This article explores important recent changes in the way that we treat personal property in commercial finance transactions. Among other things, these changes reduce or eliminate the obligation to give notice of interests in personal property when it is used in commercial finance transactions (as, e.g., collateral for a loan).

A principal purpose of notice-filing has been to deter the creation of secret liens, interests in property that are neither recorded nor otherwise readily observable. Secret liens are universally castigated as abhorrent.

Yet, two recent sets of legislative developments suggest that we may care much less about the problem of secret liens than we might acknowledge. First, recent revisions to Article 9 of the U.C.C (which governs many commercial finance transactions) tolerate secret liens as to such increasingly important assets as data, intellectual property, bank accounts, and securities.

Second, states have recently begun to enact non-uniform legislation designed to promote “asset securitizations.” This legislation gives fully-preemptive effect to the parties’ contracts, and would therefore appear to displace rules on notice-filing that might otherwise apply. They effectively end the obligation to give notice.

The article considers how we have come to diminish the role of notice-filing, and what that might mean. I argue that tolerance of secret liens challenges a deeply-held intuition about the relationship between property rights and notice obligations. This intuition enjoys both a new theoretical cache and a long lineage. I also suggest that we have become increasingly tolerant of secret liens because we have been seduced by a series of economic arguments about the alleged inefficiencies of notice-filing. I consider and reject most (but not all) of the economic arguments as incomplete or speculative.

The article then suggests that notice-filing systems may perform at least two important informational functions not fully considered by critics of these systems. First, they will act as proxy for the information that might otherwise be generated within tightly-knit merchant communities. Second, they may have important behavioral consequences both for those required to provide the notice and for the audience for the information thus provided. The article therefore counsels caution in enacting legislation that would diminish or dilute notice-filing in commercial finance transactions.
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THE END OF NOTICE: SECRETS AND LIENS IN COMMERCIAL FINANCE LAW

One of the Ten Commandments of Mercantile Law is that an effective notice filing system is the center pole that holds up the entire personal property tent.1

[I]t is certainly observable that notice filing offices tend to collect a good deal of dust between the visits of creditors seeking information . . .2

Commentators have wondered for some time just what it is we want the notice filing system to achieve.3

Introduction

Pity the poor financing statement.

This much-maligned document was once the centerpiece of most important commercial finance transactions. Until recently, to make generally enforceable any loan or similar transaction involving personal property, this simple statement identifying the borrower, the lender and the property involved had to be filed in a public office designated by applicable law (usually Article 9 of the Uniform Commercial Code).4 If the form was properly completed and filed, and the underlying contracts were executed, the lender’s rights in the borrower’s property would be “perfected” – enforceable not only against the borrower but also against anyone else seeking to stake a claim in that property, such as buyers, other creditors or a bankruptcy trustee, should the debtor fail.

As a general matter, the function of the financing statement (formally known as a “UCC-1”) has not been in dispute.6 At least nominally, the UCC-1“put[s] a

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5 A form of financing statement as envisioned by U.C.C. § 9-521 is attached as Annex A.
6 As discussed in part III, the larger informational system of which the financing statement is a part has been the subject of some controversy. Indeed, an entire symposium issue of the
person on notice of the existence of a security interest in a particular type of property so that further inquiry can be made . . . .” 7 The financing statement has thus been viewed as a potent antidote to the problem of secret liens, the ancient conflict that arises whenever one party asserts an interest in property that is neither recorded nor otherwise readily observable. 8 Secret liens are universally castigated. As the U.S. Court of Appeals for the Fourth Circuit observed long ago, “[s]ecret liens have always been repugnant to the law.” 9 Karl Lewellyn more colorfully equated the secret lien with “that rat in Denmark” 10

Minnesota Law Review was devoted to the question. See "Managing the Paper Trail": Evaluating and Reforming the Article 9 Filing System, 79 Minn. L. Rev. 519 (1995).


As Professor Alces explained –

The filing system [] prevents pure debtor fraud -- the kind that the debtor commits without the help of a collusive creditor by granting successive collateral interests in the same property without notifying each secured party of the (prior) adverse claimants. This is the true secret lien problem and, for some, it is the raison d’etre of the filing system. If the filing system did not provide an effective means to avoid the risk of pure debtor fraud, there might not be any remaining viable argument in favor of the filing system. So if there is to be a filing system, it must reduce, if not eliminate entirely, this fraud risk.

See Alces, supra note 3, at 703.

9 Holt v. Albert Pick & Co., 25 F.2d 378, 380 (4th Cir. 1928) (“[n]o citation of authority is requisite to support the proposition that [] a secret lien could not avail against an attachment or execution creditor, not chargeable with knowledge or notice of its existence. . . .”). See also In re Reliance Equities, Inc., 966 F.2d 1338 (“[T]he Bankruptcy Act abhor[s] secret liens,...”) (citation omitted). In re Brownsville Brewing Co., 117 F.2d 463, 464 (3rd Cir. 1941) (characterizing Pennsylvania as a State whose ‘abhorrence of the secret lien’ did not even admit of the palliative of recording.”) (quoting Martin v. Mathiot, 14 Serg []); Commercial Casualty Ins. Co. v. Williams, 37 F.2d 326, 327 (4th Cir. 1930) (“Secret liens are repugnant to the law”); In re Nolan Motor Co., 25 F.Supp.186, 189 (D.D.C 1938) (“The giving of a secret lien and the attempt to enforce such a lien against the claims of creditors represented by the trustee in bankruptcy is repugnant not only to the spirit but to the letter of the Bankruptcy Act.”); In re Collins Hosiery Mills, 19 F.Supp. 500, 502 (E.D.Pa. 1937) (“... the common law of Pennsylvania [] abhors a secret lien”); In re Stein, 17
Yet, despite the chest-thumping, two recent sets of legislative development suggest that we may care much less about the problem of secret liens than we might acknowledge. First, Article 9 of the U.C.C. -- which governs many commercial finance transactions, and which was revised effective 2001\textsuperscript{11} -- appears increasingly tolerant of secret liens. For a variety of reasons (some intended, some perhaps not), secured transactions involving such increasingly important assets as data, intellectual property, bank accounts, and securities will in many cases be undiscoverable from the public record.

Second, and perhaps more controversially, several states have recently enacted non-uniform legislation designed to promote asset securitizations.\textsuperscript{12} At least in theory, a securitization differs from a traditional loan because the “debtor” in the securitization “sells” property, rather than encumbers it. Sometimes called “structured financings,” transactions with these general contours were apparently central to much of Enron’s activities.\textsuperscript{13} The drive to enact facilitation statutes stems in large part from a concern that courts may second-guess the contracted-

\textsuperscript{10} See Karl N. Llewellyn, Across Sales on Horseback, 52 Harv. L. Rev. 725, 730 (1939).

\textsuperscript{11} Revised Article 9 has been enacted in all states, and in most went into effect July 1, 2001. See NCCUSL—Introductions & Adoptions of Uniform Acts, at http://www.nccusl.org/nccusl/uniformact_factsheets/uniformacts-fs-ucca9.asp. I occasionally denote revised Article 9 “Rev. § 9-\[xxx\];” and former Article 9 “F. § 9-\[xxx\].”


\textsuperscript{13} There has already been some effort to distinguish securitizations from the types of transactions in issue in Enron. See, e.g., Steven L. Schwarz, Enron and the Use and Abuse of Special Purpose Entities in Corporate Structures, 70 U. Cin. L. Rev. 1309, 1314 (2002). Schwarz has argued that “unlike in Enron, structured transactions [securitizations] typically transfer substantive risk away from the company originating, or sponsoring the transaction . . . .” Steven L. Schwarz, Rethinking the Disclosure Paradigm in a World of Complexity, 2004 Univ. Ill. L. Rev. 1, 3-4 [hereinafter, Schwarz, Complexity]. As discussed in section [], infra, the securitization facilitation statutes would insulate these transactions from all other applicable rules, including those on notice-filing, even if they had none of the distinctive virtues identified by Professor Schwarz. See also Jonathan C. Lipson, Enron, Asset Securitization and Bankruptcy Reform: Dead or Dormant?, 11 J. Bankr. L. & Prac. 101 (2002) (discussing Enron’s use of securitization) [hereinafter “Lipson, Enron”].
for character of the transaction, and treat it not as a sale, but as a financing. If so, the property purportedly sold would remain available for all of the debtor’s other creditors to share if the debtor went into bankruptcy.

These statutes solve this problem by giving full preemptive power to the underlying contracts (e.g., the sales documents). If they mean what they say, these statutes should create an enormous exception to all state-law-based notice-filing systems, including those contemplated by the UCC. They effectively end the obligation to give notice.

This article considers how we have come to diminish the role of notice-filing in so many instances, and what that might mean. Section I examines the deeply held intuition that property rights turn on public notice obligations as reflected in both recent scholarship and long history. At a theoretical level, property rights come with notice obligations. The recent work of Thomas Merrill and Henry Smith, for example, suggests that these obligations appear designed to reduce the transaction costs associated with discovering and respecting property rights. Historically, notice-filing appears to have developed in part as a response to the fragmentation of community that followed in the wake of the industrial revolution.

Section II explains in detail how, despite this intuition, secret liens can arise in a variety of common transactions, including those in which increasingly important types of assets such as data and intellectual property are involved. Section II also explains how the securitization facilitation statutes work to defeat notice-filing regimes.

Section III of the article explains how we have lost sight of the link between property rights and notice-filing obligations in commercial finance transactions. In essence, we have been seduced by a series of arguments about the economics of commercial finance and notice-filing.

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15 See note [], infra.

16 While Revised Article 9 and the securitization facilitation statutes do not directly cite this body of literature, it would appear that the economic challenge to notice-filing has influenced these recent developments. An overarching goal of Revised Article 9 was to promote economic efficiency by making secured transactions easier (and theoretically cheaper) to engage in. The Reporters for the committee that drafted Revised Article 9 explained it thus:

[M]any . . . provisions of Revised Article 9 reflect the Drafting Committee’s effort to achieve more than merely ‘better,’ more ‘efficient,’ ‘equitable,’ or ‘reasonable’ rules to govern secured transactions. An overarching goal of the revisions was to provide in the transactional context enhanced certainty and predictability from the inception of transactions. This certainty can facilitate transactions even though an understandable rule with predictable consequences may be normatively suboptimal.

notice-filing regimes impose direct and indirect costs of compliance that fail to produce corresponding informational benefits. Unfortunately, the economic arguments are incomplete and lack empirical support.

Part IV suggests that there are other ways to understand the role of notice-filing. These understandings are rooted in the ways that information functions in commercial communities and the behavioral consequences of notice-filing systems. These other views of notice-filing suggest that we should think carefully before doing away with it.

I. Property, Notice and Commercial Finance Law

A strong intuition in our law links property rights to public notice obligations. This intuition enjoys both theoretical currency and an ancient lineage. Strong claims about this intuition have been made by, among others Richard Epstein, Carol Rose, Douglas Baird and Thomas Jackson. Most recently, Thomas Merrill and Henry Smith have elaborated on this intuition in what may be characterized as a neoclassical approach to property law theory. They argue that property rights are unique because they create “universal duties” that “are broadcast to the world from the [property] itself.” Historically, linking property

"make new document filing more efficient, transparent, and uniform."). See also Patrick A. Murphy, Revised Article 9 in Bankruptcy Cases, PRACTISING LAW INSTITUTE COMMERCIAL LAW AND PRACTICE COURSE HANDBOOK SERIES, PLI ORDER NUMBER A0-00HP (Sept. 2003) (“The purpose of Revised Article 9 is to simplify commercial transactions and, in the process, to make them more efficient and less likely to be upset in bankruptcy cases.").


21 Merrill & Smith, Law and Economics, supra note 20.
rights to notice goes back at least as far the Greeks, for whom the “horos” gave posted notice of an interest in real property. 22

This section summarizes the development of the intuitive link between property rights and notice obligations, especially as expressed in commercial finance law. “[O]ne of the most firmly rooted doctrines of the common law,” Grant Gilmore has observed, was “the protection of creditors against undisclosed interests in property.” 23 This link is the foundation of our abhorrence of secret liens. Satisfying the link between notice and property axiomatically neutralizes the problem of secret liens. Thus, if we can understand where the relationship between property and notice comes from, and why it persists (at least in theory), we should have some background sense of the problems created by secret liens.

