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THE UNSECURED CREDITOR'S BARGAIN: A REPLY

*Susan Block-Lieb**

INTRODUCTION

UNLIKE Law and Economics scholars who view secured lending as a consensual relationship benefiting not only debtors and their secured parties but also the debtors' unsecured creditors, Lynn LoPucki describes secured transactions as a subsidy because they benefit debtors and their secured creditors at the expense of unsecured creditors. He believes security "is an institution in need of basic reform" because it "tends to misallocate resources by imposing on unsecured creditors a bargain to which many, if not most, of them have given no meaningful consent."¹ He divides these unsecured creditors into two groups: involuntary creditors, and uninformed creditors who underestimate the risk of unsecured status.² He proposes, first, that secured creditors should be subordinated to involuntary creditors,³ and, second, that voluntary unsecured creditors should be bound to the terms of their debtor's security agreement "only if and to the extent that a reasonable person in the position of the unsecured creditor would have expected to be bound at the time that person extended credit."⁴

LoPucki's reformulation of the unsecured creditor's bargain is a provocative critique of the economic theory of secured and unsecured lending. I am troubled by LoPucki's suggested reforms, however. Except for his proposal to modernize the Article 9 filing system⁵—a proposal I commend—I question whether LoPucki's reforms are likely to be more harmful than helpful.

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¹ Lynn M. LoPucki, *The Unsecured Creditor's Bargain*, 80 Va. L. Rev. 1887, 1891 (1994).

² See *id.*

³ *Id.* at 1902.

⁴ *Id.* at 1947-48.

⁵ LoPucki's proposal to modernize the Article 9 filing system incorporates reforms he suggested in an earlier article. See Lynn M. LoPucki, *Computerization of the Article 9*

I. INVOLUNTARY CREDITORS

LoPucki begins by noting empirical evidence that “a substantial portion of all unsecured creditors do not consent to their status in any meaningful sense.”⁶ By introducing involuntary creditors to the paradigm, LoPucki rightly questions the relevance of a consent-based theory of secured credit. If the model depends upon an assumption that unsecured creditors consent—either explicitly or impliedly—to the existence of secured credit, then the existence of involuntary creditors in substantial numbers renders the model suspect. In addition to noting that many unsecured creditors lend involuntarily, LoPucki also contends that involuntary creditors—particularly tort creditors—can be rendered worse off by their debtor’s grant of a security interest.⁷ “Simply by entering into a security agreement, the debtor and a favored creditor can expropriate for themselves value that, absent the agreement, would go to [tort and other] involuntary creditors.”⁸

Filing System: Thoughts on Building the Electronic Highway, *Law & Contemp. Probs.*, Summer 1992, at 5, 15-31.

⁶ LoPucki, *supra* note 1, at 1896. He points to Sullivan, Warren, and Westbrook’s study of consumer bankruptcies, which found that “twenty-three percent of the unsecured debt of persons filing bankruptcy under Chapters 7 and 13 of the Bankruptcy Code was owed to what the researchers called ‘reluctant creditors.’” *Id.* (citing Teresa A. Sullivan, Elizabeth Warren & Jay L. Westbrook, *As We Forgive Our Debtors* 18, 294 (1989)). This statistic may be irrelevant if, as I suspect, LoPucki’s reform is primarily directed toward corporate tortfeasors and their secured creditors. See *infra* notes 21-23 and accompanying text. Moreover, although these data refer to a wide variety of involuntary creditors—taxing authorities, other governmental entities, utilities, health care providers, and ex-spouses and children with unpaid support orders—LoPucki often limits his analysis to tort creditors (although his proposal would apply to all involuntary creditors). See LoPucki, *supra* note 1, at 1896-1916. His limitation is understandable, because his criticisms are less apt as applied to nontort involuntary creditors, a point discussed more fully below. LoPucki goes on to “speculate that money owed to reluctant creditors constitutes an even larger portion of the debt of financially distressed companies.” *Id.* at 1896. Whether this speculation is empirically justified is difficult for me to gauge, so I will accept it as true.

⁷ *Id.* at 1897-98.

⁸ *Id.* For other discussions of the incentive to externalize tort risk, see Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 *Yale L.J.* 1879 (1991); David W. Leebron, *Limited Liability, Tort Victims, and Creditors*, 91 *Colum. L. Rev.* 1565 (1991); Steven Shavell, *The Judgment Proof Problem*, 6 *Int’l Rev. L. & Econ.* 45 (1986); [hereinafter Shavell, *Judgment Proof*]; Steven Shavell, *Liability for Harm Versus Regulation of Safety*, 13 *J. Legal Stud.* 357 (1984) [hereinafter Shavell, *Liability vs. Regulation*]; Robert B. Thompson, *Unpacking Limited Liability: Direct and Vicarious Liability of Corporate Participants for Torts of the Enterprise*, 47 *Vand. L. Rev.* 1 (1994); Christopher M.E. Painter, *Note, Tort Creditor Priority in the Secured Credit*

LoPucki concludes that the exploitation of involuntary creditors should be eliminated by subordinating secured creditors to involuntary creditors,⁹ conceding that this proposal would “drastically change the American legal system.”¹⁰ Subordination of secured debt to involuntary debt *would* drastically alter the law of secured transactions, but drastic reform would be justified *only if* it were the most effective means of internalizing the risk of accidents, and *if* the benefits of internalizing this risk would outweigh the detrimental effects that basic reform of Article 9 might have upon the available credit pool. LoPucki has shown neither.

A. *Are Secured Creditors the Second-Best Cost Avoiders?*

LoPucki’s argument builds on an economic analysis of the law of tort. Tort liability rules—whether rules of negligence or strict liability—can be viewed as efficient to the extent that they create

System: Asbestos Times, the Worst of Times, 36 Stan. L. Rev. 1045 (1984). The phrase “externalization of tort risk” is Leebron’s. Leebron, *supra*, at 1648.

For discussions of the incentives to externalize the risk of other involuntary claims, such as environmental liability and liability for underfunded pension plans, see, e.g., Michael D. Green, Successors and CERCLA: The Imperfect Analogy to Products Liability and an Alternative Proposal, 87 Nw. U. L. Rev. 897 (1993); Kathryn R. Heidt, Cleaning Up Your Act: Efficiency Considerations in the Battle for the Debtor’s Assets in Toxic Waste Bankruptcies, 40 Rutgers L. Rev. 819 (1988) [hereinafter Heidt, Cleaning Up Your Act]; Kathryn R. Heidt, Liability of Shareholders Under the Comprehensive Environmental Response Compensation and Liability Act (CERCLA), 52 Ohio St. L.J. 133, 172-73 & n.280 (1991) [hereinafter Heidt, Shareholder Liability]; Howell E. Jackson, The Expanding Obligations of Financial Holding Companies, 107 Harv. L. Rev. 507 (1994).

⁹ See LoPucki, *supra* note 1, at 1902, 1907-16. LoPucki’s proposal is therefore distinct from the reforms proposed by other commentators. Shavell suggests mandatory insurance and other regulations to offset the incentive to externalize tort risk. See Shavell, Judgment Proof, *supra* note 8, at 53-55 (suggesting mandatory universal insurance); Shavell, Liability vs. Regulation, *supra* note 8 (suggesting regulation in defined circumstances). Hansmann and Kraakman instead propose abolition of the corporate rule of limited liability. See Hansmann & Kraakman, *supra* note 8, at 1880. Other scholars would alter, but not abolish, the rule of limited liability. For example, Howell Jackson contends that enhanced liabilities should be imposed on financial holding companies. Jackson, *supra* note 8, at 513, 612-14. Heidt contends that environmental liability should be assessed against shareholders of the corporate “dumper” when the shareholder could have prevented the “dumping.” Heidt, Shareholder Liability, *supra* note 8, at 172-73 & n.280. In another article, Heidt contends that the government should be allowed to recover environmental cleanup costs out of a corporate “dumper’s” assets before secured creditors are allowed access to them—although she apparently recommends that these remedies against the secured creditors be cumulative, rather than exclusive, of remedies against shareholders. See Heidt, Cleaning Up Your Act, *supra* note 8, at 839-41.

¹⁰ LoPucki, *supra* note 1, at 1916.

incentives for actors to minimize the cost of accidents.¹¹ Imposing liability upon a tortfeasor can be viewed as efficient if the tortfeasor, rather than the tort victim, is the best cost avoider—the party best able to determine and implement the efficient level of care¹² and the efficient level of activity.¹³ An insolvent tortfeasor cannot be the *best* cost avoider, however. To the extent that a tort judgment exceeds the value of the tortfeasor's assets, liability does not create an incentive to avoid the accident by incurring preventive measures.¹⁴ The question then becomes which party, among various third parties, is the *second-best* cost avoider.

