and to gain priority in this way over F and G has a historical origin but is part of an intricate puzzle as to when and why setoff claims succeed. The Article 9 question is why E should succeed, especially when fellow creditors had no easy means of discovering the existence of the relevant cross-claims. This question becomes more difficult when such a setoff claim is sufficiently powerful to defeat an earlier perfected secured creditor.

We can whittle down the setoff puzzle from several angles. First, the Bankruptcy Code denies a setoff claim when the debtor incurred the debt within ninety days of the filing of the bankruptcy petition.[104] In the absence of this rule, the debtor and E might collude and agree, for example, that something sold to E was defective.[105] Second, setoff claims sometimes arise out of the commercial-bank practice that requires "compensating balances." A bank may lend the debtor $100,000 but require the debtor to maintain a deposit balance of $30,000 in the lending bank. This indirect method of lending $70,000 enables the parties to circumvent usury laws because it allows the deposit to be low- or non-interest-bearing. In these cases, the sympathy or hostility with which courts treat setoff claims might be taken as a proxy for their reaction to interest rate regulation itself rather than as a set of reactions to this kind of new money.

There remain, however, many situations in which a later setoff claimant, C2, prevails over an earlier creditor, C1. For example, when C1 is a prior perfected secured party and C2's setoff claim relies only on Article 9's exclusion of setoff,[106] C1 normally prevails under Article 9. But many courts will allow C2 priority where C2

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104 11 U.S.C. § 553(a)(3) (1988).

105 More generally, the seller can favor one creditor, perhaps in return for a side payment, simply by agreeing that this creditor, as a buyer, received defective goods. This collusion can occur "outside" bankruptcy because U.C.C. § 2-717 permits the buyer to deduct damages from the unpaid price.

106 U.C.C. § 9-104(i).

had neither actual knowledge of C1's security interest nor reason to inquire about it.[107] Other courts generally limit the class of successful setoff claimants to banks by requiring not only absence of actual knowledge but also reliance by C2 on the setoff right (for example, a bank's claim regarding the importance of the debtor's deposit to the lending decision).[108] In any event, unlike the purchase-money lender, but very much like the salvor and surety, C2's setoff claim does not depend on the provision of notice to C1.

The risk alteration theme illuminates some of this setoff law. When the debtor owes money to C2 but is also owed money by C2, C2's payment to the debtor can create a risk alteration danger because the debtor receives new funds with which to embark on risky projects. Note that we do not argue that the debtor is tempted by risky projects because of greater debt; C2's payment to the debtor does not, after all, increase the debtor's outstanding debt. But at the debtor's given level of debt, new funds represent new possibilities for risk alteration. All other creditors may prefer C2 to withhold its payment and send it to the trustee in bankruptcy, who will, in turn, divide it among the creditors. C2's setoff claim is thereby limited to the amount that C2 might have paid to the debtor earlier in time, which the debtor might have exploited in a risky fashion. This may occur where, for example, C2 is a bank that is owed money by the debtor but also holds the debtor's deposit account. The funds in this account might be seen as money that the debtor could use in risky ventures were it not safely tied up in this bank account. The bank's setoff right with respect to these funds is thus consistent with the risk alteration idea.

A more difficult case is presented by the bankruptcy of a party to a clearinghouse arrangement, which may itself be a means of enjoying multiparty setoffs.[109] Following the insolvency of an air-

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[107] See Dwight L. Greene, Deposit Accounts as Bank Loan Collateral Beyond Setoff to Perfection—The Common Law Is Alive and Well, 39 Drake L. Rev. 259 (1989).

[108] See Luize E. Zubrow, Integration of Deposit Account Financing into Article 9 of the Uniform Commercial Code: A Proposal for Legislative Reform, 68 Minn. L. Rev. 899, 978-80 (1984) (describing arguments and citing cases); Frances A. Rauer, Note, Conflicts Between Set-Offs and Article 9 Security Interests, 39 Stan. L. Rev. 235, 249-50 (1986).