A. Neoclassical Property Theory and Information Costs

The link between property rights and notice obligations is enjoying something of a renaissance among property theoreticians, especially in the work of Professors Thomas Merrill and Henry Smith. 24 The heart of this neoclassical

22 As Benito Arruñana explains –

[H]oroi contained the essential data of the encumbrance (always, the nature of the horos as security, and more often, but not always, the existence of a written agreement, the name of the creditor, and the amount of the debt) and, in some cases, the name of the person who kept the document of the transaction, supposedly to make it possible for third parties to collect more information. This system was one of the first to make an hypotheca possible--namely the use of land as collateral without temporarily transferring ownership or possession to the lender.


23 1 GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY (1965), § 3.2, at 67. & § 8.7, at 274 (“In the history of our security law there has been one constant factor: whenever a common law device has been covered by a statute, some form of public recordation or filing has been required as a condition of perfection of the security interest.”). Gilmore was a principal drafter of the U.C.C. As Peter Coogan, another prominent participant in the development of the U.C.C, explained:

A history of chattel security could well be written in terms of the 400-year struggle by debtors and their secured creditors to create security interests of various sorts in the debtors’ property without affording notice to buyers or other creditors, and the attendant demands by unsecured creditors generally for some kind of notice when all or part of the debtors’ assets become subject to security interests. The parties favoring secrecy have, for the most part, been the losers.


position is that property differs from other common law rights at tort or contract because property deals with a limited set of *in rem* rights that are good against “the world.” Although there are traces of this approach to property in the work of Richard Epstein and Carol Rose, Merrill and Smith take the argument a step further, and find a deeper link between notice and property rights. They argue that a unique feature of property is that property creates “universal duties” that “are broadcast to the world from the [property] itself.” Only if something is “marked in the conventional manner as being owned,” they write, will “we know that we are subject to certain negative duties of abstention with respect to that thing.” Because the thing has been “marked” “we know all this without having any idea who the owner of the thing actually is.” Even those who criticize neoclassical conclusions about the character and development of property rights nevertheless agree that “third-party information costs are central to the law’s regulation of property rights.”

1. The Numerus Clausus

Neoclassical views about the notice-function of property are rooted in the “numerus clausus,” the idea that property rights come in a fixed and closed number of forms. “Property law,” Merrill and Smith argue, “requires that the parties adopt one of a limited number of standard forms that define the legal dimensions of their relationship; generally speaking, these are mandatory rules that may not be modified by mutual agreement.” The number (*numerus*) of property forms is, in the vernacular, closed (*clausus*) because “common-law courts will not enforce an agreement to create a new type of property right.”

The numerus clausus appears to be a well-articulated feature of many civil law jurisdictions. In the common law, however, its role is more opaque. Although courts and lawyers are characterized as hostile to the numerus clausus, Merrill and Smith nevertheless contend that they “routinely abide by the principle, even if they are unaware of its existence.” For example, as to estates in land, “courts enforce the numerus clausus principle strictly. . . . The menu of forms is regarded

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25 See supra notes [] & [].
27 See id.
28 Id.
30 See Merrill and Smith, *Interface*, *supra* note 20, at 776.
31 See Merrill and Smith, *Optimal Property*, *supra* note 20, at 5.
32 See id. at 4-5 (in civil law countries the numerus clausus is “widely acknowledged by commentators as being a substantive limitation on the definition of property”).
33 See id., at 8. See also id at 6 (“Scholars and judges tend to react to manifestations of the numerus clausus as if it were nothing more than outmoded formalism.”).
as complete and not subject to additions.” With respect to personal property, Merrill and Smith claim, the list is even narrower. The chief exception, they argue – the one area in which courts will respect novel claims of property rights – is in the intellectual property arena. Here, “judicial creativity in fashioning new intellectual-property interests has been sanctioned” in the recognition of rights of publicity and on the misappropriation of information.

The principal explanation for the (sub rosa) vitality of the numerus clausus has been economic, oriented around the inefficiency that stems from the excessive fragmentation of rights (or rights holders). Merrill and Smith take the economic explanation one step further, arguing that we restrict property forms not out of concerns about fragmentation, per se, but about information costs associated with the creation of excessively idiosyncratic property rights (“fancies”). Thus, Merrill and Smith believe that the need for the numerus clausus “stems from an externality involving measurement costs: Parties who create new property rights will not take into account the full magnitude of the measurement costs they impose on strangers to the title.”

The information costs of idiosyncratic property forms (they use the example of a one-hour time-share in a wrist-watch) thus explain for Merrill and Smith the underlying basis of the numerus clausus. “One way to control the external costs of measurement to third parties is through compulsory standardization of property rights.” The standardization of property forms imposed by the numerus clausus, according to Merrill and Smith,

reduces the costs of measuring the attributes of such rights. Limiting the number of basic property forms allows a market participant or a potential

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34 See Merrill and Smith, Optimal Property, supra note [], at 13.
35 Id. at 17. (“Personal property is restricted to fewer available forms of ownership than real property.”).
36 Id. at 20.
38 Merrill and Smith refer to idiosyncratic property forms as “fancies,” after the opinion in Keppell v. Bailey 39 Eng. Rep. 1042, 1049 (Ch. 1834)(novel forms of property cannot “be devised and attached to property at the fancy or caprice of any owner.”). Merrill and Smith, Optimal Property, supra note 20, at 26, nn 102-104.
39 Merrill and Smith, Optimal Property, supra note 20, at 26-27.
40 Id. at 27. Note that U.C.C. Article 2A would appear to recognize the time-share in the watch as a lease. U.C.C. § 2A-103(j) defines a lease as “a transfer of the right to possession and use of goods for a term in return for consideration.” There is no apparent reason why the “term” of the lease couldn’t be every Monday for one year. It might be fanciful – and inefficient – but it is permissible.
41 Id. at 33.
violator to limit his or her inquiry to whether the interest does or does not have the features of the forms on the menu. Fancies not on the closed list need not be considered because they will not be enforced. When it comes to the basic legal dimensions of property, limiting the number of forms thus makes the determination of their nature less costly. The "good" in question here might be considered to be the prevention of error in ascertaining the attributes of property rights. Standardization means less measurement is required to achieve a given amount of error prevention. Alternatively, one can say that standardization increases the productivity of any given level of measurement efforts. 42

There is, on this view, an “optimal” number of property forms, and this number is determined by the information costs associated with excessively idiosyncratic forms of property. On the one hand, costs in error and measurement would be lowest, Merrill and Smith observe, in a highly regimented system, which recognized only a single, simple form of property (such as the fee simple absolute). 43 However, frustration costs arising from stymied creativity would be quite high. On the other hand, a system of unfettered customization of property forms – pure contract – may have low frustration costs (how can you be frustrated if the law recognizes anything you do?) but high costs of verification and measurement. Both the parties that created the fancy, and others who might try to discover what it is and what rights are held in it, will expend large sums in ascertaining and managing these rights. The social cost of limitless customization of property rights is simply too great. The optimal level of customization – the number and type of fancies permitted by the numerus clausus – is somewhere in between, where all classes of information cost are the lowest.

Merrill and Smith’s view of the existence of and rationale for the numerus clausus is not without critics. In a recent article, Henry Hansmann and Reinier Kraakman question the neoclassical assertion that the list of property forms is closed or that there may be an “optimal” number of types of property forms. 44 Rather, they argue that “the law’s limitations on property rights take the form of regulation of the types and degree of notice required to establish different types of property rights.” 45 Non-standard property rights are recognized by the common law, they argue, but “are simply governed by highly unaccommodating verification rules that place a heavy burden on the holder of the right to provide notice to third parties.” 46 “The optimal standardization theory makes little sense when applied at the category level,” they suggest. 47 By this, they seem to mean

42 Id at 33-34 (footnotes omitted).
43 Id, at 39-40.
44 Hansmann & Kraakman, supra note 20.
45 Id. at 374.
46 Id. at 399.
47 Id. at 401.
that a highly idiosyncratic form of property right in one category – say, intellectual property – should not create meaningful information costs for property in another category, such as real estate.\footnote{Id.\hspace{1em}48} Even within categories, increasing the number and complexity of rights will not necessarily increase costs significantly, “assuming the same verification rules are used” for types of rights within the given category.\footnote{Id.\hspace{1em}49}

2. Property as Information

Perhaps the key point about the numerus clauses is informational: The forced standardization of property forms creates a kind of short-hand which, in turn, reduces information costs. “When we encounter a thing that is marked in the conventional manner as being owned,” Merrill and Smith write, “we know that we are subject to certain negative duties of abstention with respect to that thing.”\footnote{Id.\hspace{1em}50} Because the thing has been “marked” “we know all this without having any idea who the owner of the thing actually is.”\footnote{Id.\hspace{1em}51} Property law creates “universal duties” that are “broadcast to the world from the thing itself.”\footnote{Id.\hspace{1em}52}

Because property rights are, in the neoclassical conception, “good against all the world,” property law essentially “presents a massive coordination problem.”\footnote{Id. at 387.\hspace{1em}53}

If the legal system allowed in rem rights to exist in a large variety of forms, then dutyholders would have to acquire and process more information whenever they encountered something that is protected by an in rem right. If in rem rights were freely customizable--in the way in personam contract rights are--then the information-cost burden would quickly become intolerable. Each dutyholder would either incur great costs in informing herself, or would be forced to violate property rights wholesale, defeating the benefits of security, investment, and planning that these rights were meant to secure.\footnote{Id. at 387.\hspace{1em}54}

For Merrill and Smith, the numerus clausus is the silent but stealthy force that “reduce[s] the widespread information-gathering and processing costs imposed on third parties by any system of in rem rights.”\footnote{Id. at 387 (footnote omitted).\hspace{1em}55} In other words, simplicity (of a
sort) reduces the cost of informing the world that a property interest exists.

Although Hansmann and Kraakman disagree with the neoclassical conclusion that the form of property rights is (and economically-speaking) must be limited, they whole-heartedly endorse the link that Merrill and Smith make between property rights and notice (which they call “verification”). Indeed, Merrill and Smith err, they argue, by suggesting that notice is required to facilitate communication among persons who transact in property rights. Rather, Hansmann and Kraakman argue, limitations on the types of property “facilitate the verification of ownership of the rights offered for conveyance.” Notice and property rights are correlated because “[t]he degree of notice required and the extent to which the law affirmatively facilitates the giving of notice vary across different types of property rights according to the utility of the partitioning and the costs of giving notice.” In other words “[b]ecause the benefits of partial property rights are often low and the costs of verifying these rights are generally high, property law necessarily takes an unaccommodating approach to all but a few basic categories of partial property rights.”

Neither Merrill and Smith nor Hansmann and Kraakman express a strong opinion about how property-information should be disseminated. Merrill and Smith seem to believe, for example, that notice-filing systems generally are cheap sources of information about property rights. They offer as an example of this the Article 9 financing statement system which, they claim, “allowed the loosening of the earlier quite strict limits on the types of security interests permitted.” But they are not insensible to the possibility that there may be other, cheaper ways to disseminate comparable information, such as via electronic transmission.

There may be problems with the neoclassical position. First, it appears tautological. It may be true that property rights are those with low information costs. But how do we know something is property in the first place, if we do not have the information? What, in other words, came first – the property rights or our knowledge of them? Second, this model seems most fully explanatory with respect to tangible property. If there is nothing to “mark” – because the res is an intangible – it is not clear how universal knowledge is possible. The “world” knows very little about my bank account, but most would agree that it is my property. Conversely, many things that have very low information costs –

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56 Id.
57 Id. at 375.
58 See Merrill & Smith, Optimal Property, supra note 20, at 40 (“registers of interests in real property, that is, recording acts . . . lower[ ] the costs of notice . . .”).
59 Id. at 42 (footnote omitted).
60 Id. At 42 (“Notice is arguably easier to furnish (if not to process) when, for example, rights to digital content are being transferred, and notice of restrictions and other features of rights transferred are technologically not difficult to provide.”).
61 I do not, of course, claim that a deposit account creates an interest in specific funds. I am also mindful of the fact that Citizens Bank of Maryland v. Strumpf, 516 U.S. 16 (1995) undermines the
archetypal human relationships -- are not property. Virtually anyone who sees me with my daughter will deduce our relationship. It will be “universally broadcast” from our behavior, but no one would say that either of us has a property interest in the relationship, or in one another.