By proposing to subordinate secured debt to involuntary debt, LoPucki must believe that secured lenders are the second-best avoiders of their debtors' accident costs. In contending that revolutionary change of Article 9 is justified because alternatives—subordination of involuntary debt to secured debt¹⁵ and mandatory universal insurance¹⁶—are or would be ineffective, LoPucki impliedly asserts that secured lenders are better cost avoiders than their debtors, the debtor's victims, and the debtor's insurers. LoPucki does not examine other important second-best cost

¹¹ See, e.g., Guido Calabresi, *The Costs of Accidents: A Legal and Economic Analysis* 26 (1970) ("I take it as axiomatic that the principal function of accident law is to reduce the sum of the costs of accidents and the costs of avoiding accidents."). It is important to be precise about the *costs* sought to be avoided. In the case of tort and environmental liabilities, one such cost is the cost of accidents. Moreover, Calabresi distinguishes between primary, secondary, and tertiary accident costs. See *id.* at 26-28 (defining "primary" accident costs as those related to the "reduction of the number and severity of accidents," "secondary" accident costs as those concerned with "reducing the societal costs resulting from accidents," and "tertiary" accident costs as involving "the costs of administering our treatment of accidents"). Another cost is the risk that the tortfeasor will be judgment proof—insolvency costs. In the case of pension liabilities, there are no accident costs—only insolvency costs—because there is no accident to avoid other than the insolvency, or underfunding, of the defined-benefit pension plan.

¹² See *id.* at 135 ("A pure market approach to primary accident cost avoidance would require allocation of accident costs to those acts or activities (or combinations of them) which could avoid the accident costs most cheaply.").

¹³ See Steven Shavell, *Strict Liability Versus Negligence*, 9 *J. Legal Stud.* 1, 2-3 (1980).

¹⁴ Shavell, *Judgment Proof*, *supra* note 8, at 45. However, Shavell posits that the "judgment proof problem" he identifies "is less pronounced under the negligence rule than under strict liability" because "taking proper care allows injurers to escape liability entirely under the negligence rule, whereas it merely lowers the likelihood of liability under strict liability." *Id.*

¹⁵ LoPucki, *supra* note 1, at 1903-06.

¹⁶ *Id.* at 1906-07. LoPucki does not articulate whether this universal scheme would mandate first-party or liability insurance, but his criticisms apply to either sort of system.

avoiders, however. He seems to view lenders as better cost avoiders than their debtors' shareholders but does not delve very deeply into this question, because he "see[s] no reason to choose between the two reforms."¹⁷ He also does not consider whether there are circumstances in which the government would be a better cost avoider than a secured lender.

Identification of the second-best cost avoider is not only necessary, but also messier than LoPucki admits. My provisional thoughts on the topic are that this choice depends on four factors: (1) the nature of the involuntary claim, (2) the nature of the debtor, (3) the nature of the second-best actor and the cost avoidance mechanisms available to that actor, and (4) the retroactivity of the enhanced liability imposed against the second-best actor.

1. The Nature of the Involuntary Claim

Although LoPucki often limits his analysis to tort creditors, the logic of his argument applies to all involuntary creditors. The breadth of his reformulation of the unsecured creditor's bargain is, in part, its strength—when he questions the efficiency of Article 9's subordination of involuntary claims to secured claims, he raises a sweeping challenge to the Law and Economics model of secured transactions.

The breadth of this challenge is also its weakness, however, because the validity of his analysis, and particularly the reform he proposes, varies substantially depending upon the type of involuntary claim to which it is applied. LoPucki focuses on tort claims, but by innuendo and the occasional footnote raises the possibility that his reform should be applied to environmental and pension claims as well.¹⁸ The notion that secured lenders are the second-best cost avoiders of environmental costs and pension costs is distinct from the argument that these lenders should be relied upon to minimize the costs of other accidents. The single largest distinction among tort, environmental, and pension claims that leaps to mind is that environmental and pension claims, unlike tort claims, arise

¹⁷ *Id.* at 1915.

¹⁸ See, e.g., *id.* at 1896-97 & n.41.

in the context of highly detailed regulatory schemes.¹⁹ Adding this regulatory dimension to the analysis raises the possibility of the government as a second-best cost avoider. Then the question arises whether the secured creditors of either a “dumper” of toxic waste or the sponsor of a single-employer defined-benefits pension plan are better cost avoiders than the government. LoPucki does not address this question.²⁰

2. *The Nature of the Debtor*

The tortfeasors LoPucki has in mind must be corporate. When noncorporate tortfeasors are instead considered,²¹ it is unclear that the tortfeasor has an incentive to “reduce [its] real exposure to tort

¹⁹ This distinction may follow from happenstance rather than deliberation. Several influential scholars argue that, in certain circumstances, regulation may be a better means of allocating the risk of *tortious* injury as well. See, e.g., Shavell, *Liability vs. Regulation*, supra note 8, at 365 (concluding “not only that neither tort liability nor regulation [sh]ould uniformly dominate the other as a solution to the problem of controlling risks, but also that they should not be viewed as mutually exclusive solutions to it”).

²⁰ Other commentators have. In a series of articles, Kathryn Heidt contends that lenders and shareholders are both better cost avoiders than the government because, unlike shareholders and lenders, the government does not have access to market mechanisms as a means of creating incentives for “dumpers.” See Heidt, *Cleaning Up Your Act*, supra note 8, at 839-41 (arguing that “dumper’s” secured creditors make better environmental cost avoiders than the government); Heidt, *Shareholder Liability*, supra note 8, at 172-73 & n.280 (arguing that shareholders of “dumpers” are better cost avoiders than the government).

By contrast, Howell Jackson, who views a corporate sponsor as a better avoider of its pension plan’s insolvency costs than creditors and other third parties, contends that the best cost avoider of pension liability is clearly the government. See Jackson, supra note 8, at 613. He argues that a rule of law that renders plan sponsors liable for pension claims, or that subordinates claims of the sponsor’s lenders to pension claims, creates incentives for the sponsor to internalize insolvency costs, see *id.* at 612-13, but that these incentives can be accomplished more directly through regulation—simply requiring that pension plans be fully funded as a condition of their receipt of tax and other benefits, see *id.* at 613.

At times, enhanced obligations may also have a role to play as a second-best or interim regulatory strategy. Private pension plans, for example, invest the bulk of their assets in marketable securities, and traditional capital requirements—in the form of strict full-funding rules—would be a simple and efficient way to ensure the solvency of private pension plans. Nevertheless, the transitional costs and political consequences of imposing a full-funding requirement may make it difficult for regulatory authorities to impose full funding obligation in the near term. *Id.* (footnotes omitted).

²¹ Even when corporate tortfeasors are considered, however, there are substantial disincentives for overleveraging. Not all corporate debtors are risk neutral, and where financial markets are imperfect, the choice between debt and equity will matter to a risk-averse debtor, even a corporate one. Moreover, reputational concerns may provide

liability”²² by granting security interests covering all of its property and by rendering itself insolvent.²³ Once it is clear that LoPucki is referring primarily to corporate tortfeasors, it is also clear that his proposed reform—subordination of secured to involuntary debt—will be ineffective unless combined with a healthy disrespect for corporate form. This is because the subordination of voluntary to involuntary debt does not affect a debtor’s incentive to incur an all-secured-debt capital structure. A debtor’s incentive to render itself insolvent is inhibited if the debtor’s decisionmakers are required to bear the costs of this decision. Because the corporate doctrine of limited liability insulates even managerial shareholders from insolvency costs, only abolition or restriction of this doctrine would affect a corporate tortfeasor’s incentive to issue secured debt to reduce its real exposure to tort liability.²⁴

Agreeing that his proposal to subordinate secured to involuntary claims is an incomplete solution to the externalization of tort risk, LoPucki concludes that tort priority, in combination with shareholders’ unlimited liability for tort claims, “would seem best to serve the goal.”²⁵ The question therefore becomes whether the secured creditors of a corporate debtor are better cost avoiders than its shareholders. LoPucki only briefly considers this issue and

effective disincentives to corporate tortfeasors if the corporations are subject to various disclosure regulations, or when the geographic or industry community is close-knit.

²² LoPucki, *supra* note 1, at 1899.

²³ A partnership would have little interest in expropriating assets for the benefit of secured creditors, for example, because partners remain liable for the partnership’s tort liability that exceeds partnership assets. Individuals have more incentive to employ an all-secured-debt capital structure to defeat tort claims than partnerships, because they are entitled to a discharge from most tort claims in bankruptcy; however, bankruptcy may be its own disincentive—more costly to the individual than payment of the tort claim. Moreover, reputational concerns are likely to act as a complete disincentive against an individual rendering herself insolvent to “reduce [her] real exposure to tort liability.” *Id.*

²⁴ Even abolition of the corporate doctrine of limited liability would only affect, and not ameliorate, the corporation’s incentive to render itself insolvent because individual shareholders can obtain a discharge of their unlimited liability for the corporation’s tort claims by filing a bankruptcy petition. See 11 U.S.C. § 727 (1988).

²⁵ LoPucki, *supra* note 1, at 1915. LoPucki states:

Unlimited liability is an incomplete solution; it would leave the involuntary creditor without remedy in the common cases where all shareholders are judgment proof or the debtor is unincorporated. Involuntary creditor priority is an incomplete solution as well; it would leave the involuntary creditor without remedy in the case where tort damages exceed the value of an incorporated debtor’s assets.

Id.

concludes that he need not resolve it.²⁶ I disagree that analysis of the second-best cost avoider is unnecessary. If enhanced shareholder liability creates both disincentives for a tortfeasor to render itself insolvent and incentives for preventing accidents, why should we also subordinate secured claims to involuntary claims? Even if the injurer, its shareholders, and its secured creditors should share responsibility for the injurer's involuntary liabilities, there also

²⁶ See *id.* Other commentators have explored the issue in greater detail. In the tort context, Hansmann and Kraakman considered and rejected a rule that subordinated contract creditors to tort creditors, reasoning that shareholders were in a better position than contract creditors to internalize the full expense of tort recovery:

The firm's numerous small creditors will usually be ill-equipped to evaluate tort risks: although contract creditors, when deciding on the terms of credit they will offer a firm, can judge fairly easily the amount of a firm's assets net of other prior contract claims, they might have great difficulty evaluating likely tort claims. Similarly, contract creditors will generally have difficulty influencing management's policies, and they are unlikely to be better insurers than the firm's shareholders who, in large firms at least, can diversify their holdings.