[109] In a jurisdiction where when J owes K, K owes L, and L owes J, setoff among these claims is disallowed because of the lack of "mutuality" of obligations. In the example that follows in the text, a clearinghouse that serves as the creditor or debtor of each party (airline) and not simply an agent for the transmission of balances may be useful as a means

line company, for example, the company generally will owe other carriers money as a result of ticketing that placed passengers on these other carriers. These and other carriers, however, also will owe the insolvent airline money because the now-insolvent carrier transported passengers ticketed by these other carriers. Risk alteration explains why the argument for setoff priority is generally, but not always, a good one.[110] Creditors of an airline can hardly be surprised by the presence of these debts (and credits); the debtor has not used these advances by fellow carriers to engage in risk alteration. The debtor merely carried on the familiar task of running an airline with some intercarrier bookings.[111] There is always the danger, however, that a carrier will alter risk by drastically lowering fares. This sort of risky marketing and operating strategy can easily lead to bankruptcy, but in the process it is likely to increase sales and therefore ticketing on behalf of other carriers. In this situation earlier creditors have been harmed—not so much because of the funds injected by other carriers through the clearinghouse arrangement but because the risk alteration strategy harms all creditors.

Risk alteration alone suggests that the first-in-time rule should retain its vitality and that the setoff claimants should lose because earlier creditors have been harmed. But the only way other carriers can prevent these losses is to deny clearinghouse privileges to the discounter. On antitrust grounds alone we may therefore prefer that it be the nonairline, earlier creditors who lose priority and therefore exert influence on the debtor. In short, risk alteration may explain the elevated status of clearinghouses, but other consid-

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of overcoming this doctrinal hurdle. See R.M. Goode, Legal Problems of Credit and Security 175-76 (2d ed. 1988). If the clearinghouse is solvent, the arrangement amounts to a homemade pro rata rule. The text explains that the clearinghouse arrangement is also not risk altering; the theme of the Article as a whole predicts that the clearinghouse therefore will be welcome in the law of creditor priorities.

110 In this case, the setoff priority allows other carriers priority over earlier creditors by subtracting the amounts they are owed before making payments to the bankruptcy trustee.

111 Setoff priority thus allows efficient intercarrier booking because, with no priority, carriers would wish either to exclude airlines more likely to become insolvent or to charge price differentials corresponding to the risk of insolvency. Put differently, a risky strategy would be to insist that one did not engage in any interairline booking.

erations may better explain priority for these setoff claimants even where they are associated with a risk alteration problem.[112]

Consider next a situation where C2 is one of several creditors and satisfies a debt it owes by creating an account in the debtor's favor.[113] Following the debtor's bankruptcy, C2 claims that its setoff right in this account is superior to C1's claim. (C1 might claim that this account represents the proceeds of the sale of inventory that was the subject of C1's prior perfected security interest.) Although this account may not lead to risk alteration, it may have thwarted C1's agreement with the debtor. C1 may have awaited these proceeds as partial payment of its own debt. C2 might be rewarded for helping to combat risk alteration, but this reward should not completely defeat C1's prior expectations.

There are two obvious ways in which the law, or the Code itself, could address the situation in which C2's setoff claim sometimes represents a partial solution to the risk alteration problem but sometimes hinders earlier creditors. First, the law could require notice from C2 so that an informed C1 can withdraw or take protective steps.[114] We have seen this strategy in the context of the conflict between purchase-money lenders and earlier lenders (especially with respect to inventory).[115] Notice can be useful both to C1, who fears breaches by the debtor, and to later creditors, who can then search more economically for information about the debtor. Most importantly, however, notice gives earlier creditors

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112 Similar arguments might be made about other clearinghouse arrangements. Compare In re Iowa R.R., 840 F.2d 535 (7th Cir. 1988) (holding that setoffs between railroads with no formal clearinghouse arrangement were general, unsecured debts with no priority) with Pioneer Commercial Funding v. United Airlines, 122 B.R. 871, 886 (Bankr. S.D.N.Y. 1991) (holding that setoffs between airlines with a clearinghouse arrangement are nevertheless susceptible to challenge under principles of law and equity beyond the U.C.C.).

113 If the debtor's debt to C2 is due, the repayment poses no problem unless it can be attacked as a preference or a fraudulent conveyance because of its proximity to bankruptcy or its terms. The discussion in the text thus assumes that if the creation of the account is simply an attempt to avoid these rules, by accelerating due dates or otherwise setting the stage for a future setoff claim, the law will rise to the occasion and thwart such an attempt. See 11 U.S.C. § 553 (1988).

114 There are really two versions of this solution because C2 can be asked to file (so that C1 needs to search for information) or C2 can be made to inform C1 directly. We will prefer the latter the more we think that C1 needs to act upon the information. These two solutions reflect one of the differences between U.C.C. § 9-312(3) (notice required) and § 9-312(4) (filing sufficient to perfect interest).

115 See supra Part IV.C.

an opportunity to take steps in the face of risk alteration while allowing late-in-time creditors to make relatively efficient marginal decisions.