Third, and as developed in the balance of this article, it fails to account for the legislative trend toward eliminating notice-filing, which would seem to make property rights more difficult and costly to discover.

B. A Short History of Notice in Commercial Finance Law

Yet the core intuition – that property rights create notice obligations – is powerful. Much of the power of the intuition comes from its lineage. Historically, information about property was signaled by possession. This may have made sense in a simpler world. But as societies became more complex and disaggregated, community structures could no longer be reliable sources of information about a debtor’s property. As increasingly devious transactions occurred in increasingly sophisticated forms, notice-filing became proxy for the information (and controls) that community might otherwise have provided.

1. Possession as Notice

Historically, possession was viewed as the basis of property rights, and this was as true of the security interest (“pledge”) as any other property interest. If creditor A took possession of debtor B’s flock of sheep to secure B’s debt to A, at least in theory, there would be no doubt in the minds of those asserting an interest in B’s property about B’s rights in the sheep: To all appearances, he had none. And, conversely, where B did have possession, it would be reasonable for creditors or purchasers to conclude that he did, in fact, have title or some other equally important set of rights (e.g. a lien). Possession was property. Or, perhaps more accurately, the signal sent by possession was said to justify the conclusion that the possessor had a “property interest” in the thing possessed.

62 See Epstein, supra note []; Rose supra note []. Or, in the immortal words of English play write Colley Cibber (1671-1757), “Possession is eleven points in the law.” COLLEY CIBBER, WOMAN'S WRT, Act 1.

63 “The legal system’s original method of providing [information about ownership] was to give primacy to possession. At common law, a debtor’s possession of personal property assured a prospective creditor that the debtor could give him an unencumbered interest in that property.” Baird and Jackson, Possession and Ownership, supra note 19, at 180 (footnoted omitted). According to Baird and Jackson, this was because “possession has been viewed as the best available source of information concerning “ownership” of most types of personal property.” Id. (Citing Twyne’s Case, 76 Eng. Rep. 809 (1601) and statute 13 ELIZ., CH. 5 (1570)).
Perhaps the most famous articulation of the link between notice and possessory property rights appears in *Clow v. Woods*.\(^{64}\) In *Clow*, a tanner (Hancock) conveyed to creditors Clow and Sharp mortgages on his vats of hides and tanning equipment. The creditors neither took possession of this personal property collateral, nor recorded the mortgage. The debtor’s former business partner (Poe) sued for his share of the value of the firm, obtained a judgment, and sent the sheriff to execute on the same hides and equipment. The secured creditors sued the sheriff seeking to recover the proceeds of the sale of this property, arguing in substance that their mortgage had priority over Poe’s execution lien. Unfortunately for the secured creditors, the Pennsylvania Supreme Court had no desire to enforce their mortgage, since the court viewed it as fraudulent in law, if not in fact.\(^{65}\)

*Clow* turned in significant part on the informational problem created by the separation of property right from possessory fact. Judge Gibson reasoned that the “secrecy” of the mortgages (security interests) would harm other creditors of the debtor, Hancock, because these other creditors would (mistakenly) rely on the apparent value of his hides and equipment in deciding to lend to him.\(^{66}\) His ownership of this property, ostensibly free and clear of the rights of all others, would induce unwitting (perhaps unsophisticated) creditors to extend unsecured credit, at their peril:

> [A] creditor ought not to be suffered to secure himself by means that may ultimately work an injury to third persons,” Judge Gibson opined . . . . Where possession has been retained without any stipulation in the conveyance, the cases have uniformly declared that to be, not only evidence of fraud, but fraud per se. Such a case is not inconsistent with the most perfect honesty; yet a court will not stop to inquire, whether there be actual fraud or not; the law will impute it, at all events, because it would be dangerous to the public to countenance such a transaction under any circumstances. The parties will not be suffered to unravel it, and show, that what seemed fraudulent, was not in fact so. Would it be less against sound policy to suffer a vendor to remain in possession, under an agreement to that effect expressed in the conveyance, and thus to create a secret [e]ncumbrance on his personal property, when to the world he appears to be the absolute owner, and gains credit as such.\(^{67}\)

*Clow* thus articulated what came to be known as the problem of ostensible ownership – the making of credit (or other investment) decisions in reliance on the (misleading) appearance that a debtor has rights in property by virtue of physical possession.

\(^{64}\) 5 Serg. & Rawle 275 (Pa. 1819).

\(^{65}\) Id. at 283, 288. The court held that the mortgage transaction was a per se fraud against creditors and was void under the statute of 13 Elizabeth.

\(^{66}\) *Clow* id at *4 (The contract between the debtor and creditors was a “secret matter[] between the parties themselves, and can afford no notice to creditors.”).

\(^{67}\) *Clow* at *5 (Gibson, J.).
Some have questioned whether ostensible ownership creates much of a problem.\textsuperscript{68} Professor Mooney, for example, has argued that creditors (or others) are unlikely to rely (reasonably or otherwise) on the mere fact that a debtor possessed certain assets when making a credit or other investment decision.\textsuperscript{69} Mooney’s argument centered principally on proposals to extend notice-filing rules to personal property leasing transactions.\textsuperscript{70} Mooney successfully argued that notice-filing would add nothing to such transactions because sophisticated creditors either already knew that the debtor leased its property, or did not care one way or the other.\textsuperscript{71} Because ostensible ownership problems by definition involved misplaced reliance on a debtor’s property, and creditors rarely relied in “unreasonable” ways, Mooney concluded that “[p]erhaps there is no real ‘problem’ at all.”\textsuperscript{72}

While possession technically remains a viable method of creating and enforcing property interests in commercial finance transactions,\textsuperscript{73} it would appear


\textsuperscript{69} Mooney, id. at 740 (“Although hard empirical data remains elusive, a review of Code cases dealing with priority disputes between lessors and third parties supports the argument that mistaken and detrimental reliance on lessees’ possession of equipment is not commonplace.”)(footnote omitted).


\textsuperscript{71} Mooney, supra note 68, at 785-88.

\textsuperscript{72} Id. Note that personal property leasing cases sometimes have important implications for notice-filing. The so-called recharacterization cases hold generally that a lease that was, in substance, a secured financing may be recharacterized as such and, if the lessor (read: secured party) failed to give adequate notice, it would lose its priority to a bankruptcy trustee. See, e.g., Duke Energy Royal, LLC v. Pillowtex Corp. (In re Pillowtex, Inc.), 349 F.3d 711 (3d Cir. 2003)(setting forth criteria for determining whether transaction is a “true lease” or “disguised financing.”); PCH Assocs., 949 F.2d at 595-97 (citing PCH Assocs. v. Liona Corp., 55 B.R. 273 (Bankr. S.D.N.Y. 1985); In re Independence Village, Inc., 52 B.R. 715 (Bankr. E.D. Mich. 1985). U.C.C. § 9-505 now explicitly contemplates (and permits) the filing of precautionary financing statements. In at least some states, that might be a good idea, as a sale-leaseback that is not recorded may be treated as a fraudulent transfer. California Civil Code § 3440, for example, makes a sale-leaseback void as against creditors of the transferor unless a UCC financing statement is filed in the office of the California Secretary of State prior to the sale of the equipment and a notice of the intended transfer is published not less than 10 days before the transfer.

\textsuperscript{73} U.C.C. § 9-313(c) provides that a secured party may take and perfect a possessory security interest in certain types of collateral in the physical possession of some third party (i.e., not the debtor) so long as the third party has agreed that it holds the collateral for the benefit of the secured party. See U.C.C. § 9-313(c). Possessory security interests are not only permitted with respect to most tangible collateral, but are actually required to perfect a security interest in money (i.e., currency). U.C.C. § 9-312(b)(3). The possessory security interest is presumed to perform the informational functions one might ordinarily associate with notice-filing, since it is an exception to the general rule that a financing statement must be filed to perfect a security interest. U.C.C. § 9-310(b) (6). It is also considered a proxy for the contract that creates a security interest, a written (or electronic) security agreement. U.C.C. § 9-203(b)(B) & (C). This is somewhat surprising.
that Mooney is at least half right, since it is simply not clear what possession “means.”

As any first-year law student can tell you, possession is a highly elusive concept. We do not “possess” most of the things that we claim to possess in ordinary language. Professor Schroeder has elaborated on this point, noting that the enormous number of potential, complex property relationships, coupled with the development of fictitious legal entities such as corporations (which may have and convey interests in property) make physical custody an extremely poor signal of any information about either the property itself, or its “ostensible” owner.

The ambiguity of possession also infects the creditor’s side of things. For example, even if a lender has actual physical possession, we still do not know what to make of other creditors of this (the possessory) creditor. After all, it is entirely conceivable that A (B’s creditor) may take possession of B’s property to secure B’s obligation. But it is at least theoretically possible that A may have its own creditors, or purchasers, or what have you (C). Why should C be any less gullible than B’s creditors? Doesn’t A’s possession (of B’s property) signal to A’s secondary stakeholders (such as C) the very same thing that B’s possession would signal to B’s creditors, etc? How would A’s creditor (C) verify the absence of B’s equity (if any) in the collateral?

given that the U.C.C. provides no guidance about what “possession” might mean for these purposes. The U.C.C. “does not define `possession.’” U.C.C. § 9-313 cmt 3. The U.C.C. “adopts the general concept [of possession] as it developed under former Article 9.” Id. While former Article 9, § 9-305, certainly contemplated the creation and perfection of security interests by secured party possession, it also said little about what possession might have meant in this context. See U.C.C. § 9-305(2000).

74 It is this uncertainty that led Professor Phillips to observe that “business people look to written, not possessory evidence of ownership. And this view leads generally to recognizing filing, but not possession, as a means of notice.” David M. Phillips, Flawed Perfection: From Possession to Filing Under Article 9--Part I, 59 B.U.L.REV. 1, 35 (1979).

75 See Jeanne L. Schroeder, Some Realism About Legal Surrealism, 37 WM. MARY L. REV. 455, 486-87 (1996) [hereinafter Schroeder, Realism] (“Regardless of what has been historically assumed, contemporary property practices suggest that, today, physical custody provides very, very little (if any) information about ownership.”). See also Jeanne L. Schroeder, Death and Transfiguration: The Myth that the U.C.C. Killed “Property,” 69 TEMP. L. REV. 1281 (1996) [hereinafter Schroeder, Death and Transfiguration]. Professor Schroeder thus argues with some force that possession in commercial law is at best a metaphor for what she calls “sensuous grasping.” Schroeder, Surrealism, supra note [], at 455. Yet, as Schroeder observes, it is a metaphor that fails to serve commercial law well. It is simply not meaningful to view transactions in intangible property – which is increasingly where the real value is – as like a physical conveyance, a simple “farmer’s transaction.” Schroeder, Surrealism, supra note [], at 492 (citing Karl N. Llewellyn, Across Sales on Horseback, 52 HARV. L. REV. 725, 732 (1939)). For example, investment property (e.g., stocks and bonds) often exists in complex networks of computers which are owned (and perhaps “possessed”) by firms, which are then linked in complex, pyramidal broker-dealer relationships. See Prefatory Note, U.C.C Art. 8 (1994) (discussing evolution of securities holding systems).

76 See Baird and Jackson, Uncertainty, supra note 19, at 307.

77 Baird and Jackson dismiss this problem of “repledge” as being “largely a theoretical one.” Id. at 307. Presumably they were at the time unaware of the basic functioning of the securities markets. Professor Kettering has thoughtfully demonstrated that this problem is not merely theoretical in the context of securities transactions, especially by and among broker-dealers. See Kenneth C.
Yet, assertions about what the law should be based on assumptions about how
people process information turn out to be very difficult to sustain. It seems fairly clear
that in smaller and more tightly knit communities, possession may well have been an
effective signal. Otherwise, it seems unlikely that possession could ever have been an
acceptable means of distributing property rights. If so, Clow is ultimately wrong in
result, even if it may be correct in its policy concerns. If, as seems likely, Hancock’s
creditors -- and in particular, Poe, the creditor and former business partner -- knew or
had reason to know that Clow and Sharp had a mortgage on Hancock’s property, what
value would notice-filing (or creditor possession) have added? How did Poe (or
anyone else) rely unreasonably on Hancock’s (the debtor’s) possession?