Hansmann & Kraakman, *supra* note 8, at 1902 n.66.

Hansmann and Kraakman's proposal to abolish the rule of corporate limited liability has engendered its own criticism. See, e.g., Janet C. Alexander, *Unlimited Shareholder Liability Through a Procedural Lens*, 106 *Harv. L. Rev.* 387 (1992); Joseph A. Grundfest, *The Limited Future of Unlimited Liability: A Capital Markets Perspective*, 102 *Yale L.J.* 387 (1992). These criticisms are also apt as applied to the proposal to accomplish drastic reform of Article 9. Unless repeal of Article 9 is uniform among the fifty states, conflicts of law and jurisdictional issues would create procedural nightmares. See Alexander, *supra*, at 393-418. Even if uniform repeal were accomplished, evasion of the repeal through contractual agreements that create the practical equivalent to a security interest would be commonplace and difficult to prevent. See Grundfest, *supra*, at 392-410. If Article 9 were repealed, creditors seeking "security" would instead require the debtor to transfer the "collateral" to a special purpose finance subsidiary, see LoPucki, *supra* note 1, at 1914 & n.106, or exact a negative pledge agreement from the debtor, see *id.* at 1926-28, or "lease" or "purchase" the same assets, see James J. White, *Efficiency Justifications for Personal Property Security*, 37 *Vand. L. Rev.* 473, 505-08 (1984).

In the context of pension claims, Howell Jackson contends that corporate sponsors should be held responsible for the insolvency costs of their underfunded single-employer defined-benefit pension plans, viewing a sponsor as the practical equivalent of a holding company (and thus a shareholder) of the plan. See Jackson, *supra* note 8, at 540-58, 613. Jackson compares enhanced obligations of pension sponsors and other financial holding companies to alternative means of minimizing insolvency costs, including subordination of secured debt to pension debt. *Id.* at 598-600. Significantly, he concludes that enhanced liabilities are preferable to other third-party penalties because they are more likely to be correctly calibrated. *Id.* at 599 ("By forcing losses from institutional failures back onto the holding company, enhanced obligations ensure that the holding company, which by virtue of its relationship bears minimal informational costs with respect to the activities and prospects of its subsidiaries, will factor the possibility of such liability into its decisionmaking processes.").

should be a system for allocating this liability among the various defendants. One obvious allocation is to assign liability first to the injurer, next to the second-best cost avoider, and so on. This priority scheme of cumulative liability requires a determination of the second-best cost avoider. Alternatively, a combination of reforms might develop contractually although liability is imposed against a single cost avoider. For example, LoPucki notes that “[i]n a tort-first world, those secured creditors could be counted on to expand those guarantees [from the owners of corporate borrowers] to include the secured creditor’s losses from tort priority. The effect would be to expand the beneficiaries of consensual unlimited corporate liability to include the tort creditors.”²⁷ But in deciding that one reform (subordination of secured claims to involuntary claims) should be imposed, where another (restriction of the corporate doctrine of limited liability) can be left to develop on a case-by-case contractual basis, LoPucki is also implicitly asserting that secured creditors are better cost avoiders than their debtor’s shareholders.

3. *The Nature of the Second-Best Actor*

In choosing from an array of second-best actors—either the government or a shareholder, lender, officer, director, successor, insurer, or professional of the tortfeasor—we should be precise about *how* second-best actors could avoid accident and insolvency costs, for there are direct and indirect means of cost avoidance. Although a growing area of academic discussion,²⁸ the ability of second-best actors to minimize costs has not been explicated clearly.

Second-best actors are unable themselves to prevent an accident from occurring. They can influence the injurer to take appropriate preventive measures,²⁹ however, because they can exert control over the injurer in several ways. First, the second-best actor may be able to influence the injurer to take cost-justified precautions because the second-best actor is in a position both to control or otherwise influence the injurer’s operational and financial deci-

²⁷ LoPucki, *supra* note 1, at 1915-16.

²⁸ See *supra* note 8.

²⁹ The preventive measures referred to here may involve efforts to make the activity less risky or efforts to determine the optimal level of an inherently risky activity.

sions, and to monitor for compliance.³⁰ Second, that actor may simply create incentives for the injurer to prevent the accident. For example, a lender or successor to the tortfeasor may obtain covenants in lending or purchasing agreements that require the tortfeasor to take specified operational or financial action as a condition of the loan or sale, and then monitor for compliance. As another example, second-best actors may attempt to influence the tortfeasor to avoid accident or insolvency costs through market mechanisms such as the purchase price (in the case of shareholders or successors of the tortfeasor)³¹ or the interest rate (in the case of lenders).³² Market mechanisms may be an imperfect means of con-

³⁰ See Jackson, *supra* note 8, at 513. Jackson states:

Not only are financial holding companies apt to be more proficient than government officials in evaluating institutional behavior, but holding companies also can monitor risks at a lower cost than government agencies, because holding companies already have substantial information about their regulated subsidiaries as a result of ordinary managerial activities.

Id.; see also Heidt, *Shareholder Liability*, *supra* note 8, at 173 n.280 (“[I]f the costs [of environmental accidents] are placed upon the shareholders, there is an incentive created for shareholders to avoid this improper disposal and place the cost of avoidance on the corporation itself—exactly where it should be placed in order to internalize costs.”); Painter, *supra* note 8, at 1076 (“[I]f a firm’s voluntary creditors are threatened by tort claims, they will have an incentive to monitor the manufacturer’s potentially tortious behavior . . .”).

³¹ See Green, *supra* note 8, at 906-07. Green states:

The strongest argument for requiring the successor to assume responsibility was that the successor could serve as a conduit to transfer the liability to the predecessor at the time of the asset purchase. Thus, the successor, knowing that it would assume the predecessor’s liability to future claimants, would discount the price paid to the predecessor by the estimated amount of the liability assumed.

Id.; see also Hansmann & Kraakman, *supra* note 8, at 1907 (“If shareholders faced full liability for potential tort losses, share prices would incorporate available information about the full extent of these possible losses.”).

³² See Heidt, *Cleaning Up Your Act*, *supra* note 8, at 839-40. Heidt states:

If the state were accorded priority for cleanup costs over all other creditors, including the secured creditors of a toxic waste dumper, creditors would adjust their interest rates to reflect the increased risk of losing their collateral. . . . In a model market the increase in the cost of credit will be included in the producers’ price and ultimately paid by the consumers. The effect is that a portion of the cost of cleanup will be internalized through the pricing of credit.

Id. (footnotes omitted); see also Painter, *supra* note 8, at 1079 (“[In a world in which tort claimants were equal in seniority to secured creditors,] secured creditors . . . would have to raise their interest rates and engage in increased monitoring because of the increased risks of nonpayment they face when more parties are ‘in line’ before them.”).

trolling the injurer's actions,³³ but may require less monitoring by the second-best actor.³⁴

Any comparison of the government to other second-best actors must also recognize that the government faces limited means for influencing a tortfeasor's level of care and level of activity: it can regulate, it can tax, or it can condition the conferral of some benefit upon the tortfeasor's satisfaction of some standard. But the government generally does not use market mechanisms of price or interest rate as a means of creating incentives for tortfeasors to internalize the costs of their accidents.³⁵

Alternatively, second-best actors, of whatever sort, can indirectly minimize accident and insolvency costs either by requiring the tortfeasor to obtain more complete insurance coverage³⁶ or by "self-insuring" for these costs by spreading the risk of their occurrence.³⁷ Risk spreading may occur through the market mecha-

³³ To some extent, the effectiveness of market mechanisms—whether employed by shareholders, lenders, or other second-best actors—will depend upon the nature of the accident and the tortfeasor. For example, second-best actors may effectively implement market mechanisms as applied against entire risky industries—in a tort-first world, shares of stock in a dynamite producer should be cheaper than shares of stock in producers of cotton balls (and the cost of credit and insurance higher for dynamite manufacturers than cotton ball manufacturers). Market mechanisms will be much less accurately applied to corporations that manufacture both dynamite and cotton balls simultaneously, however. Theoretically, it would be possible for second-best actors to distinguish between corporation A and corporation B, both of which manufacture dynamite and cotton balls, based on their level of production and precautionary expenditures, and for this information to be reflected in the markets for capital, credit, and insurance in which A and B compete. In practice, these markets—especially the market for credit—may be incapable of incorporating these complex differentiations.

³⁴ Monitoring would still occur, but of a different sort. Contractual provisions would need to be monitored for compliance and enforcement. Price terms need not be enforced for continuing accuracy, except as to prospective purchases or extensions of credit.

³⁵ See, e.g., Heidt, *Shareholder Liability*, *supra* note 8, at 172-73 & n.280. Environmental law is, of course, the exception to this general rule. See generally Symposium, *Free Market Environmentalism: The Role of the Market in Environmental Protection*, 15 *Harv. J.L. & Pub. Pol'y* 297 (1992) (discussing the use of market mechanisms to internalize the costs of environmental problems).