A second solution to the setoff problem is to deny C2 priority when C2 knows of C1's interest—and therefore knows of C1's expectations regarding the proceeds or other funds now arranged as a debt owed to C2. This solution is most reasonable when C1 is unlikely to benefit from the arrangement between the debtor and C2; C2 would then need to secure a subordination agreement from C1 to overcome this presumption. Setoff law (at least in its interaction with Article 9) seems to have adopted this second solution.[116] Once again, it is interesting that this solution illustrates that the law facilitates non-risk-altering advances even where earlier creditors would prefer no advance at all.[117]

The "solution" itself highlights the idea that notice and knowledge are not merely neighbors on an information spectrum. Notice can be used to offer prior creditors the opportunity to take action. Knowledge (by a latecomer) can be used as a proxy for unexpected, or non-ordinary-course, injections. A purchase-money lender may have knowledge of an earlier security interest but nevertheless gain priority in a way that the earlier lender accepts because of the latecoming lender's superior information, contribution, non-risk-altering advance, or some combination of these characteristics. Here, the latecomer's knowledge is not a proxy for nonordinariness, and the notice requirement gives the earlier lender the opportunity to veto this default rule. In contrast, the latecomer that purchases chattel paper and has knowledge of an earlier direct interest in the

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116 See supra note 108 and accompanying text. The actual knowledge requirement on C2's part therefore should represent a proxy for C2's knowledge that C1 expected payment from the debtor and would not benefit from C2's help in reducing the risk alteration problem. Of course, C1 may have the same expectations where C2 was unaware of C1's interest, but the compromise encourages C2's creation of a conservative "parking spot" for these funds in return for priority when C2 was unaware of C1's interest. C1, however, may be able to broadcast its interest.

Those courts that give C2's setoff claim priority over C1 only when C2 also relied on the debtor's account either limit priority to the easiest case of compensating balances, as described earlier, or seek some evidence that creditors in the aggregate may have benefited (with lower interest rates from C2) from the priority.

117 It would be interesting to find a rule, or perhaps truer solution, that gives C2 a smaller reward (such as a setoff right for a fraction of the amount advanced) so that C1 will more likely benefit from the priority afforded C2.

paper must assume that the earlier lender is not eager to embrace this new money.[118]

In this setting, where we would not expect the latecomer to be a non-risk-altering value-enhancer, notice does not travel up the chain to an earlier lender, who may wish to take evasive action, but rather travels down to later lenders, who will know they are unexpected, perhaps unwanted, and certainly subordinated. Apparently, courts that have considered such setoff situations have assessed the likelihood of value enhancement and risk alteration as modest and therefore treat setoff claimants more like purchasers of chattel paper than like purchase-money lenders. It is therefore not terribly surprising that setoff claimants have not been asked to file. When they win they are similar to successful purchasers of commercial paper, whose success depends on the expectations of earlier lenders and not on the information provided to later or earlier lenders.

V. Conclusion

The theory offered here stresses the problem of debtors' increasing the riskiness of their enterprises as they take on more debt. We have tried with this springboard not only to explain the central puzzle of secured financing, but also to account for the variety of exceptions found in Article 9 (and other systems of creditor priorities) that permit certain late-in-time creditors to escape the pro rata rule of bankruptcy and even to prevail over earlier creditors that have done all that is legally possible to gain priority. We also have discussed why priority is generally tied to specific assets of the debtor.

Even positive theories have practical implications, and because there is presently a substantial effort aimed at revising Article 9,[119] it seems appropriate to comment on the relationship between the theory we have developed and recently proposed revisions. There are, first, a variety of proposals to clarify or to expand the scope of Article 9.[120] One theoretically interesting question is when other

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118 See supra Part IV.B.

119 See PEB Study Group, Uniform Commercial Code Article 9: Report (Dec. 1, 1992) [hereinafter PEB Report].

120 Id. at 43-71.

claims should be subject to the rules of the Article 9 race (when they might previously have defeated or been defeated by Article 9 claims even with no notice).

Article 9's scope is a subtle thing. Many of the suggested expansions of scope concern claimants that are not risk altering (so that one is tempted to say that these claimants should or could succeed even when late in time), but that also do not inject money at the margin leading to value-enhancement or more efficient lending decisions. For example, tort claims[121] generally are not themselves risk altering. Because they generally arise in "accidental" fashion, however, there is no sense in which they may contribute to efficient decisionmaking. The purchase of a tort claim therefore is similar to the purchase of many other assets in that the injection can promote risk alteration unless the purchase can somehow be described as "ordinary." Arguments to expand Article 9 to include these claims therefore might be more about the ability to offer additional certainty at low cost than about net social gain.[122]

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121 The suggestion is to expand Article 9 to include security interests in claims arising out of tort and seriously to consider including security interests in claims for personal injury arising out of tort. Id. at 58-59.