Possession undoubtedly sends an ambiguous signal, but that is only half the story.
As discussed in Part IV.B below, we are just beginning to develop theories about how
human beings process information and form judgments in the presence of ambiguity.
In any case, it would appear that information has complex affects on both the audience
for, and the providers of, information about property, none of which have been fully
accounted for by those who dismiss the problem of ostensible ownership.

Perhaps the ultimate problem with the possessory security interest has only
indirectly involved information. This is the practical problem arising from the
fact that, as the economy grew in depth, breadth and complexity, possessory
security interests became neither useful nor appealing to those engaged in increasingly
sophisticated mercantile transactions.78 If true to form, the debtor could not possess or
make use of property held by the secured creditor. Hancock, the tanner in Clow,
would not have been able to produce the leather goods that were presumably his stock
in trade and the sale of which would make it possible for him to repay the loan. If not
true to form, there remained the distinct possibility of ex post judicial nullification.
For manufacturers, this meant that their equipment could not secure a loan; for
merchants, the same prohibition limited the value of their inventory. Nor could future
interests secure present loans. Nor could intangible rights serve as collateral. And so
on. Possession thus became a speed-bump on the road to increasingly complex,
disagggregated property rights. Increasingly dynamic uses of property would render
possession vestigial at best, and misleading at worst.79

2. Notice Systems

Given these problems with the possessory security interest, it is not surprising that
pressure developed to find an alternative. The alternative was notice filing.80 Linking
the right to enforce a nonpossessory interest in property (e.g., a security interest) to

Kettering, Repledge and Pre-Default Sale of Securities Collateral Under Revised Article 9, 61 U.

78 Baird and Jackson, Uncertainty, supra note 19, at 308.

79 See JAMES WILLARD HURST, LAW AND THE CONDITIONS OF FREEDOM, 9-10 (1956)
(“[P]revailing nineteenth century attitudes in fact made private property pre-eminently a dynamic,
not a static institution.”).

80 At least originally, however, it was not considered to be a particularly good one. Professor
Gilmore observed that “[o]riginally filing was looked as merely an alternative, a less desirable
alternative, to possession taken by the secured party.” Gilmore, supra note [], at § 15.1, p. 462
publicly filed notice of that interest has had a long and complex career. While notice-filing may have served a number of purposes over time, one undoubtedly involved preserving the link between property rights and notice-obligations. Since notice-filing systems exploded with the disaggregation of community during the industrial revolution, it may also be that notice-filing developed as a proxy for the information that community would once have provided to creditors.

(a) The Roots of Notice-Filing – Recordation, Fraudulent Conveyance and Sign-posting

Separating property from information about it – conveying property information in some way other than possession – well precedes the modern notice-filing systems we have today. Indeed, even while Clow might have counseled that possession was the only (or principal) method of creating an effective security interest in personal property, real property rights were being reified in recordation systems that would be the forerunner for the notice-filing systems that became ubiquitous in the 19th century.

In England, for example, recordation systems developed with respect to real property, and were used as a matter of choice or custom. In colonial North America, real property recording systems performed several different functions. Certain communities in Massachusetts, for example, may have used recording and acknowledgment rules to limit the admission of new members of the community or to control improvements to property. More frequently, it appears that

See John Hanna, *The Extension of Public Recordation*, 31 COLUM. L. REV. 617, 620 (1931) ("Prior to the Norman conquest there seems to have been a system of voluntary registration of land deeds in monasteries"). Even where not voluntary, Professor Bowers reports that they may have been easily circumvented. See James W. Bowers, *Of Bureaucrats’ Brothers-in-Law and Bankruptcy Taxes: Article 9 Filing Systems and the Market for Information*, 79 MINN. L. REV. 721, 722-23 (1995). The 1535 English Statute of Enrollments, which required recordation of a “bargain and conveyance” of real property, was in fact a disguised taxation device. (citing 27 Hen. 8, ch. 16 (Eng.). It was, in his view, one which often failed because lawyer simply paper around the transaction. Bowers, *supra* at 731. See also Hanna, *supra* note [], at 619 (discussing Statute of Enrollments).

In a 1907 issue of *Green Bag*, Joseph H. Beale, Jr. suggests that borough custom in England required the registry of deeds to real property, and might have influenced the settlers in Massachusetts and Virginia. See Joseph H. Beale, Jr., *The Origin of the System of Recording Deeds in America*, 19 GREEN BAG 335, 338 (1907). The custom of London, for example, was said to be as follows:

The persons that sealed the deed must go before the Lord Mayor, or the Recorder and one Alderman, and make acknowledgement that the same is their act and deed; if a wife be a party, she is to be examined by them, whether it was done with her full and free consent, without any kind of compulsion; in testimony of which the Lord Mayor or the Recorder and Alderman set their hands to it, for which each may demand 4d, and the attorney’s fee for the judgment is 2d. Afterwards the deed must be delivered to the clerk of the Inrolments who at the next Hustings will cause the proclamation to be made thereof according to the customs of the court.


recordation was viewed as a way to address the problem of fraudulent conveyance—
a conveyance intended to place property out of the reach of creditors. For example, in 1640, both Jamestown and the Massachusetts court enacted rules providing that a nonpossessory interest in real property (title or mortgage) would be treated as fraudulent unless publicly recorded.

The problem of fraudulent conveyance appears to have had a significant influence on the development of notice-filing rules, and provides some insight into the historic role that community might play in all of this. Perhaps the classic case of fraudulent conveyance was Twyne’s Case. There, one Pierce was indebted to Twyne and to another creditor. “In secret,” however, Pierce conveyed all of his property to Twyne in satisfaction of the debt. Despite the conveyance, Pierce nevertheless continued to act as if the property remained his, including by marking and selling his sheep as if they were his, and not Twyne’s. In avoiding


85 Id.

86 Id. at 337. The Massachusetts rule provided as follows:

For avoyding all fraudulent conveyences, & that every man may know what estate or interest other men may have in any houses, lands or other hereditamants they are to deale in, it is therefore ordered, that after the end of this month no morgage, bargaine, sale, or graunt hereafter to bee made of any houses, lands, rents, or other hereditamants shalbee of force against any other person except the graunter & his heires, unless the same bee recorded, as is hereafter expressed.”

I Records of Massachusetts 116.

Perhaps foreshadowing the streamlined notice requirements of the UCC, the ordinance further provided that “it is not intended that the whole bargaine, sale, &c. shalbee entered, but onely the names of the graunter & grauntee, the thing & the estate graunted & the date; and all such entryes shalbee certified to the recorder at Boston.” Id. As discussed below, the modern UCC-1 financing statement requires only a cursory recitation of the debtor (grantor), secured party (grantee) and brief description of the collateral. U.C.C § 9-503(a). Hanna also suggests that colonial law embraced recordation as a response to the problem of fraudulent conveyance. See Hanna, supra note [], at 620 (“England has influenced American law makers in the drafting of recording statutes …. as a result of the statutes of fraudulent conveyance and reputed ownership.”) (citing 13 Eliz.. c. 5)

87 Professor Howe uncovered certain amendments to Massachusetts’ statute suggesting that recording was required only where a grantor (i.e., debtor) retained possession following a conveyance. See Howe, supra note [], at 4 (“the provision in the Code of 1648 makes it abundantly clear that recording would thereafter be required only if the grantor remained in possession.”). This suggests that, contrary to Beale’s view, discussed in note [] supra, the Massachusetts system provided only a limited model from which the current system might have developed.

88 3 Co. Rep. 806, 76 Eng. Rep. 809 (Star Chamber 1601). The Star Chamber was enforcing the Statute of 13 Elizabeth which provided that transfers with the ‘intent [] to delay, hinder or defraud creditors and others’ were void, provided for recovery of the ‘whole value of . . . goods and chattels’ transferred, to be shared by the Crown and aggrieved parties (such as creditors), and provided for criminal sanctions against the parties to the transfer. 13 Eliz., ch. 5 (1570).

(undoing) the conveyance, the Star Chamber reasoned that “a secret transfer is always a badge of fraud.”

One way to understand fraudulent conveyance was as an affront to community norms. The statute that *Twyne’s Case* enforced – the Statute 13 Elizabeth c. 5 – was enacted in part to deal with debtors who would remove themselves and/or their property from the community once it became apparent that they could not satisfy their debts. As Professor Flint explains –

Overburdened debtors in the fourteenth and fifteenth centuries frequently transferred all their lands and goods to their friends in trust for use of the grantor through fictitious sales, fled to one of the numerous sanctuaries where the king's courts' power did not govern, lived luxuriously from the income of the property transferred until the creditor accepted payment of a small portion of the debt and released the remainder, then returned, and had back their property.

Recordation systems appear to have developed, in part, as an informational proxy for possession which could deter or correct the problems of fraudulent conveyance and secret liens. Although these systems existed even before the Revolution, they began to flourish later, in the early part of the 19th century with a view to preventing or remedying problems like those in *Twyne’s Case*. Recording was viewed as a means of deterring the actual or constructive fraud

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90 Professor Mooney, and others, have argued that *Twyne* was a case chiefly about fraud and not, as Baird and Jackson claim, about ostensible ownership. See Mooney, *supra* note 68, at 727 & n. 166. However that may be, the problem of fraudulent conveyance differs in some respects from the problem of secret liens. At least historically (as in *Twyne’s Case*) a fraudulent conveyance involved a transfer of property after a debt was incurred and not satisfied. Placing the property out of reach of the creditor was the chief evil in such cases. Secret lien cases, however, often involved a transfer of property prior to a debt being incurred. The problem of fraudulent conveyance is thus largely ex post, while the problem of secret liens may be ex post or ex ante. Yet the essential informational problem is the same in both. The actual secrecy of the transaction in *Twyne’s Case*, and the presumptive secrecy of the transaction in *Clow*, appear to have been as troubling as any ill intent in either (to evade creditors).

91 Professor Mooney maintains that the Statute of Elizabeth was “intended in large part as a revenue measure.” Mooney, *supra* note 68, at 726, n.162 (citing 1 G. GLENN, FRAUDULENT CONVEYANCES AND PREFERENCES § 61b, 61c, at 89-93 (rev. ed. 1940)).


94 See Gilmore, *supra* note [], at §§ 2.1 & 2.2 (discussing history of chattel mortgage acts as response to problems of fraudulent conveyance); compare Flint, *Fraudulent Myth, supra* note [], at 367 (“This study importantly eliminates Gilmore's implication of the nonpossessory secured transaction as a fraudulent transaction.”). For purposes of this article, it is not necessary to resolve whether nonpossessory secured transactions were or were not fraudulent. The ultimate questions are why public notice systems took hold, and whether they continue to make sense.
presumed to be at the heart of the non-possessory property interest. To the extent that fraudulent conveyance was a transgression of community norms, therefore, the compulsory disclosure of information became a method of regulating that which the community could not.

These systems bloomed with the industrial revolution, and its insatiable demands for liquidity. As Professor Gilmore explained:

The unprecedentedly rapid expansion of industrial facilities created and equally unprecedented demand for credit. The financing institutions which were the source of credit naturally desired security for the loans . . . . As industrialization progressed, personal rather than real property came to be the principal repository of wealth. The mortgage on Blackacre would not longer be enough to support the merchant’s insatiable demand for credit and the banker’s demand for security. Nor would the medieval institution of pledge suffice to take up the slack . . . [industrial] property which could not be pledged because it had to be used in the borrower’s business represented a nearly inexhaustible source of prime collateral for loans. The story of how the equipment and the rolling stock and the stock in trade came to be available as collateral is essentially the story of personal property security law in the nineteenth century.95

Yet, while growing industrialization in the 19th century may have sought increasingly efficient methods of creating liquidity, it would appear that commercial finance statutes of that era were anything but simple. First, the recording systems did not, strictly speaking, require notice filing. Rather, being rooted in the real property recordation systems, they usually called for the recording of elaborate documentation, including the filing of the mortgage itself and sometimes ancillary materials, such as affidavits and acknowledgments of good faith and consideration.96 These additional documents were, in Professor Gilmore’s estimation, “self-serving,” and reflected “the deep-rooted nineteenth century suspicion that a [non-possessory] mortgage on personal property was in all probability a species of fraudulent conveyance.”97

Second, because there were several different independent security devices, there were several different independent recording systems.98 Because lenders frequently had to avail themselves of several different forms of security, they would have had to comply with several different filing systems. While this would presumably have increased the incidence of innocent mistakes, it is not clear that

95 See Gilmore, supra note [], at § 2.1, p. 25. Of course, Professor Gilmore also observes that the same pressures that led to a wide variety of complex alternatives to the pledge were not replicated in England, where commercial needs were addressed “in an altogether simpler fashion.” Id.