³⁶ See Painter, *supra* note 8, at 1076 ("[I]f a firm's voluntary creditors are threatened by tort claims, they will have an incentive to monitor the manufacturer's potentially tortious behavior and to force the manufacturer to purchase adequate insurance.").

³⁷ See Thompson, *supra* note 8, at 3-4. Thompson states:

Tort law seeks to create incentives for an enterprise to control risks and to spread costs to more efficient risk-bearers. Liability aimed at managers suggests that the incentive to control corporate actions is the principal focus of extending liability, since corporate managers control an enterprise but may not be efficient risk-bearers.

nisms of price and interest rates—by shifting the accident risk faced by individual victims, initially, to the injurers' markets for capital and debt in the form of a discounted price for equity or increased cost of credit, and, eventually, to the injurers' customers in the form of increases in the cost of the goods sold or services rendered by the injurer.³⁸ Finally, the harsh effects of accident costs can be minimized by shifting the risk of accidents from victims, who are unlikely to be able to bear the expense, to second-best actors, who are likely to be wealthy enough to absorb the loss.³⁹ These indirect mechanisms may work independently of any effort to create incentives for the tortfeasor to prevent the occurrence of an accident; they also work to minimize secondary accident costs by ensuring compensation for victims' loss.

LoPucki briefly compares secured lenders and shareholders as cost avoiders but ends up concluding that neither unlimited liability nor tort priority offers a complete solution to the problem because, in both instances, uncompensated victims would remain.⁴⁰ In making this point, LoPucki appears both to focus on lenders' and shareholders' comparative abilities to compensate victims and to ignore their comparative abilities to influence tortfeasors to prevent accidents. Both qualities, however, are important to the choice of a second-best cost avoider. Moreover, in comparing the deep pockets of secured lenders and shareholders, LoPucki neglects to consider the deep pockets of the tortfeasor—he forgets that the injurer's assets would also be available for distribution to victims. If the corporate doctrine of limited liability were abol-

Liability directed toward shareholders, particularly in publicly held corporations in which investors are numerous and dispersed, suggests an emphasis on distributive concerns such as the ability to bear risk.

Id. (footnotes omitted); see also Hansmann & Kraakman, *supra* note 8, at 1916 (“[S]hareholder liability should be seen as a standard problem of tort law. Viewed this way, the right question is simply: When are a corporation’s shareholders cheaper cost avoiders and/or cheaper insurers than the persons who may be injured by the corporation’s activities?”).

³⁸ The decreased price and increased interest rates charged by self-insuring second-best actors are therefore analogous to premiums charged by insurers.

³⁹ See, e.g., Green, *supra* note 8, at 916-17. Green argues that “unless one is willing to advocate imposing obligations on a random entity simply because it is wealthier or better able to absorb a loss, the justifications for imposing liabilities on successors *qua* successors are quite empty.” *Id.* at 917.

⁴⁰ See LoPucki, *supra* note 1, at 1915.

ished or restricted, then an injurer's incentive to render itself insolvent would diminish.⁴¹ In such a world, the choice between secured creditors and shareholders no longer would turn on whether one is better able than the other to compensate victims. The important issue would become whether secured lenders are better than shareholders in controlling and monitoring their debtor's risky behavior.

In making these comparisons, we should recognize that these actors come in a variety of shapes and sizes and that these distinctions relate to their abilities to control and monitor, as well as their abilities to spread risk and wealth.⁴² Equity that is publicly held and widely dispersed among small holders ("mom and pop" shareholders) is unable to control and monitor its publicly traded corporate tortfeasor because it has no role in managing it. Yet it may be able to create incentives for the tortfeasor to internalize the cost of accidents through a market mechanism—the price paid for shares of stock. Moreover, publicly held equity is capable of spreading the risk of these accident costs through the market.⁴³ For the identical reasons that apply to public equityholders, lenders may be equally effective second-best cost avoiders—not because they enjoy the power to manage the corporate tortfeasor, but because, through contractual or market mechanisms, they can create incentives for their debtor to internalize the risk of tort liability and to spread the risk of accident costs.⁴⁴ By contrast, equity that is pri-

⁴¹ Moreover, as discussed in the text accompanying notes 21-24, subordination of secured claims to involuntary claims does not affect a tortfeasor's incentive to render itself insolvent.

⁴² See Thompson, *supra* note 8, at 5 (disputing the efficiency of Hansmann and Kraakman's proposal to abolish corporate doctrine of limited liability as applied to shareholders of publicly held corporate tortfeasor, because "[n]either ability to control nor distributive concerns of tort law supports liability for passive shareholders").

⁴³ Whether equity of a publicly traded corporate tortfeasor that is held in large blocks by institutions would be able to control or monitor effectively seems an open question. Clearly, even institutionally held public equity does not generally manage its corporation. On the other hand, institutional equityholders may have sufficient leverage with their corporations to make them effective second-best cost avoiders, much in the same way that secured lenders, who have no direct responsibility for management but enjoy substantial leverage with their borrower, might be effective second-best cost avoiders.

⁴⁴ In theory, this rationale would seem to apply equally to secured and unsecured lenders. In practice, secured lenders appear to have better access to information than do unsecured creditors. In addition, secured creditors seem better able to control debtor conduct through contractual mechanisms than can unsecured lenders only because

vately held by individuals, or wholly owned by a corporate parent, is likely to be held by persons able to control and monitor their privately held corporate tortfeasor by virtue of their power to manage. These managerial equityholders may or may not be adequate risk spreaders: individual owners of privately held corporations are unlikely on their own to be able to spread risk; holding corporations, on the other hand, are likely to be excellent channels for risk spreading. LoPucki only touches on these distinctions among various equity- and debt-holders⁴⁵ when he concludes that both judgment-proof individual shareholders and undersecured lenders would make ineffective second-best cost avoiders.⁴⁶

Finally, in choosing a second-best cost avoider, we should recognize that, despite the numerous distinctions between them, second-best actors are extraordinarily similar—they all attempt to cause the tortfeasor to minimize the costs of accidents in roughly the same way as does an insurer. Insurance seeks to create incentives for accident avoidance through the market mechanism of premiums and to minimize the costs of accidents by spreading their risk among the entire market for insurance. Other second-best actors attempt to create incentives for accident avoidance through the analogous market mechanisms of price and interest rate, as well as to minimize these costs by spreading their risk through the market for capital and the market for credit. Thus, another issue to consider in reflecting on the effectiveness of LoPucki's proposal to subordinate secured debt to involuntary debt is whether secured lenders are better cost avoiders than are insurers.

LoPucki does address the comparative abilities of secured lenders and insurers as cost avoiders when he rejects mandatory universal insurance as an effective means of accomplishing the internalization of tort risk.⁴⁷ He rejects mandatory universal insur-

unsecured credit is more often extended informally (without elaborate documentation) than secured credit.

⁴⁵ Other commentators have analyzed these distinctions in greater depth. See Jackson, *supra* note 8, at 612 (justifying imposition of enhanced liabilities against financial holding companies, including corporate sponsors of single-employer defined-benefit pension plans); Thompson, *supra* note 8, at 39-40 (concluding that the corporate doctrine of limited liability should persist for passive shareholders but should be abolished as applied to corporate parents of tortfeasors).

⁴⁶ See LoPucki, *supra* note 1, at 1915.

⁴⁷ See *id.* at 1906-07.

ance largely because he does not believe that the incentive for reactive risk created by the existence of liability insurance (sometimes referred to as a “moral hazard” problem⁴⁸) can be resolved.⁴⁹ But this argument seems inconsistent with his claim that the subordination of secured debt to tort debt can be justified on efficiency grounds. Both insurers and secured lenders are second-best actors who, by controlling and monitoring the debtor, create incentives for the internalization of accident costs. When insurance creates incentives for reactive risk, so too does the subordination of secured to tort debt. And insurance creates moral hazard problems when it is difficult or impossible for the insurer to control and monitor the tortfeasor’s preventive expenditures. But if an insurer encounters difficulties in controlling and monitoring the behavior of its insured, then shareholders, lenders, and other second-best actors are likely to encounter similar problems. For if insurers are unable to “link premiums or the conditions under which they will honor claims to injurers’ precautions,”⁵⁰ surely shareholders and secured creditors are also unable to link the cost of credit or the conditions under which they will extend credit to debtors’ precautions. After all, insurers have more experience in combating a moral hazard problem than do others.

4. *The Effect of Time*

Another issue that LoPucki does not address is the retroactivity of his proposed reform. Temporal considerations, however, are important to the choice among various second-best cost avoiders.⁵¹

⁴⁸ For a discussion of the “moral hazard” problem, see Leah Wortham, *The Economics of Classification: The Sound of One Invisible Hand Clapping*, 47 *Ohio St. L.J.* 835, 844-45 & n.56 (1986).

⁴⁹ See LoPucki, *supra* note 1, at 1915-16.

⁵⁰ Shavell, *Judgment Proof*, *supra* note 8, at 46.

⁵¹ See Green, *supra* note 8, at 917, 922. Green argues that “liberal successor liability (or indeed any form of successor liability) [cannot] encourage better environmental disposal practices, as the great bulk of the hazardous substance disposal activity governed by CERCLA has already occurred.” See *id.* at 917 (footnotes omitted). As a result, [l]iberal successor liability can only serve as a conduit if the successor anticipates that it will be held liable for obligations of the predecessor, enabling the successor to discount the price it pays for the predecessor’s assets. Thus, liberal successor liability can only operate fairly if it is imposed prospectively—only those successors who purchase assets with fair warning of such a rule should be held liable.