122 Other suggestions regarding the scope of Article 9 would benefit from an attempt to link the question of scope to some general theory of Article 9's present patterns and exceptions. Thus, the Article 9 Study Committee recommends that

> Article 9 . . . be revised to include deposit accounts within its scope as original collateral [and] to provide that a depositary institution owes no duties to a secured party claiming a security interest in a deposit account maintained with that institution unless, and then only to the extent that, the institution agrees to assume such duties or is served with legal process concerning the deposit account.

Id. at 68. Furthermore,

> Article 9 should be revised to provide that perfection in an obligation (e.g., a note) secured by real estate should be accomplished by perfection as to the obligation under Article 9 in the same manner as if the obligation were not secured by the real estate and to make clear that no additional perfection is required with respect to the real estate.

Id. at 61. Deposit accounts are, however, part of the puzzle of setoff rights. Although the Article 9 Study Committee's suggestion for revision does not necessarily mean that a first-to-file rule should be legislated, we focus on the possibility that the evolved rule is a sensible one, so that the proposed revision would amount to nothing more than a codification of existing law.

The presence of secured real estate claims is not puzzling when they do not coexist with unsecured debt. The purchase of notes from a mortgagee brings us back to the question of ordinary purchases of paper, discussed in Part IV.B, supra. More generally, rules regarding perfection are sometimes driven by the priority decision among creditors; reformers should

Many substantive proposals to revise Article 9 assume too quickly that current law is flawed. These proposals include the suggestion to change section 9-308 to provide a single set of circumstances under which a purchaser of chattel paper prevails over an earlier perfected security interest.[123] But the distinction between a claim on the chattel paper as proceeds and a claim on the chattel paper directly may make some sense.[124] The proposal to deny priority to a buyer in the ordinary course who leaves the seller in possession of the goods may also dismiss underlying explanations or theories too quickly.[125] We still need some theory to explain the victory of the buyer (with possession) before we can evaluate the argument that possession be required for this priority. Risk alteration suggests, but hardly requires, that possession be insignificant in this setting.

Several proposals to reform Article 9 could be argued for more forcefully with the theory advanced in this Article. The recommendation that financing buyers be afforded purchase-money priority if a rule "can be fashioned that is practical, not unacceptably complex, and adequately protective of the rights of earlier-in-time inventory financers"[126] reflects the very difficulties explored in our earlier discussion of meshing priority for a financing buyer with the mechanics and advantages of an asset-based priority system.[127] But we agree that in the absence of tracing and notice problems the financing buyer is (in risk alteration terms) like the financing seller. Finally, the recommendations regarding purchase-money priorities would only be strengthened by reference to the underlying, non-risk-altering justification for the priority itself.[128]

It is easy, of course, for the theorist in every area of law to insist that no law be written or case decided until there is agreement

exercise caution before altering or indirectly affecting these priorities. We argue that virtually any attempted reform would benefit from some linkage to the theory put forth here.

[123] PEB Report, supra note 119, at 166-68.

[124] See supra Part IV.B.

[125] PEB Report, supra note 119, at 191-92.

[126] Id. at 194-95.

[127] See supra Part IV.C.2.

[128] The Article 9 Study Committee's suggestions include attempts to ensure or clarify that purchase-money security status is not lost if the collateral also secures non-purchase-money debt, if the advance is secured by additional collateral, or if the debt has been refinanced. See PEB Report, supra note 119, at 97-99.

about normative goals and the effects of prevailing rules and proposed changes. But the lawyer and pragmatic academic know that law has a job to do, that virtually no area of law satisfies the purist's quest for a perfect theory, and that one must make informed guesses to effect socially useful changes. We like to think that there is something of a happy middle ground on which the best available theories are used by reformers and where reform is undertaken more cautiously the more it is possible that prevailing rules, however difficult to understand, may reflect some truths or functions not yet included in our philosophy. In the case of Article 9, we have tried to share our enthusiasm for the ways in which risk alteration can explain not only the rules of the primary race among creditors but also, and especially, the exceptions that enable certain latecoming creditors to prevail. Even a perfect positive theory does not justify a set of rules, but it does suggest the presence of a coherent theme. Where there is such a theme, the burden ought to shift to reformers either to show how their proposals fit within, or improve upon, this theme or to demonstrate that the system as a whole does more harm than good.