96 See, e.g., Coogan, supra note [], at 291; Gilmore, supra note [], at § 15.2, p. 466.

97 Gilmore, supra note [], at § 15.2, p. 466.

98 See Gilmore, supra note [], at § 15.1, p. 463 (“The typical pre-Code pattern included separate filing systems for chattel mortgages, for conditional sales, for trust receipts, for factor’s liens, and for assignments of accounts receivable.”).
it resulted in more or (more importantly) better information on which creditors and other investors could rely.

This tendency to confuse quantity of information with quality persisted into the early 20th century, reaching an apex of sorts with the enactment of the factors’ lien acts. These acts often required both notice filing and the posting of signs on debtors’ doors. The prototype for this sort of law was the New York Factors’ Lien Act,\textsuperscript{99} enacted after some political skirmishing in 1911.\textsuperscript{100} As enacted, the bill provided that --

Liens upon merchandise or the proceeds thereof created by agreement for the purpose of securing the repayment of loans…made upon the security of said merchandise …shall not be void or presumed to be fraudulent or void as against creditors or otherwise, by reason of want of delivery to or possession on the part of the lienor, whether such merchandise shall be in existence at the time of the creation of the lien or shall come into existence subsequently thereto…provided there shall be placed and maintained in a conspicuous place at the entrance of every building…at which such merchandise…shall be located…a sign on which is printed…the name of the lienor and…provided further that a notice of the lien is filed…\textsuperscript{101}

Duplicative notice – filed and posted – was justified on informational grounds. Assemblyman (later Governor) Alfred E. Smith argued in support of the Factors’ Lien Act that “[a]ll that the bill does is to substitute public notice for actual possession of the goods.”\textsuperscript{102} Notice – by filing and sign-posting -- was, in Smith’s words, “a form of constructive possession of the goods.”\textsuperscript{103} If one believed that


\textsuperscript{100} The Factors’ Lien Act was initially vetoed in the year that it was introduced in New York (1910). \textit{See} Robert M. Zinman, \textit{Dominion and the Factor’s Lien: Does Section 45 of the New York Personal Property Law Abrogate the “Dominion Rule”?}, 30 Fordham L. Rev. 59, 70 (1961). The history of the initial veto and subsequent modification and enactment of the Factors Lien Act is somewhat confused. Peter Coogan indicates that Hughes vetoed the legislation because it lacked a provision requiring sign posting. Coogan \textit{supra} note [], at 294, n 8. Professor Zinman and several other authors he cites suggest that the Act originally contained only the sign-posting requirement, and not the additional requirement of notice-filing. \textit{See} Zinman \textit{supra}. The weight of authority would appear to be on Professor Zinman’s side. In any case, the important point is not the legislative history of the Act, but as discussed throughout this article, the role that public notice played in its enactment (or not). I should note, however, that sign-posting as a particular method of rendering security interests enforceable was for a brief period popular with state legislatures, and then flamed out. Problems with sign-posting and the factors’ liens acts in general are discussed in a symposium issues of Law and Contemporary Problems. \textit{See} 13 Law and Contemp. Prob. [] (1948).

\textsuperscript{101} N.Y. Sess. Laws 1911, ch. 326, § 1.

\textsuperscript{102} Zinman, \textit{supra} note [], at 70 (citations omitted)

\textsuperscript{103} Zinman, \textit{supra} note [], at 70.
possession was a meaningful method of conveying information about property, one might then accept the idea that notice-filing was at least as effective.¹⁰⁴

Factoring is a good example of how notice-filing became proxy for information that a community might otherwise have generated about a debtor’s property. Factoring began as a form of consignment sales transaction:¹⁰⁵ remote manufacturers (often garment makers) would deliver goods to factors in the cities, who would sell the goods and remit proceeds to the manufacturer.¹⁰⁶ So long as the factor had possession, it appears that the factor also had a lien.¹⁰⁷ Problems arose for factors, however, when the manufacturers began to retain possession of their finished goods in warehouses they owned or leased in the sales markets, while factors continued to provide financing, principally by purchasing the receivables that would be generated when the merchandise was sold.¹⁰⁸ Without possession of the goods, the factor would lose its common law lien.

Because these transactions were not covered by the recording statutes then in force, the parties had to develop some way to establish the factor’s nonpossessory lien on the manufacturer’s goods in the event the manufacturer went bankrupt. The method chosen by the community of factors and merchants was “sign posting.” For example, in Ryttenberg v. Shefer,¹⁰⁹ a case that arose before enactment of the New York Act, the parties assigned the manufacturer’s warehouse lease to the factor, and a sign was posted at the entrance to the storage floor, indicating that the premises had been “annexed” to the factor.¹¹⁰ Despite expert testimony to the effect that this was the industry’s way of giving public notice of a factor’s lien, the court concluded there that the sign was “indecisive”

¹⁰⁴ It should be noted that not everyone shares this belief. See, e.g., Phillips, supra note [], at 6 (“By providing generally for possession either to constitute the exclusive or preferred means of perfection or to alternate with filing, Article 9 follows the premise that possession satisfies the function of perfection. [Yet] possession both fails to satisfy the equitable basis for the preferential effects of perfection and imposes costs....”).

¹⁰⁵ See Herbert R. Silverman, Factoring: Its Legal Aspects and Justifications, 13 LAW & CONTEM. PROB. 593 (1948). Silverman has suggested that, broadly understood, factoring well preceded the law of the United States, and was apparently part of Roman commerce. See Silverman, supra at 593.

¹⁰⁶ See Silverman, supra note [] at 593. Factors differed from brokers because the factor was said to be entrusted with the merchandise, and would apparently absorb the loss in the event the customer ultimately failed to pay. Id. at 593 (citing Parsons on Contract 100 (5th ed. 1905).

¹⁰⁷ See Zinman, supra note [], at 65 (citations omitted). See also Kruger v. Wilcox, Ambler 252, 27 Eng. Rep. 168 (Ch. 1755) (holding at common law that factor had a general lien on the goods and products of his principal in the factor’s possession). The common-law possessory lien was later enacted by the New York Legislature as N.Y. Sess. Laws 1830, ch. 179.

¹⁰⁸ Zinman, supra note [] at 66-67.

¹⁰⁹ 131 Fed. 313 (1904)

¹¹⁰ 131 Fed., at 320. The sign stated “Shefer, Schramm & Vogel, Annex.” Shefer was the factor. Id.
because the premises did not in substance belong to the factor, and the factor could therefore have been barred by injunction from the premises. 111

Cases like Ryttenberg called for a legislative response, which came in the form of the New York Factors’ Lien Act. As noted above, New York may have been willing to permit factors to retain nonpossessory liens on merchants’ inventory, but only if public notice of the interest was given. Sign posting was one way this notice was to be given. Yet sign-posting was not, by itself, apparently sufficient notice of the property interest in question. As originally proposed, the New York act required only sign posting, and not the additional step of notice-filing. For this reason, Charles Evans Hughes, then-governor of New York, 112 vetoed it in 1910. Without notice-filing, he said, the Act “‘would . . . facilitate secret liens and fraudulent transactions.”113 Once notice filing was added, Hughes signed the bill into law.

Sign-posting as required by the Factor’s Lien Act would have a short-shelf life as a method of conveying property information in commercial finance transactions. In 1954, New York amended the Factor’s Lien Act to eliminate the sign-posting requirement.114 The reasons for eliminating sign-posting would sound familiar to us, today. The proponent of the amendment, Assemblyman Stanley Steingut, argued that sign-posting was “completely old-fashioned, in that it presupposed that credit grantors make a personal examination of the premises of the credit seeker. As a matter of fact, credit grantors rely upon financial statements and upon credit reports issued by . . . credit agencies . . . .”115

This suggests that community norms about the generation of information have historically been important in deciding what information should be conveyed, and how. While sign-posting may at one time have conveyed important signals about relationships between things and people, it became increasingly clear that the sign told the community little of value. The sign became, in Professor Zinman’s words, a “superfluous nuisance.”116 Worse, while it may have provided little useful information to the merchant community, it did give information to others who may have had no legitimate reason to know about the debtor’s finances, such as customers, competitors and employees. And, of course, there was always the possibility that the unscrupulous debtor might remove the sign on the eve of bankruptcy, thereby exposing the lender to the risk that it would effectively lose its entire property interest. The sign, like possession before it, impeded the development of richer, and more complex, commercial relationships.

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111 Id.
113 See Silverman, supra note [], at 599 (quoting statement of Hughes) (citations omitted).
115 Zinman, supra note [], at 83, n. 117.
116 Zinman, supra note [], at 83.
(b) Notice-filing

While sign-posting may have withered away, notice-filing survived. Indeed, it flourished, and continued to abstract away from the real property recordation model which preceded it. The Uniform Trust Receipts Act, promulgated in 1933, “popularized the idea that for certain kinds of transactions,” such as those involving inventory or accounts receivable, “it is not essential for all of the details of the transaction to be spread upon the public record so long as the record gives an indication where an interested party might inquire to learn whether or not particular collateral of the indicated class or type is subject to the perfected security interest.”

The drafters of the U.C.C. picked up on this theme. Until recently, notice filing was the dominant means of rendering a nonpossessory security interest in personal property enforceable against third parties. While highly important transactions and types of collateral are effectively exempt from notice-filing, giving notice remains an important method for perfecting a security interest.

Today, if notice is required at all, it will be given in one of two general ways. If some registry already exists with respect to the type of property in question, Article 9 “steps back” to require that notice of the security interest in that type of property be perfected by giving notice in the existing registry. But where another registry does

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117 Coogan, supra note [], at 314-15. The Uniform Trust Receipts Act, promulgated by the National Conference of Commissioners on Uniform State Laws in 1933, permitted the filing of a “statement of trust receipt financing” of the following form:

The entruster, .............................................................. whose chief place of business within this state is at ............................................................................................ or who has no place of business within this state and whose chief place of business outside this state is at..................................................... ..................................

is or expects to be engaged in financing under trust receipt transactions the acquisition by the trustee, ................................................................................. whose chief place of business within this state is at....................................................... of goods of the following description:

[coffee, silk, automobiles, or the like.]

[Signed] Entruster

[Signed] Trustee


This form can be seen as an ur-UCC-1, a simple notice of the pre-UCC equivalent of the nonpossessory security interest.

118 See Gilmore, supra note [], at § 15.1, p. 463 (“As nonpossessory security interests become more familiar, filing comes to be looked on not merely as an alternative to possession but as the exclusive method of perfection.”). See also William C. Hillman, What’s in a Name: The U.C.C. Filing System in the Courts, 45 OKLA L. REV. 151 (1991) (“the primary method of perfection [under former Article 9 was] by the filing of a financing statement”). The rules on notice in prerevision Article 9 appeared principally in U.C.C. §§ 9-401 – 9-407 (2000).

119 See U.C.C § 9-310(a).

120 See UCC §§ 9-311(a)(1); 9-310(a). UCC § 9-311 provides that a financing statement is not effective to perfect a security interest in property subject to “a statute, regulation, or treaty of the United States whose requirements for a security interest’s obtaining priority over the rights of a
The End of Notice

not exist – and that may well be true much of the time – the security interest will be perfected by filing a UCC-1 financing statement in the state of the debtor’s location.\textsuperscript{121}

The UCC-1 is – as set forth in Annex A – a simple form (paper or electronic) that sets forth the debtor’s name, the secured party’s name, and a brief description of the property subject to the security interest.\textsuperscript{122} The financing statement may also set forth certain other items of information about the debtor, including its organizational type and identification number (if any) and its address.\textsuperscript{123}

The financing statement system may thus be seen as an articulation of the link between property rights and notice obligation that arises when other means of gathering information about a debtor (e.g., its community) are unavailing. As Baird and Jackson have observed “[notice filing systems work because the legal rules provide not only a benefit to a person who desires to acquire a property right but also a corresponding responsibility. One is obliged to stake one’s claim in the lien creditor with respect to the property,” preempts the general rule contained in section 9-310 that a financing statement must be filed to perfect a security interest.