Id. at 922.

In a tort-first world, if litigation is pending between the tortfeasor and victim, or if a judgment has been rendered in favor of a tort victim at the time the tortfeasor seeks to issue publicly traded equity or to borrow from a lender, then the shareholder or lender can discover the existence of the litigation or the judgment by searching public records. It can then condition its purchase or financing upon settlement of the claim or payment of the judgment, or discount the purchase price or interest rate accordingly. If, in this world of subordinated secured claims or unlimited liability, the equityholder or lender searches the public records and finds nothing, contractual or market mechanisms would still be useful to create incentives for the debtor to take cost-justified preventive measures.

Substantial uncertainty would still exist in this tort-first world, however. Even if the shareholder or lender obtained contractual or market concessions from its debtor, it would still face a significant risk of subordination to unknown tort claims—subordination relating to actions of the debtor that occurred before the inception of the lending relationship but that do not manifest injury to putative tort victims until after the sale or loan is made. Shareholders and secured creditors would have no way to influence the debtor's actions as relates to these “long-tail” claims; thus, the efficiency of the elevation of these tort claims must be justified primarily on risk-spreading and other distributional grounds rather than on the grounds that elevation creates incentives for the avoidance of the accident.⁵² Even where risk spreading is conceded to be the primary efficiency goal, second-best actors may be unaware of the need to discount their purchase price or to increase the cost of credit to account for tortious conduct that occurred prior to the transaction, especially where victims have not yet manifested injury

⁵² See *id.* at 917 (making a similar argument in contending that successors are unlikely second-best cost avoiders in the environmental context). Heidt concedes that retroactive application of a rule subordinating secured debt to environmental clean-up costs would only approximate allocative efficiency because “current and future consumers [would] bear the [increased] cost [of credit], not the past consumers who actually benefited from the incorrect lower price.” Heidt, *Cleaning Up Your Act*, *supra* note 8, at 850. I agree with Green that any approximation of allocative efficiency would be coincidental. See Green, *supra* note 8, at 917.

in any way.⁵³ Nor are these concerns improved by influencing the tortfeasor to obtain more complete insurance coverage—if neither the shareholder nor the lender can calculate the extent of the potential liability, then both can only guess about proper coverage. In addition, as uncertainties about potential liability increase, insurers may be less likely to offer any coverage at all.⁵⁴ As to long-tail liability,⁵⁵ shareholders may be slightly better cost avoiders than secured creditors—shareholders, as a group, exist from the inception of the corporate debtor until its dissolution; lenders only acquire a relationship with the debtor at the inception of the financing transaction.⁵⁶ Moreover, the government may be a better cost avoider of long-tail harms than either shareholders or secured lenders are, because it can spread the risk of this sort of harm among all taxpayers.

B. Side Effects of the Subordination of Secured Debt

The Kaldor-Hicks efficiency of a shift from the current rule to one in which secured debt is subordinated to involuntary debt depends upon whether the gains from the shift exceed the losses—whether the increased numbers of involuntary creditors paid in full are completely offset by an increase in credit costs and a contraction of credit availability. I, like prior commentators,⁵⁷ view this comparison as an untestable empirical question.

⁵³ Moreover, depending upon the point in time at which lenders' secured claims would be subordinated to involuntary claims, secured parties might simply accelerate the loan and repossess the collateral as soon as the lender becomes aware of the potential tort liability but before any litigation is commenced or judgment entered.

⁵⁴ See Green, *supra* note 8, at 928-29 & n.158 (noting difficulties in obtaining environmental insurance).

⁵⁵ Temporal considerations are especially heightened in the context of environmental liability because the injury often does not manifest itself until years after the toxicity occurs.

⁵⁶ This temporal analysis does not seem to change perceptibly when applied to insolvency, rather than accident, costs. In a tort-first world, assessments of the debtor's solvency depend not only upon a valuation of the debtor's assets, but also upon a valuation of the debtor's liabilities, including putative tort claims.

⁵⁷ See Paul M. Shupak, *Solving the Puzzle of Secured Transactions*, 41 *Rutgers L. Rev.* 1067, 1117 (1989) ("The question raised by this line of analysis becomes entirely empirical. Data do not exist, nor are they likely to exist, which show that the beneficial effects of debt to tort claimants either outweigh or are outweighed by the detrimental effect that results from strategic behavior."); Painter, *supra* note 8, at 1082 (noting impossibility of testing contentions that "increased credit costs might be offset by decreased accident costs" and

LoPucki contends that the empirical issue can be resolved intuitively through the following simple inequality: $W \geq W + A - T$.⁵⁸ Noting that “[t]he right side of the inequality can be greater only if A is greater than T,” he deduces that “[f]or A to be greater than T for the economy as a whole, A must be greater than T for at least some person in the economy.”⁵⁹ He asserts that, absent an assumption of risk aversion, “[t]he existence of many such people seems unlikely. They would all be people who could have expanded their activity in the tort-first world, paid the tort liability with their added wealth, and had some left over.”⁶⁰ But his conclusion is dependent upon the assumptions that “transaction costs are small”⁶¹ and that secured lenders not only are risk neutral, but also possess sufficient information about accident and insolvency costs, as well as the ability to control and monitor the tortfeasor.⁶² These assumptions seem especially “false”⁶³ as applied both to liability

that “interest and insurance rates to firms making dangerous products might be prohibitive”).

Recognizing the empirical nature of the question, a student commentator nonetheless “suspects” that the gains would exceed the losses because “[e]quity security holders now invest in firms that make dangerous products.” *Id.* (“Since the proposal would put creditors in the same position that equity holders now occupy relative to tort claimants, creditors might well continue to invest, albeit at a higher rate of interest.”). Of course, equity holders may just as likely be ignorant of the firm’s risk of accidents and insolvency. The student commentator goes on, however, to note that, even if the losses resulting from the reform exceeded its gains, the reform could still be viewed as allocatively efficient because “a company that cannot internalize all the costs of its product and remain solvent should not continue to exist in the market. Government subsidies could be arranged to guarantee production of essential but unprofitable products.” *Id.* (footnote omitted). But this assumes that secured creditors can perfectly cause their borrowers to internalize the costs of involuntary claims—it assumes that secured creditors will not overshoot the mark and increase the cost of credit beyond what is necessary to create incentives to alleviate risk. LoPucki makes this same assumption.

⁵⁸ LoPucki, *supra* note 1, at 1911. LoPucki defines W as “the wealth created by economic activity that would occur in a world where tort debt comes first,” A as “the wealth created by activity that would not occur in a world where tort debt comes first but would occur in a world where secured debt comes first,” and T as “the tort loss that would not occur in a world where tort debt comes first but would occur in a world where secured debt comes first.” *Id.* at 1910-11.

⁵⁹ *Id.* at 1911.

⁶⁰ *Id.*

⁶¹ *Id.* at 1902 & n.64.

⁶² Assumptions of nearly perfect information and nearly perfect ability to control and monitor are implicit in this equation because, where perfection exists (namely, where $W = W + A - T$), A must equal T .

⁶³ See LoPucki, *supra* note 1, at 1893 & n.16.

that develops over long stretches of time, such as environmental liability, and to lenders who do not have the power to manage their debtor's operations.

Moreover, if risk-averse lenders would view a world in which secured claims are subordinated to involuntary claims as risky, LoPucki suggests that a market in "secured creditor insurance" would arise to "transform [the secured creditor's] tort risk into a fixed premium, which [the secured creditor] can require its debtor to pay in advance."⁶⁴ He compares this "secured creditor insurance" to mortgagee title insurance.⁶⁵ Another analogy may be to insurance coverage of a successor for the products liability of a predecessor.⁶⁶ Yet another may be to the "portfolio insurance" Hansmann and Kraakman propose in response to critics who claim that abolishing the rule of limited liability would harshly affect shareholders whose portfolios of equity holdings are insufficiently diverse.⁶⁷

The secured creditor insurance LoPucki proposes, however, is not likely to prevent his reform from being Kaldor-Hicks inefficient, because, despite his assertions to the contrary, it will not resolve moral hazard problems.⁶⁸ The example he provides and his

⁶⁴ *Id.* at 1912.

⁶⁵ *See id.*

⁶⁶ *See Green, supra note 8, at 928-29* (distinguishing successor products liability insurance from successor CERCLA liability insurance by arguing that "the uncertainties associated with CERCLA liability are so great that insurance coverage for it is severely limited" and that "insurance coverage of a successor for the products liability of a predecessor is generally available and has become common, partly at the insistence of creditors financing asset acquisitions") (footnote omitted); Michael D. Green, *Successor Liability: The Superiority of Statutory Reform To Protect Products Liability Claimants*, 72 *Cornell L. Rev.* 17, 55 n.157 (1986) (noting general availability of successor products liability insurance).