The Official Comment to U.C.C. § 9-311(a) explains that an example of such a statute is 49 U.S.C. § 44107, for civil aircraft. Section 44107 establishes “a system for recording (1) conveyances that affect an interest in civil aircraft of the United States” including “leases and instruments executed for security purposes, including conditional sales contracts, assignments, and amendments.” 49 U.S.C. § 44107(a) (1994). Section 44108 sets forth a limited rule of priority, providing that until recorded under § 44107, a security interest in civil aircraft “is valid only against—(1) the person making the conveyance, lease, or instrument; (2) that person’s heirs and devisees; and (3) a person having actual notice of the conveyance, lease, or instrument.” Id. § 44108. Although “no conveyance or instrument affecting the title to any civil aircraft is valid against third parties without notice of the sale until such conveyance or instrument is filed for recordation with the F.A.A.,” Air Vt., Inc. v. Beech Acceptance Corp. (\textit{In re} Air Vt., Inc.), 44 B.R. 433, 437-38 (Bankr. D. Vt 1984) (citing South Shore Bank v. Tony Mat., Inc., 712 F.2d 896, 897 (3d Cir. 1983)), Article 9 has nevertheless been used as a gap filler. \textit{See id.} at 436-37 (applying buyer in ordinary course rules of F. § 9-307 to sale of federally-titled civilian aircraft); \textit{see also} Pers. Jet, Inc. v. Callihan, 624 F.2d 562 (5th Cir. 1980) (applying Former Article 9 to fill void in Federal Aviation Act). Other federal statutes that might preempt Article 9’s filing system include the Ship Mortgage Act, and federal law governing security interests in rolling stock 49 U.S.C. § 11301(a) (1994). \textit{See Drabkin v. Cont’l Ill. Bank & Trust Co. (\textit{In re} Auto Train Corp.), 9 B.R. 207 (Bankr. D. D.C. 1981).

An especially important category of collateral here will be copyright, and perhaps other types of intellectual property. \textit{See also} Jonathan C. Lipson, \textit{Remote Control: Revised Article 9 and the Negotiability of Information}, 63 OHIO ST. L. J 1327 (2002) [hereinafter, “Lipson \textit{Remote Control}”]; Jonathan Lipson, \textit{Financing Information Technologies: Fairness and Function}, 2001 WIS. L. REV. 1067, 1104-1122 [hereinafter “Lipson, \textit{Information Technologies}”]. As discussed below, the recent decision in \textit{World Auxiliary Power} provides some clarity about the scope of federal law in this context, but may also create other problems. \textit{[CITE AND CROSS REFERENCE]}

\textsuperscript{121} U.C.C. §§ 9-301, 9-307, 9-310 & 9-501. Generally speaking, a corporate (or other “registered organization” debtor will be “located” in its state of formation (e.g., a Delaware corporation is located in Delaware, even if it has no physical presence in that state). \textit{See generally} Lynn M. LoPucki, \textit{The Article 9 Filing System: Why the Debtor’s State of Incorporation Should be the Proper Place for Article 9 Filing: A Systems Analysis}, 79 MINN. L. REV. 577 (1995).

\textsuperscript{122} U.C.C. §§ 9-503 & 9-521.

\textsuperscript{123} U.C.C. § 9-516(b).
filing system so that future parties will be able to find it.”124

Ironically, it appears that the true force of notice-filing has come not from its informational value but from the penalty that would befall the secured creditor whose notice was defective. When a debtor entered bankruptcy, a trustee could exploit these errors and avoid transactions in which notice was flawed. This power, sometimes called the “strong-arm power” was needed, Congress indicated, “to prevent the evil of secret liens.”125 In 1910, Congress amended the Bankruptcy Act then in force to expand the bankruptcy trustee’s avoidance powers.126 Congress was concerned that cases like York Mfg v. Cassell127 paralyzed bankruptcy trustees trying to recapture for the estate property that had been conditionally assigned in unrecorded transactions.128 In response to York Congress amended the Bankruptcy Act to provide that bankruptcy trustees “shall be deemed vested with all the rights, remedies, and powers of a creditor holding a lien by legal or equitable proceedings . . . .”129 Congress reasoned that an “unrecorded instrument [of conveyances] . . . which would have been void in the state courts had the property been . . . . levied upon by attachment or execution from a state court” should be ineffective (“void”) as against a bankruptcy trustee.130

Eradicating secret liens remains the goal of the strong-arm power. Thus, the 1973 Report of the Commission on Bankruptcy Laws of the United States, which led ultimately to the current Bankruptcy Code, observed that “[o]ne of the essential features of any bankruptcy law is the inclusion of provisions designed to invalidate secret transfers made by the bankruptcy prior to the date of the filing of petition.”131 Although the Bankruptcy Code has been through several major revisions since the early part of the 20th century, the strong-arm power remains essentially intact, and is today found in section 544(a)(1).132

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124 Baird and Jackson, Uncertainty, supra note 19, at p. 312.
125 45 Cong. Rec. 2275 (1910).
127 201 U.S. 344 (1906).
128 Id. at 352. The Court reasoned in York Mfg that because the bankruptcy trustee “stands simply in the shoes of the bankrupt . . . . he has no greater right than the bankrupt.” Id. Having no greater rights in the machinery that was conditionally assigned to the “unperfected” seller in that case, the trustee was unable to recover the property for the benefit of the debtor’s other creditors. Id. at 353.
130 45 Cong. Rec. 2271 (1910).
132 See 11 U.S.C. § 544(a)(1). Section 544(a)(3) gives the bankruptcy trustee the rights and powers of “a bona fide purchaser of real property . . . . from the debtor, against whom applicable law permits such transfer to be perfected.” 11 U.S.C. § 544(a)(3). This section differs from 544(a)(1) in several respects, including that it implies in law that the trustee has the rights of a “bona fide purchaser.” Ordinarily, lien creditors (i.e., the bankruptcy trustee under section 544(a)(1)) are not “bona fide purchasers.” See, e.g., Rev. § 1-201(32) (defining “purchase” so to exclude “involuntary” conveyances).
If deterring the creation of secret interests in a debtor’s property was the purpose of the strong-arm power, one might think that merely technical failures in notice, which did not meaningfully impair the quality of the notice actually given, would not expose the transaction to avoidance. That is, to the extent that notice was actually given, the transaction should be good against the bankruptcy trustee, since the transaction was no longer “secret.”

That, however, is not the way avoidance law developed. Case law under the strong-arm power is replete with instances of secured parties losing their security interests for reasons that appear, in retrospect, to have been nit-picky, at best, and capricious at worst.133 Initially, it was thought that these injustices could be attributed to the arcane statutes that governed secured transactions prior to general enactment of the U.C.C.134 The great formalities that attended pre-code law created ample opportunities for aggressive trustee’s counsel.135 Yet, it remains clear that even under the U.C.C., trustee’s counsel has been able to exploit seemingly innocuous footfaults in the notice given. Mistakes in the debtor’s name,136 descriptions of collateral137 or the place of filing138 have all been used against the secured party.

133 See White, Wasteful Litigation supra note [] at [] (collecting cases); Lipson, Information Technology supra note 120.

134 See Coogan, supra note [], at 319 (“The secured party has had a rough time with the filing systems of pre-Code chattel security law. Decision after decision, to say nothing of the statutes themselves, has disregarded the real function of a filing or recording system—namely, to give notice to other creditors of the actual or possible existence of security interests in property which appears to be owned by the debtor.”). See generally David Gray Carlson, Debt Collection as Rent Seeking, 79 MINN. L. REV. 817, 834(“It cannot be denied . . . that debtor’s counsel and bankruptcy judges exult in hanging a secured creditor out to dry for the most inconsequential mistakes.”)

135 Some of the older cases are collected by Coogan, supra note [], at 291, note [], and include In re Urban, 136 F.2d 296 (7th Cir. 1943) (absence of affidavit); In re International Harvester Co., 9 F.2d 299 (6th Cir. 1925) (copy of affidavit not sufficient); In re Leven, 42 F. Supp. 484 (D. Md. 1941) (affiant failed disclose agency status); Sickinger v. Zimel, 6 N.J. 149, 77 A.2d 905 (1951) (false recital of consideration); In re Holley, 25 F.2d 979 (N.D. Iowa 1928) (failure to disclose title of subscribing notary); Amberson Inv. Corp. v. Fitzgerald, 266 F.2d 767 (10th Cir. 1959) (recorded mortgage failed to recite maturity date of secured note); In re Production Aids Co., 193 F. Supp. 180, 185 (S.D. Iowa 1961) (failure to indicate corporate authority to sign); Nordman v. Rau, 86 Kan. 19, 119 Pac. 351 (1911) Rhode Island Hosp. Nat’l Bank v. Larson, 137 Conn. 541, 79 A.2d 182 (1951) (failure to specify day when monthly payments were due).


137 In re K.L. Smith Enters., Ltd., 2 Bankr. 280 (Bankr. D. Colo. 1980) (laying hens were “livestock,” not “equipment” or “inventory”); See also In re Northeast Chick Serv., Inc., 43 Bankr. 326 (Bankr. D. Mass. 1984) (chickens were “farm products” not “inventory”).

138 Perhaps the leading candidate here is In re Peregrine Entm’l, Ltd., 116 B.R. 194 (Bankr. C.D. Cal. 1990), which held that, even though the secured party filed effective UCC-1 financing statements, its security interest in the debtor’s library of copyrighted films and the proceeds from those films (royalties) was not perfected because not recorded in the Copyright Office. See
It is not clear how these uses of the strong-arm power support the informational goals of notice-filing. If, as may well have been true in many of these cases, the community of creditors knew or had reason to know that the debtor’s property was encumbered, it is not clear that a minor error in the debtor’s name or collateral description created a secret lien, perpetrated a fraud, or otherwise violated norms of the applicable merchant community. It may be that the strong-arm power is a necessary evil, exerting *in terrorem* force over creditors, compelling them (as the Clow court suggested) to “leave nothing unperformed, within the compass of their power, to secure third persons from the consequences of the apparent ownership of the vendor.”\(^{139}\) But simply asking lenders to do more does not necessarily assure that the community of creditors will have a meaningful understanding of what the debtor has.

As discussed in the next two sections, the legislative response is not likely to produce more or better information. Rather, we have seen increasingly sophisticated attempts to exempt transactions from the obligation to give notice at all. Sometimes, as with data and intellectual property, the exemptions will be an inadvertent byproduct of the unusual interactions of new technologies and old rules. In other cases, however, it is clear that those who draft commercial finance legislation seek affirmatively to undermine the role of notice-filing.

II. The End of Notice-filing – Three Secret Liens

While the intuitive link between property rights and notice obligations enjoys both theoretical and historical support, it would appear that commercial finance law has other ideas. Although revised Article 9 of the U.C.C. continues to require notice-filing in a broad range of transactions, notice-filing will, as discussed below, often have little effect in transactions involving increasingly important collateral, such as data, intellectual property and bank and brokerage accounts. Moreover, securitization “facilitation” statutes have the potential to render notice-filing entirely optional. This section summarizes how recent legislative developments tolerate, if not promote, the creation of secret liens.

A. Security Interests in Data and Intellectual Property – Rules on Proceeds and Continuity of Interest

A shallow reading of Article 9 of the U.C.C. might lead to the conclusion that secret liens will be a rarity. U.C.C. § 9-310(a) provides that perfection of a security interest presumptively requires the filing of a financing statement.\(^{140}\) U.C.C. § 9-310(b)(9), however, contains an important exception for security interests in “proceeds.” Because revised Article 9 has greatly expanded the definition of proceeds,\(^{141}\) its rules will often (unwittingly) create secret liens on data

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\(^{139}\) Clow v. Woods, 5 Serb. & Rawle, at 282 (Gibson, J.) (emphasis in original).

\(^{140}\) U.C.C. § 9-310(a) (“Except as otherwise provided in subsection (b) and Section 9-312(b), a financing statement must be filed to perfect all security interests . . . ”).

\(^{141}\) Comment 13 to section 9-102 explains that “[t]he revised definition of ‘proceeds’ expands the
and intellectual property.  

A “proceeds” security interest arises in at least three ways that might create secret liens. First, revised section 9-102(a)(64)(A) defines proceeds as including, among other things, “whatever is acquired upon the . . . license . . . of collateral.” This means that licenses of a copyright or patent, for example, should be “proceeds” of the original collateral. Second, revised section 9-102(a)(64)(A) provides that the secured party may pursue proceeds in the hands of parties other than the debtor. This means that, unless a license is “ordinary course” (non-exclusive), the security interest continues even as to third party licensees, sub-licensees, and so on.

Third, revised section 9-102(a)(64)(C) provides that proceeds include “rights arising out of collateral.” This cryptic phrase is not explained in the Official Comment. It may, however, be quite expansive and pick up all kinds of rights associated with original collateral, including intangible rights in technologies and data associated with original collateral. I have argued elsewhere that this should mean that a patent is proceeds of a trade secret, and a derivative work under the Copyright Act is proceeds of a security interest in a copyright. In both cases, the later rights “arise out of” the earlier rights. This is one reason security interests in data and intellectual property will arise secretly. It is highly unlikely that a debtor granting a security interest in one copyright understands that it is, as a matter of law, also


See generally Lipson, Remote Control supra note 120 (discussing affect of rules on proceeds and continuity of interest on intellectual property and data).


Compare In re Transp. Design and Tech., Inc., 48 B.R. at 640 (declining to treat patent as proceeds of patent application under former Article 9), with Lipson, Information Technologies, supra note 120, at 1135–36 (questioning continued viability of Transportation Design rule in light of revised Article 9).

Courts applying former Article 9 had come to this conclusion. See, e.g., Centerre Bank, N.A. v. New Holland Div. of Sperry Corp., 832 F.2d 1415 (7th Cir. 1987); In re Guaranteed Muffler Supply Co., 27 U.C.C. Rep. Serv. (CBC) 1217 (Bankr. N.D. Ga. 1979); Eastern Idaho Prod. Credit Ass’n v. Idaho Gem, Inc., 842 P.2d 282 (Idaho 1992); First State Bank v. Clark, 635 N.W.2d 29 (Iowa 2001). There was, however, a split of authority on the issue. See First State Bank, 635 N.W.2d at 30 (discussing split). The Official Comment now emphasizes the point: “This Article contains no requirement that property ‘be received’ by the debtor for the property to qualify as proceeds.” U.C.C. § 9-102 cmt. 13(d) (2001).

Article 9 provides that, as a general matter, security interests continue in collateral notwithstanding sale, exchange or other disposition. U.C.C. § 9-315(a)(1). Security interests will be cut off, however, if such a transaction is in “ordinary course.” U.C.C §§ 9-320 (ordinary course disposition of goods) & 9-321 (ordinary course license of general intangibles). A license will only be “ordinary course” if, among other things, it is “non-exclusive” and in the ordinary course of the licensor’s business. See U.C.C. § 9-321(a). See generally Lipson, Remote Control, supra note 120 (discussing continuity of interest rules).

Id. § 9-102(a)(64)(C) (2001).

See Lipson, Information Technologies, supra note 87, at 1132–38.

Id.
granting a security interest in all derivative works it later produces.  

The rules on the perfection of security interests in proceeds are complex, but the basic idea is that the security interest in proceeds will be perfected if the security interest in the original collateral was perfected\(^{151}\) and any one of three things is true: (i) the financing statement that was filed to cover the original collateral does (or could) cover the proceeds, (ii) the proceeds are cash or cash equivalents, or (iii) the security interest in the proceeds becomes perfected in some other way.\(^{152}\) It will be fairly easy to satisfy at least one of these requirements, especially when the collateral is data or intellectual property.\(^{153}\) But satisfying these requirements does not necessarily mean that anyone is likely to know anything about the proceeds security interest.

Consider an example. Assume that D is an internet retailer of toys. D finances its inventory with money borrowed from SP. SP takes a security interest in D’s inventory, which SP perfects by filing a financing statement indicating a security interest in “inventory.” Assume further, as is often the case, that when D sells toys in the ordinary course, it collects spending, demographic and similar information about its customers. Finally, assume that D sells or licenses its list of customer information to a data aggregator, (B/L).

Presumably, B/L would believe that it was acquiring its interest in this customer data free of the property claims of others. Even if B/L was highly diligent, and conducted a lien search, it would only find a financing statement describing a security interest in “inventory” not “data” (or “general intangibles,” the UCC label most likely to cover customer data).\(^{154}\) But SP would have a perfected security interest in this data, because it is proceeds of the debtor’s inventory, and there is no “good faith purchaser” rule that would apply to cut off SP’s security interest.\(^{155}\) And, if B/L sold or licensed this list to others – even

\(^{150}\) Of course, to the extent the debtor simply granted a security interest in “general intangibles,” all copyrights would be covered, whether or not derivative works. Moreover, as discussed in note 168 supra, the instability of the rules on perfecting security interests in intellectual property may provide some cover for debtors who unwittingly grant security interests in derivative works. The security interest may attach automatically, by virtue of the proceeds rules, but would have little practical force if not perfected.

\(^{151}\) U.C.C. § 9-315(c).

\(^{152}\) U.C.C. § 9-315(d).

\(^{153}\) Usually, it will be satisfied by the first alternative because data and intellectual property are general intangibles in which a security interest could be perfected by the filing of a financing statement. See U.C.C. §§ 9-310(a) & 9-315(d)(1)(2001).

\(^{154}\) See U.C.C. 9-102(a)(42)(defining general intangibles). See also Lipson, Information Technologies, supra note 120, at [] (discussing data as general intangibles under UCC).

\(^{155}\) See U.C.C 9-321 (2001). This section provides that a “licensee in ordinary course of business takes its rights under a nonexclusive license free of a security interest in the general intangible created by the licensor, even if the security interest is perfected and the licensee knows of its existence.” A “licensee in ordinary course of business” is defined as “a person that becomes a licensee of a general intangible in good faith, without knowledge that the license violates the rights of another person in the general intangible, and in the ordinary course from a person in the
with D’s permission – the party that acquired the data from B/L (B/L2) would
take the data subject to the same encumbrance. Here, it is virtually inconceivable
that B/L2 would be able to discover SP’s security interest, assuming B/L2 even
thought to look for it. It is not clear how the UCC-1 filed by SP as to D would put
B/L or B/L2 on notice of anything. A clean record as to B/L2 would be false –
SP’s secret lien would survive, and would be enforceable against B/L2.

The full magnitude of this problem is difficult to gauge. In theory, of course,
it should mean that most data in the computers of most businesses is encumbered
in ways (and by parties) not anticipated by the owners (or users) of the data. That
said, should SP actually show up and claim the right to freeze or seize B/L2’s
computer, B/L2 may be able to argue that the data is not “property,” in which case
no security interest would be possible. This argument seems a bit recondite
and implausible, since B/L2 probably treats the data as it would treat its other
valuable property. In any case, the jury is out on the question whether data is
property for these purposes.

A better argument might be one of impossibility. SP may have a security
interest in the data, but, B/L2 would argue, so too would a large number of
unnamed, unidentified secured parties, whose proceeds security interests all arose
in more or less the same way. The data may, in other words, be so fully
cumbered that no one could sort out the real rights in it. An “anti-commons”
would infect the data like a regenerating computer virus. Observe, however,
that these arguments, whatever their merits, do not come from Article 9. B/L2
wins only if Article 9 is somehow neutralized.

What if the problem involved intellectual property, rather than data? Assume,
for example, that D developed a data management software program which it
licensed to B/L. Assume further that the security agreement with SP includes
general intangibles, the category that would most likely describe intellectual
property. The software would be subject to the U.S. Copyright Act which would,
for certain purposes, preempt Article 9. Until recently, there was some reason
to believe that the Copyright Act preempted all of Article 9’s rules on the
perfection of security interests. If so, B/L might have argued that unless the
security interest was actually recorded in the Copyright Office, the security

business of licensing general intangibles of that kind.” Id. § 9-321(a). See also Lipson,
Information Technology, supra note 120.

156 See Lipson, Remote Control, supra note 120, at 1350-1356.
159 See Lipson, Information Technology, supra note 120, at 1107.
160 See Lipson, Information Technology, supra note 120, at 1107-1114 (discussing preemptive force of Copyright Act).
interest would have been unperfected. If unperfected (because undiscoverable in
the copyright records), then B/L’s rights would have had priority over SP under
most circumstances.

Recent case law suggests that preemption will no longer protect the B/L’s of
the world if the underlying copyright is not registered. In In re World Auxiliary
Power, the debtor had granted security interests in certain unregistered copyrights.
The bank filed UCC-1 financing statements as required by the U.C.C., but did not
record the security interest with the United States Copyright Office (the
"Copyright Office"). The debtor’s bankruptcy trustee attempted to sell the
copyrights free of the bank’s security interests, but the bankruptcy court sustained
the banks’ objections, finding that the bank perfected its security interest in
unregistered copyrights by filing and recording its security interest in accordance
with Article 9 of the Uniform Commercial Code. The Ninth Circuit affirmed and
held that federal copyright law does not preempt state law with respect to
perfection and priority of security interests in unregistered copyrights. “There is
no reason to infer from Congress’s silence as to unregistered copyrights,” the
court wrote, “an intent to make such copyrights useless as collateral by
preempting state law but not providing any federal priority scheme for
unregistered copyrights. That would amount to a presumption in favor of federal
preemption, but we are required to presume just the opposite”.

Recording copyrights and registering security interests in them would
undoubtedly be a cumbersome, expensive and time-consuming proposition, one
which I have certainly not advocated. Nevertheless, it is important to see that
whenever a security interest arises in a copyright, it will automatically arise in a
license of that copyright. World Auxiliary Power makes it easier to perfect the
security interest in both the original copyright and the license. If the license is not
ordinary course, the security interest will continue and the licensee may have no
idea that it is taking its license subject to the prior interest of the licensor’s bank.
As with data, the problem grows as intellectual property is sublicensed and
subdivided, moving further and further away from the parties that initially created
the encumbrance. While sublicensees may take subject to the security interest, it
will (like all secret liens) be difficult to discover ex ante.

The bottom line, then, is that whole categories of increasingly important assets
may be encumbered by secret liens. It should be noted that revised Article 9 is
not entirely responsible for this state of affairs. Even prior iterations, which might
have required notice more of the time, tolerated remote proceeds security
interests, which effectively create secret liens. Rather, the problems arise from

161 In re World Auxiliary Power Company, 303 F.3d 1120 (9th Cir. 2002).
162 303 F.3d at 1131 (citations omitted).
163 See Lipson, Information Technologies, supra note 120.
164 Professor LoPucki catalogued ways that a debtor so inclined could fool creditors by secretly
encumbering property while still complying with the prior (more notice-friendly) version of
Article 9. See Lynn M. LoPucki, Computerization of the Article 9 Filing System: Thoughts on
expanding the definition of proceeds to capture property that happens to be unusually mobile and mutable. Together these developments insure a much larger universe of secret liens than we would intuitively expect commercial finance law to tolerate.

B. Control Security Interests

A second source of secret liens will arise by virtue of new rules on the creation of “control” security interests in bank and brokerage accounts. One of Revised Article 9’s major changes from prior law involves the use of control as a means of creating and perfecting a security interest. Generally speaking, a secured party will have control of certain types of collateral – deposit accounts, investment property, electronic chattel paper or letter-of-credit rights – if the secured party has the right to dispose of the property in question. Because control arises solely by operation of law or contract, notice filing is either not required or not permitted.

Although the statute does not make this distinction, there would appear to be two different kinds of control, bilateral and trilateral. Bilateral control involves two parties, such as, a bank and a depositor/borrower. U.C.C. § 9-104 automatically gives the secured party that is also a debtor’s depositary bank a security interest in the account in question. Because security interests in deposit accounts as original collateral (not proceeds) may only be perfected by control, the bank need not give notice of its security interest in the bank account.

Bilateral control has much in common with the right of set-off. Set-off says that a creditor may apply amounts it owes to a debtor to reduce the debtor’s obligation to the creditor. The classic examples involved bank accounts held at banks that also made loans to the borrower. Because a deposit account is simply a debt the bank owes the depositor, set-off permits the bank to apply the amount credited to the account (meaning owning to the debtor) against any amounts the debtor owes the creditor (meaning the loan the debtor is obligated to pay the secured party). Although the UCC does not generally govern the right of set off, the right has often been characterized as a kind of equitable security interest.