⁶⁷ *See Hansmann & Kraakman, supra note 8, at 1901.*

⁶⁸ LoPucki contends that "secured creditor insurance," in combination with a rule giving tort victims priority over secured debt, has "advantages over universal tort insurance as a solution to the tort priority problem." LoPucki, *supra note 1, at 1912.* Primarily, LoPucki views "secured creditor insurance" as preferable to mandatory universal insurance because "risk that is reactive when the debtor is the insured would not be reactive when the secured creditor is the insured." *Id.* LoPucki suggests two other advantages, which seem more like distinctions than advantages to me:

Second, secured creditor insurance would not have to be mandatory, because the tort victims would not have to depend on it for their recoveries; they could look to the collateral. Secured creditors could have the option to insure or assume the risk. Third, the insurance would be limited to the amount of the secured debt, so the

analogy to mortgagee title insurance disregard his earlier conclusion that debtors (at least corporate ones) face incentives to adopt an all-secured-debt capital structure.⁶⁹ His argument thus loses all force. He posits:

[C]onsider the risk that the debtor will intentionally infringe on the patent of a competitor. This risk is reactive in the sense that if the debtor has insurance that protects it against liability for the infringement, the debtor's incentives not to infringe are greatly reduced. If the policy merely insures the secured creditor against loss because of the debtor's infringement and subrogates the paying insurer to the secured creditor's rights against the debtor, the debtor's incentives not to infringe are hardly reduced at all. If the debtor infringes, the insurer will pay the secured creditor and then sue the debtor on the secured debt.⁷⁰

However, subrogation to the secured creditor's claim against the debtor will provide no disincentive to a debtor who has encumbered all its assets to the secured creditor, other contract creditors, and involuntary creditors. Secured creditor insurance suffers from the same moral hazard problems that beset mandatory universal insurance and any other means of insuring or self-insuring against accident costs incurred by corporate tortfeasors.⁷¹ Only abolition of the rule of limited liability, in conjunction with a rule prohibiting shareholders from obtaining a discharge from this corporate liability, would completely resolve this reactive risk.⁷²

Finally, secured creditor insurance is likely to be unavailable in precisely those circumstances in which liability insurance is unavailable for the lender's borrower: a market for secured creditor insurance may develop to mitigate the effects of subordination of secured claims to products liability claims, but insurers are unlikely to offer secured creditor insurance against the subordination of secured claims to environmental and other long-tail claims.⁷³ This is because, contrary to LoPucki's thought experi-

potential loss insured against would be both lower and more predictable than the debtor's entire potential tort liability.

Id. at 1912-13 (footnote omitted).

⁶⁹ See id. at 1898-99.

⁷⁰ Id. at 1912 n.99.

⁷¹ See supra notes 21-24, 47-50 and accompanying text.

⁷² See supra notes 21-24 and accompanying text.

⁷³ See supra notes 54-55 and accompanying text.

ment, transactions costs are not small. Where time is considered and long-tail involuntary claims included, secured creditors will face substantial uncertainty in a tort-first world. Because insurers face the same substantial uncertainties, it appears unlikely that a market for secured creditor insurance will develop to cover these sorts of claims.

II. UNINFORMED CREDITORS

LoPucki believes that “[a] grant of security exploits not only creditors who are forced into unsecured status but also creditors who accept unsecured status on the basis of an underestimation of the risk.”⁷⁴ Exploitation of voluntary creditors is said to occur when they are uninformed about: (1) the law of Article 9,⁷⁵ (2) the terms on which the secured creditor has lent funds to the debtor,⁷⁶ and (3) the secured creditor’s intentions to discontinue the lending

⁷⁴ LoPucki, *supra* note 1, at 1916.

⁷⁵ What emerges as LoPucki’s primary criticism of the law of Article 9, the only “law” affected by his proposed reform, is the “law” that “absent a specific provision of Article 9 to the contrary, any security agreement, no matter how bizarre, unreasonable, or unexpected, will bind unsecured creditors, whether they extend credit before or after the security agreement is made.” *Id.* at 1948.

Throughout the article, LoPucki takes potshots at numerous other provisions of Article 9, but does not end up proposing any particular reform to address these concerns. For example, LoPucki describes Article 9 as “notoriously deceptive” and provides three examples of its departures from “basic principles of justice”: (1) it “employs generally what is often referred to as a ‘pure race’ filing system,” *id.* at 1917, (2) it “ignores the common expectation that a seller can recover the property it sells if the buyer does not pay for it,” *id.* at 1917-18, and (3) it attempts “to abolish the equitable doctrines by which courts have traditionally protected unsecured creditors against the harshest effects of security,” *id.* at 1919. He also criticizes Article 9’s failure to require secured creditors to provide unsecured creditors with needed information, particularly with respect to execution sales, an omission he describes as “so obvious and egregious . . . that it cannot be ascribed to mere negligence on the part of the drafters.” *Id.* at 1944. Other provisions of Article 9 that LoPucki criticizes in the footnotes are those permitting a secured creditor to prevail as to advances made after later lenders. See *id.* at 1942 n.206 (criticizing U.C.C. § 9-312(5), (7)); *id.* at 1944 n.213 (criticizing § 9-504(4)); *id.* at 1945 n.216 (criticizing § 9-301(4)).

⁷⁶ The sorts of terms that LoPucki criticizes include the following: clauses providing that the loan amount is payable “on demand,” *id.* at 1939 n.194, 1950; “blocked account” and “lock box” financing arrangements, *id.* at 1938 n.191; clauses prohibiting a debtor from granting other liens, including purchase-money security interests, *id.* at 1942; and after-acquired property clauses permitting lenders to take a floating lien that covers all of the debtor’s property, *id.* at 1918 n.121. Presumably, he anticipates that implementation of his proposed reform would often result in juries’ refusal to enforce these sorts of clauses.

relationship. LoPucki concludes that the exploitation of uninformed voluntary creditors should be remedied by binding unsecured creditors to the terms of a security agreements “only if and to the extent that a reasonable person in the position of the unsecured creditor would have expected to be bound at the time that person extended credit,”⁷⁷ and by “moderniz[ing] the Article 9 filing system to serve the needs of all who are to be bound by the terms of the security agreement.”⁷⁸ Except briefly to quibble in the footnotes about what LoPucki refers to as his formulation of Bowers’ Law,⁷⁹ I generally do not question the accuracy or implications of LoPucki’s recasting of the unsecured creditor’s bargain. However, I have a great deal of trouble with the first of these two proposed reforms—specifically, the substitution of a jury’s

⁷⁷ *Id.* at 1947-48.

⁷⁸ *Id.* at 1948.

⁷⁹ See *id.* at 1931-33. The Law and Economics model of secured lending posits that unsecured lenders are not harmed by the presence (or possibility) of a perfected security interest because, cognizant that the security interest substantially increases the risk that the debtor’s assets will be insufficient to permit repayment of both secured and unsecured creditors, they charge a higher rate of interest than secured lenders do. See Thomas H. Jackson & Anthony T. Kronman, *Secured Financing and Priorities Among Creditors*, 88 *Yale L.J.* 1143, 1147-49 (1979). In order to demonstrate the efficiency of such a system, this model goes on to conclude that a net savings in the cost of credit results for two reasons: (1) secured creditors charge far lower rates of interest than unsecured creditors, and (2) the aggregate interest savings caused by secured transactions exceeds the aggregate increased interest costs caused by unsecured transactions. See F. Stephen Knippenberg, *Debtor Name Changes and Collateral Transfers Under 9-402(7): Drafting from the Outside-In*, 52 *Mo. L. Rev.* 57, 81-83 (1987).

LoPucki questions this conventional wisdom. He begins by contending that “security tends to expand to the liquidation value of the collateral as a debtor sinks into financial distress.” LoPucki, *supra* note 1, at 1933. He calls this LoPucki’s formulation of Bowers’ Law. *Id.* at 1931. He claims that his formulation justifies the conclusion that unsecured creditors can never be compensated for the risk they face, even by charging higher rates of interest. See *id.* at 1935 (“It should be apparent that no interest rate could compensate for the risk in a world in which unsecured creditors could look only to liquidation value but liquidation value was always fully encumbered.”).

If LoPucki is claiming that his formulation establishes that the probability of a debtor’s balance sheet insolvency is 100%—that unsecured creditors face the certainty of nonpayment and not merely an insolvency risk—then he confuses the aggregate with the individual. LoPucki’s formulation does not show that every debtor falls into financial distress, only that *if* “a debtor sinks into financial distress,” “security tends to expand to the liquidation value of the collateral.” See *id.* at 1933. But not *every* debtor “sinks into financial distress.” Nonetheless, *every* creditor lending on an unsecured basis is presumed either to charge a higher interest rate to reflect the increased insolvency risk created by the secured debt or to refuse to lend. See *id.* at 1935 n.181.

determination of a reasonable security agreement for the actual security agreement.

A. *LoPucki's Reformulation of the Unsecured Creditor's Bargain: Cash-Flow Surfing on a Coral Reef*

LoPucki proposes “an alternative conception of the unsecured creditor’s bargain that depends neither on a priority against liquidation value nor on the existence of a coercive collection right.”⁸⁰ To LoPucki, unsecured creditors lend “against a cash flow that the secured creditor can interrupt at its whim”⁸¹—that is, “they expect to be paid in the ordinary course of business *from the secured creditor’s collateral*, particularly the debtor’s usually fully encumbered bank account.”⁸² He therefore conceives of the unsecured creditor as one who “expects to be repaid as the result of a combination of nonlegal pressures on the debtor”⁸³ and who “monitors the debtor through credit reports and other sources of information and evaluates the risk that the business will be discontinued.”⁸⁴ Unsecured lending “is likely to be short term and restricted to amounts that are small in relation to the creditor’s portfolio.”⁸⁵

Interestingly, LoPucki does not explicitly describe this new paradigm as proof positive that unsecured creditors are an exploited lot, although he comes close. Instead, he states that an important implication⁸⁶ of the cash-flow surfing theory “is that the unsecured creditor is dependent on credit reporting.”⁸⁷ This leads him to conclude that the “seemingly neutral scheme of Article 9 discriminates

⁸⁰ LoPucki, *supra* note 1, at 1940-41.

⁸¹ *Id.* at 1939.

⁸² *Id.* at 1938.

⁸³ *Id.* at 1941.

⁸⁴ *Id.*

⁸⁵ *Id.*

⁸⁶ LoPucki finds that “[r]econceptualizing the unsecured creditors’ bargain as cash-flow surfing has several interesting implications.” *Id.* “First, it explains why even sophisticated creditors are willing to lend unsecured. They lend because they believe that the debtor has both the ability and the motivation to repay its short-term debt.” *Id.* LoPucki also suggests that cash-flow surfing “shows the futility of trying to reproduce the unsecured creditors’ state law entitlements in bankruptcy.” *Id.* at 1945. LoPucki’s point may be that unsecured creditors’ most important entitlements are procedural entitlements, but it could just as persuasively be argued that secured creditors’ (especially undersecured creditors’) most important entitlements are also their procedural ones.

⁸⁷ *Id.* at 1943.

against unsecured creditors” because the elaborate disclosure mandated by the U.C.C. serves the information needs of secured, but not unsecured, creditors.⁸⁸ He proposes that this filing system be modified to require disclosure of “the kinds of information needed by unsecured creditors”⁸⁹—for instance, “the amount of the earlier secured creditor’s line of credit and the amount currently drawn against the line.”⁹⁰ And, as noted above, I have no quarrel with his proposal to “modernize the Article 9 filing system to serve the needs of all who are to be bound by the terms of the security agreement.”⁹¹

It is his proposal to reformulate the unsecured creditor’s bargain as “an express or implied agreement *in fact*”⁹² that I find objectionable. By this, LoPucki intends to alter the Article 9 rule binding unsecured creditors to every term of the security agreement between the debtor and secured party. Instead, he intends to bind unsecured creditors to those terms that a jury concludes are what reasonable unsecured creditors would have expected to be included in the security agreement.⁹³

In this section of his article, LoPucki has identified an externality inherent to secured financing: the terms of the security agreement between a secured party and its debtor may harm the debtor’s unsecured creditors. Moreover, transaction costs may preclude voluntary resolution of this externality through bargaining.⁹⁴ LoPucki refers to one of these transaction costs when he notes that “under current law, unsecured creditors can be bound to security agreements the existence of which they cannot discover, even through reasonable diligence.”⁹⁵ A fairly standard argument made in the Law and Economics literature is to recommend the shift from a property rule to a liability rule when transaction costs

⁸⁸ *Id.* at 1944 & n.212.

⁸⁹ *Id.* at 1944.

⁹⁰ *Id.* at 1944 n.212.

⁹¹ *Id.* at 1948.

⁹² *Id.* Specifically, in this regard, he proposes “that a security agreement should bind an unsecured creditor only if and to the extent that a reasonable person in the position of the unsecured creditor would have expected to be bound at the time that person extended credit.” *Id.* at 1947-48.

⁹³ *Id.*

⁹⁴ See R.H. Coase, *The Problem of Social Cost*, 3 *J.L. & Econ.* 1 (1960).

⁹⁵ LoPucki, *supra* note 1, at 1948.

impede the voluntary resolution of externalities that flow from the entitlement.⁹⁶ Viewed from the perspective of this literature, LoPucki's suggestion that unsecured creditors be bound only to the terms of a security agreement that would have been "reasonable for them to have known or anticipated"⁹⁷ appears justified as a shift to a liability rule from a property rule as to which insurmountable transaction costs prevent the internalization of externalities. Although a drastic change to the law of secured transactions, this reform would be justified if it were the most effective means of internalizing the costs of cash-flow surfing, and if the benefits of internalization of this risk outweighed the detrimental effects that it might have upon the available credit pool. Once again, LoPucki has shown neither.

B. Property Rule vs. Liability Rule vs. Disclosure Rule

With his choice of liability rule, LoPucki neglects to consider alternative means of accomplishing the internalization of the costs of cash-flow surfing. First, LoPucki should explain in greater detail why an expansive disclosure rule is not a more effective reform measure than the jury standard he proposes, especially because he admits that his proposed liability rule "would give secured creditors the incentive to communicate unexpected terms that they wish to impose on unsecured creditors."⁹⁸ Why require a standard intended to create incentives for disclosure when the infrastructure for implementing mandatory disclosure already exists? Why not simply require secured creditors to disclose the terms of their security agreements, either publicly through the Article 9 filing system or privately upon request?

A substantial benefit of a disclosure rule is the certainty it provides secured creditors.⁹⁹ Compliance with these disclosure

⁹⁶ See, e.g., Guido Calabresi & A. Douglas Malamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 Harv. L. Rev. 1089 (1972).

⁹⁷ See LoPucki, *supra* note 1, at 1950.

⁹⁸ *Id.*

⁹⁹ The uncertainty inherent in LoPucki's proposal is embraced by him as a beneficial element of the standard. For example, he notes that in the regime he proposes, "important terms buried in a long security agreement might not be considered 'communicated' even if the security agreement was recorded in the public records. Terms not even discussed between the parties might be considered communicated if they were what both parties expected." *Id.* at 1950-51. He goes on to explain:

requirements would insulate the secured creditor from liability to creditors who underestimate the risk of their extension of unsecured credit. LoPucki contends that a disclosure rule is unnecessarily costly in some instances.¹⁰⁰ In many instances, however, the law accepts a degree of imprecision when it embraces a prophylactic rule rather than a factual standard—the imprecision of an objective standard often is overlooked as less problematic than both the uncertainty created *ex ante* and the judicial effort required *ex post* by a subjective standard. Where constitutional rights or personal liberty is involved, I could easily be persuaded that the costs of a prophylactic rule exceed its benefits. In the context of a commercial dispute concerning the allocation of insolvency costs, however, I view LoPucki's "reasonable expectations" standard as more harmful than helpful.

Disclosure of the terms of a security agreement, however, would be an ineffective means of regulating the externalities caused by that agreement if unsecured creditors were unable to obtain or effectively use the information. The effectiveness of a disclosure rule depends upon the workings of the markets for credit and credit information. An optimistic view of these markets posits that competent unsecured creditors gain access to the information and incompetent unsecured creditors freeride.¹⁰¹ LoPucki suggests that

The essential difference between this proposed rule and current law is that the proposed rule would make the expectations of parties an empirical fact to be proven at trial by the party who would rely on it. Current law proclaims and enforces what the parties are supposed to expect without regard to their actual expectations.

Id. at 1951 n.237. In other words, secured creditors would be uncertain about the binding effect of the terms of their security agreements until the reasonable expectations of unsecured creditors were established at a jury trial.

¹⁰⁰ See *id.* at 1951. LoPucki states:

In some situations, the amount in issue would be too small to justify the expense of communication between secured and unsecured creditors. In such situations, the lack of communication would not indicate that either side had acted unreasonably, and implied contract doctrine would be indeterminate. That is, the facts would not support the inference that either side had agreed to the other's terms, and the rule would provide no basis for decision.

Id.

¹⁰¹ Cf. Alan Schwartz, *Security Interests and Bankruptcy Priorities: A Review of Current Theories*, 10 *J. Legal Stud.* 1, 36 (1981). Schwartz argues:

Plausibly establishing the incompetence of contracting parties, such as . . . employees and consumers . . . , is hard to do. The incompetence of employees is especially problematic when, as often happens, the employees are organized in unions. Further, it is not enough to show that *some* of these parties are uninformed, because

this view of the credit market is unrealistic, for “[b]oth the decision to grant [unsecured] credit and the terms of credit ordinarily are private, making emulation difficult.”¹⁰² My current thinking is that neither position has it quite right.

Even if Article 9 required lenders to disclose to unsecured creditors the terms of their security agreements, substantial transaction costs would continue to exist. Negotiations between unsecured and secured creditors over these terms are impeded primarily because the terms appear in a contract to which the unsecured creditors are bound, but to which they are not a party. This problem of privity is exacerbated by collective action problems. The large number of unsecured creditors, and the likely divergence of their varied preferences for terms, also stand as substantial impediments to bargaining over terms *ex ante*. Negotiations can occur *ex post*,¹⁰³ but unsecured creditors have little leverage in seeking a waiver of a term. As LoPucki notes, pursuit of their state remedies may easily be thwarted by the secured lender.¹⁰⁴

On the other side of the argument, these transaction costs may not be insurmountable if spillover effects serve as a sufficient counterweight. For example, in a world that mandates the disclosure of security agreements, unsecured creditors with leverage (such as creditors who sell raw materials necessary to the debtor’s continued operations) could negotiate with their debtor’s secured party for the removal of objectionable terms from the agreement to the benefit of all unsecured creditors.¹⁰⁵ Alternatively, the debtor may,

markets can work well in the face of substantial numbers of uninformed persons. The informed employees and consumers in some cases may police the market sufficiently to ensure that wages and prices accurately reflect the existence of security.

Id. (footnote omitted).

¹⁰² LoPucki, *supra* note 1, at 1920.

¹⁰³ These negotiations could be either individual (between the secured party and individual unsecured creditors) or collective (between the secured party and all the unsecured creditors as a group). See Susan Block-Lieb, *Fishing in Muddy Waters: Clarifying the Common Pool Analogy as Applied to the Standard for Commencement of a Bankruptcy Case*, 42 *Am. U. L. Rev.* 337, 351-53 (1993) (describing unsecured creditors’ cooperative collection remedies as either individual or collective).

¹⁰⁴ See LoPucki, *supra* note 1, at 1939-40.

¹⁰⁵ Whether the harmful term will be removed from the agreement to the benefit of all unsecured creditors, or whether application of the term will be waived to the benefit of the competent creditor but not to any other creditor, depends upon the nature of the term and the nature of the negotiations. Some terms more closely resemble public goods, and thus

at times, represent unsecured creditors' interests in negotiations with the secured party to their benefit. The debtor cannot be counted on to represent unsecured creditors' interests in these negotiations as a matter of legal responsibility, however. At the time of these negotiations, the debtor will not stand as a fiduciary to its unsecured creditors.¹⁰⁶ The degree of convergence of the debtor's and unsecured creditor's interests changes with each different term. Some terms LoPucki derides as subsidies for secured creditors are terms that the debtor also has an interest in opposing—such as a term permitting the secured creditor to discontinue the lending relationship “on demand.” If the secured lender conditions the loan on the inclusion of this provision,¹⁰⁷ however, the debtor may, on balance, rationally conclude that it is better off borrowing the funds with the demand term in the agreement than not borrowing at all.¹⁰⁸ Other terms—such as a term prohibiting the debtor from granting another security interest, including a purchase money security interest (“PMSI”)—primarily disadvantage future lenders rather than the debtor, and the debtor might rationally disregard the cost such a term imposes on third parties in deciding to acquiesce in its inclusion in the agreement.¹⁰⁹ I can only guess whether the transaction costs are overridden by freer-

must be removed from the agreement altogether; others more closely resemble private goods, and thus can be waived to the exclusive benefit of the competent creditor.

¹⁰⁶ These fiduciary responsibilities arise, if at all, only after the debtor is rendered insolvent. Laura Lin, *Shift of Fiduciary Duty upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors*, 46 *Vand. L. Rev.* 1485, 1512 (1993) (“Several courts have held that once the corporation becomes insolvent, directors owe a fiduciary duty to creditors.”).

¹⁰⁷ Rather than condition the loan upon inclusion of the term, the secured creditor may rationally increase the cost of credit if the debtor does not acquiesce to the term, as the term serves to decrease the secured creditor's (and increase the unsecured creditors') risk of nonpayment.

¹⁰⁸ Because the rule of limited liability may create for corporate debtors an incentive to incur excessive amounts of debt, there can be no assurance that unsecured creditors would reach the same conclusion as their debtor.

¹⁰⁹ A negative pledge covenant may impose costs even upon the debtor, but these costs are indirect. Specifically, a perfectly informed debtor would note that the existence of a term in its security agreement prohibiting it from granting a PMSI in the future increases the cost of obtaining goods on credit in the future. See Jackson & Kronman, *supra* note 79, at 1164-78. Perfectly informed suppliers, if forced by this term to lend on an unsecured basis, would demand a higher rate of interest than if permitted by the agreement to lend on a secured basis. See *id.* at 1168-71.

ider effects in general, and I assume that the balance varies from agreement to agreement and from debtor to debtor.

As either an alternative or a cumulative liability rule, Article 9 could simply invalidate or regulate the most exploitive security terms. For example, LoPucki's critique of negative pledge clauses convinces me that a fruitful line of inquiry may be to consider whether Article 9 should invalidate anti-lien clauses in security agreements that prevent the creation of a PMSI,¹¹⁰ rather than leave this for juries to determine on a case-by-case basis.¹¹¹ Invalidation may be too harsh a reform for other terms identified by LoPucki as exploitive—such as clauses providing that the loan amount is payable “on demand,” “blocked account” and “lock box” financing arrangements, and after-acquired property clauses permitting lenders to take a “blanket lien” that covers all of the debtor's property—because these terms are either supported by valid commercial purposes or so ingrained to lending practices that invalidation would lead to an enormous contraction of credit availability. Regulation, rather than invalidation, of these sorts of clauses may be a more viable, and equally effective, reform. For example, demand obligations need not be outlawed to eradicate their potential for exploitation; instead, the U.C.C. could restrict a lender's ability to terminate a loan at will by implying that termination could occur only after reasonable notice, but permitting the

¹¹⁰ Anti-lien clauses that prohibit the creation of non-PMSIs may be efficient and, if so, should not be invalidated. LoPucki notes that many *unsecured* loan agreements contain anti-lien provisions (which in this context are called negative pledge covenants), and that the presence of an anti-lien clause in an unsecured loan agreement acts as the practical equivalent of a security interest. See LoPucki, *supra* note 1, at 1926. I do not understand him to argue that anti-lien clauses are exploitive when found in unsecured lending documents, however, and thus do not believe that they should be invalidated in this context.

¹¹¹ But see Robert E. Scott, *A Relational Theory of Secured Financing*, 86 *Colum. L. Rev.* 901, 970 (1986). Scott argues:

The leverage obtained by holding the debtor's assets hostage [by means of a blanket lien in combination with a negative pledge covenant] enables the creditor to influence the debtor's decisionmaking, particularly when the relationship is threatened by business reversals. Without a system of security, some projects of positive present value will not be pursued and others will be inadequately developed.

Id.; see also F.H. Buckley, *The Bankruptcy Priority Puzzle*, 72 *Va. L. Rev.* 1393, 1460-70 (1986) (criticizing mandatory restrictions on secured lending, specifically the superpriority rights granted to holders in due course and to PMSI holders).

parties (within limits) to specify the notice period in the security agreement.¹¹²

It may be folly to presume that a bright-line rule can be drafted to prohibit or regulate every circumstance in which uninformed unsecured creditors subsidize secured creditors. Perhaps the better reform is to adopt a more open-ended standard, analogous to the doctrine of unconscionability.¹¹³ Incorporation of this sort of open-ended standard to secured transactions would be more objectionable to the finance industry than invalidation or regulation of specific contractual terms. Because open ended, the standard would permit uncertainty to creep into the lending relationship and, as a result, might increase the cost of credit. The unconscionability of terms in a security agreement, however, would be a question for a judge, not a jury, to decide.¹¹⁴ And courts would be guided by precedent decided under Article 2's doctrine of unconscionability, rather than be asked to formulate an entirely new standard pertaining to the expectations of a reasonable unsecured creditor.

The relative effectiveness of yet another possible rule should be compared: a rule recognizing unsecured creditors' property interests in goods sold on credit to a debtor as paramount to secured creditors' property interests in after-acquired collateral. Many civil law countries recognize a vendor's lien as paramount to a compet-

¹¹² Cf. U.C.C. § 2-309(3) (1990) ("Termination of a contract by one party except on the happening of an agreed event requires that reasonable notification be received by the other party and an agreement dispensing with notification is invalid if its operation would be unconscionable."); *K.M.C. Co. v. Irving Trust Co.*, 757 F.2d 752, 759 (6th Cir. 1985) ("[T]he obligation [implied in every contract] to act in good faith . . . require[s] a period of notice to [the debtor] to allow it a reasonable opportunity to seek alternative financing, absent valid business reasons precluding [the secured party] from doing so."). Of course, even this reform would create uncertainty for lenders while courts resolve what period of notice is reasonable and what limitations should apply to the parties' ability to define reasonable notice in their contract. A better regulatory approach may be to establish a nonwaivable mandatory notice period.

¹¹³ Courts generally hold that Article 2's doctrine of unconscionability is inapplicable to secured transactions. See, e.g., *Tinsman v. Moline Beneficial Fin. Co.*, 531 F.2d 815, 818 n.5 (7th Cir. 1976). Others have applied a common-law doctrine of unconscionability to financing arrangements. See, e.g., *Williams v. Walker-Thomas Furniture Co.*, 350 F.2d 445, 448-49 (D.C. Cir. 1965).

¹¹⁴ See U.C.C. § 2-302(1) (establishing that a "court *as a matter of law* [may find] the contract or any clause of the contract to be unconscionable") (emphasis added).

ing security interest.¹¹⁵ Louisiana did, too,¹¹⁶ until 1988, the year it adopted Article 9 of the U.C.C.¹¹⁷ It ought to be possible to test empirically the relative efficiency of a supplier-first world as compared to an inventory-financer-first world by comparing lending practices in Louisiana before and after its enactment of Article 9.

CONCLUSION

LoPucki's reformulation of the unsecured creditor's bargain raises more questions than it resolves. By raising these questions, he provides us with a powerful counterclaim to the model of secured lending as a wealth-maximizing financial institution that benefits secured and unsecured creditors alike. By failing to resolve the nagging questions he poses, however, LoPucki is too quick to conclude that we would be better off without secured credit in its current form. Standing alone, his reformulation of the unsecured creditor's bargain is insufficient justification for drastic alterations to the law of secured transactions. LoPucki should justify his proposed reforms as the most effective means of redressing the exploitation of involuntary and uninformed creditors, both as compared to alternative methods of reform and as relates to the contraction of secured credit sure to follow.

¹¹⁵ See International Chamber Of Commerce, *Retention Of Title* (1989) (summarizing retention of title statutes of 19 countries).

¹¹⁶ See La. Civ. Code Ann. art. 3227 (West 1994).

¹¹⁷ See La. Rev. Stat. Ann. § 10-9-101 (West 1993).