166 As to deposit accounts, filing was apparently considered and rejected early in the process of revising Article 9. See Markell, supra note [], at 983 (citing PERMANENT EDITORIAL BD. FOR THE UNIF. COMMERCIAL CODE, PEB STUDY GROUP UNIFORM COMMERCIAL CODE ARTICLE 9: REPORT 70 (1992)).

167 See In re Communication Dynamics, Inc., 300 B.R. 220, 223 (Bankr. D. Del. 2003) (“In essence, the right of setoff ‘elevates an unsecured claim to secured status, to the extent that the debtor has a mutual, prepetition claim against the creditor.’”) (quoting University Med. Ctr. v. Sullivan (In re University Med. Ctr.), 973 F.2d 1065, 1079 (3d Cir. 1992)).

Former U.C.C. § 9-104 declared the article to be inapplicable “to any right of setoff.” However, rights of setoff are expressly recognized currently at U.C.C. §§ 9-306(d)(i), 9-318(1). Whether a creditor seeking to assert a right of set off must abide by Article 9’s notice-filing rules is somewhat unclear. In In re Apex Oil Co., the court observed that “[w]hile we agree with Artoc that a bank or other creditor need not comply with Article 9 and its filing requirements to exercise its right to setoff, we do believe that Article 9 governs the priority between that right to setoff and a perfected security interest.” In re Apex Oil Co., 975 F.2d 1365, 1368 (1992); aff’d Apex Oil Co.
Bilateral control is distinct from trilateral control. Trilateral control occurs where the secured party is not also the entity that maintains the account. For example, a secured party has control of a deposit account if the depositary bank enters into an agreement (known as a control agreement) with the secured party that the depositary bank will comply with instructions from the secured party as to the funds in the deposit account, without further consent from the debtor.\textsuperscript{168} As with bilateral control, trilateral control arises strictly by contract. Notice-filing is neither permitted nor effective.

Control is justified as a method of perfection as to deposit accounts, brokerage accounts, and so forth because there is assumed to be a kind of community

\textit{v. Artoc Bank & Trust Ltd.}, 265 B.R. 144 (2001). Some opinions holding that Article 9 governs set-off priority have relied on old UCC § 9-312(5), reasoning that a security interest perfected before the exercise of the set-off is entitled to priority over the set-off based on the "first in time, first in right" principle which these courts find to be in § 9-312(5). Whether relying on § 9-201 or § 9-312, the line of authority which gives priority to the secured creditor over the set-off claimant has developed to the point where this view has now been described as the "majority" approach. The "majority" rule gives the priority to the debtor's secured creditor rather than the bank attempting to set-off the account, as long as the secured creditor has a perfected interest in the account as proceeds of collateral.

\textit{Insley Manufacturing Corp. v. Draper Bank & Trust} illustrates the absolute reach of the proceeds interest under this interpretation. \textit{Insley Mfg. Corp. v. Draper Bank and Trust}, 717 P.2d 1341, 1 U.C.C. Rep. Serv. 2d 961 (Utah 1986). There, Insley sold backhoes to Schneider on a secured basis. Its interests extended to proceeds of the backhoes and was perfected by filing. Schneider sold two of the backhoes to O'Brien for $237,918.00, depositing O'Brien's check into its overdrawn bank account at Draper Bank. The bank then set-off against the account for the overdraft owed to it. The court held that old ' 9-201 of the U.C.C. gave Insley the priority claim over the bank. Any other result, it reasoned, would undermine Article 9's reliance on public filing and its repeal of policing requirements in the old ' 9-205. The bank was precluded from arguing that it took free of the security interest as a holder in due course since that argument was not made in the court below.

However, the \textit{Insley} court reasoned that even if this argument could be made, it could only protect the bank in taking the check. Setting off against a deposit credit which was proceeds for the check would not be protected by the holder in due course rule. The \textit{Insley} opinion shows that Courts are attracted to the 'majority' rule, discussed above, because they feel that it is necessary to maintain the Article 9 scheme of priorities. In sum, an unfiled, unsecured bank should not jump ahead of a secured creditor with a filing as to inventory, accounts, chattel paper or other assets of the debtor. Consequently, a bank should file a financing statement when they want to exercise a right of setoff to maintain priority over other secured parties, but don't necessarily have to file to exercise that right. \textit{See also Te Salle, Banker's Right to Setoff}, 34 OKLA. L. REV. 40 (1981). Other decisions holding that Article 9 gives a secured party and automatic victory over a setoff include Credit Alliance Corp. v. National Bank of Georgia N.A., 718 F.Supp. 954, 10 U.C.C. Rep. Serv. 2d 184 (N.D. Ga. 1989); National Acceptance Co. v. Virginia Capital Bank, 498 F. Supp. 1078, 30 U.C.C. Rep. Serve. 1145 (E.D. Va. 1980); Continental Am. Life Ins. Co. v. Griffin, 251 Ga. 412, 306 S.E.2d 285, 36 U.C.C. Rep. Serv. 1737 (1983); Southeastern Fin. Corp. v. National Bank of Detroit, 145 Mich. App. 717, 377 N.W.2d 900, 42 U.C.C. Rep. Serv. 603 (1985); In re Calore Express Co., 199 B.R. 424, 30 U.C.C. Rep. Serv. 2d 421 (Bankr. D. Mass. 1996); Morris Plan Co. v. Broadway Nat'l Bank, 28 U.C.C. Rep. Serv. 1112 (Mo. Ct. App. 1980); Valley Nat'l Bank v. Cotton Growers Hail Ins., Inc., 747 P.2d 1225, 5 U.C.C. Rep. Serv. 2d 735 (Ariz. Ct. App. 1987) (a secured creditor had priority over insurer's set off for unpaid policy premium.).

\textsuperscript{168} Rev. § 9-104(a).
knowledge about the kinds of property in which a security interest may be perfected by control. “No other form of notice is necessary” to perfect a security interest in a deposit account, for example, because “all actual or potential creditors of the debtor are always on notice that the bank with which the debtor’s deposit account is maintained may assert a claim against the deposit account.”

Permitting perfection of a security interest by control therefore represents “a pragmatic judgment” by the drafters of Revised Article 9 that these security interests are, in important respects, “public and unambiguous.”

Where there is “general knowledge” in an industry that certain kinds of property may be held subject to certain kinds of noncustodial claims (e.g., brokers always hold securities subject to the claims of other broker-dealers or lending institutions), it may be appropriate to dispense with public notice-filing. The “community” of banks and brokers knows or assumes that debtors’ deposit and brokerage accounts are likely to be encumbered, so they could not possibly rely to their detriment on a “clean” lien search. There is presumed to be no “secret” because “everyone” knows.

But this begs the question, who is “everyone?” Consider an example. Assume that debtor (D) purchases an item of equipment with purchase-money financing from the vendor (V). Under U.C.C. §§ 9-103, V has a purchase-money security interest in the item of equipment. If V perfects the security interest by filing an effective financing statement when the debtor receives the equipment, or within 20 days thereafter, V would have priority over any competing, prior security interest held by SP. V would also believe that it has priority in the identifiable cash proceeds associated with the equipment. Thus, if D sold the equipment or it was lost or destroyed, V would reasonably suppose that it has a proceeds security interest in whatever was received upon this disposition or loss,

169 U.C.C. § 9-104, cmt 3.

170 Schroeder, Surrealism, supra note [], at 523-24.

171 Cf. Schroeder Surrealism, supra note [], at 522. Of course, on this logic, no filing or other public notice should ever be required, since there is “general knowledge” about the kinds of borrowers that grant security interests in their assets, and what kinds of assets those might be. Professor Schroeder does acknowledge that a security interest, like any interest in property, must involve public recognition of the interest. Using a Hegelian analysis, she suggests that property “involves the publicly recognizable identification of a specific object to a specific legal subject with some rights to control, and exclude others from, the object.” Schroeder, Surrealism, supra at 527 (citing, among other things, G.W.F. Hegel. Elements of a Philosophy of Right §§ 52-53 & 58 (Allen W. Wood ed. & H.B. Nisbet trans., 1991). Although she appears to support control as a method of perfection, it is not clear how that method would be “publicly recognizable,” except among the parties to the contract.

172 U.C.C. § 9-324(a) provides that “a perfected purchase-money security interest in [equipment] has priority over a conflicting security interest in the same goods, and, except as provided in Section 9-327, a perfected security interest in its identifiable proceeds also has priority, if the purchase-money security interest was perfected when the debtor receives possession of the collateral or within 20 days thereafter.”

173 Id.
such as the purchase price D received or insurance payable with respect to the equipment.\textsuperscript{174}

V might also reasonably expect that it has priority in these proceeds. But V is likely to be wrong. \textsuperscript{175} 9-324(a) provides that the purchase-money priority in proceeds is subject to Section 9-327, which sets forth the rules on the priority of control security interests. If the cash proceeds from the sale or loss of the equipment were deposited in a bank account maintained by D, there is no easy way that V can be sure that the bank that maintains D’s account (B) does not have a control-perfected security interest in the account. It will be possible to verify that D has not granted a security interest in the account to B, but it would take more than a typical lien search.

Not only will the lien itself be secret, but if and when V discovers it, she will also find that it has priority over her security interest, despite the purchase-money for which she bargained, and which (so long as the collateral is intact) is assured by compliance with U.C.C. § 9-103. This is because B would not only have the security interest in the account, but it would also have priority, even though the funds in the account may be proceeds of V’s equipment, and even though the proceeds would otherwise be entitled to purchase-money priority.\textsuperscript{175} As the comment to section 9-327 explains, "security interests perfected by control . . . take priority over those perfected otherwise, e.g., as identifiable cash proceeds . . ."\textsuperscript{176}

How would V protect herself from the secret lien permitted by the control security interest in a deposit account? Presumably, determining the existence and nature of a control security interest would require consultation with the parties involved – the debtor, the secured party and (in the case of trilateral control) the bank or broker that maintains the accounts. It is also to be assumed that the banks and brokers would not collude with a debtor that fraudulently concealed the grant of a control security interest. There is, however, no way to assure that a debtor has not entered into a control agreement. Under U.C.C. § 9-342, a bank that has entered into a control security agreement is “not required to confirm the existence of the agreement to another person” unless the bank’s customer (i.e., the debtor) so requests.\textsuperscript{177} A similar rule obtains with respect to securities intermediaries (or issuers) who are parties to control agreements.\textsuperscript{178} It is not clear how much comfort one can ever take in a statement that the debtor has not encumbered these

\textsuperscript{174} U.C.C. § 9-102(a)(64) (defining proceeds).

\textsuperscript{175} See U.C.C. § 9-322(c) & 9-327(1) ("A security interest held by a secured party having control of [a] deposit account under Section 9-104 has priority over a conflicting security interest held by a secured party that does not have control.").

\textsuperscript{176} U.C.C. § 9-327, cmt. 3.

\textsuperscript{177} U.C.C. § 9-342.

\textsuperscript{178} U.C.C. § 8-106(g).
assets. These assurances may well turn out to be false, and there would be little or no recourse for the aggrieved party.\textsuperscript{179}

V could also resort to other contractual protections. She could, for example, ask the debtor and the insurance company have her named as loss payee with respect to the equipment. If so, and the casualty check was actually sent to V, her expectations would be protected.\textsuperscript{180} Alternatively, V could enter into a subordination agreement with B, whereby B would agree that V would have priority in D’s account with respect to any casualty payments arising from damage to the collateral.\textsuperscript{181} But there is no guarantee that the other parties will enter into these agreements. In any event, it is difficult to imagine these contractual solutions are more efficient than a notice-filing system that would readily alert V to the existence of B’s security interest and determine its priority ex ante. While control may bring important benefits to the banks and brokerages that sought this type of protection in revised Article 9, it is not clear that much consideration was given to costs associated with the secret liens that these transactions create.

C. Asset Securitizations

New twists on old secured transactions are not the only potential source of secret liens in commercial finance law. Recent statutory attempts to “facilitate” the development of asset securitization potentially dispense with notice-filing entirely. Under certain of these statutes, if a contract transferring property uses statutory language, the transfer will be effective even if in secret, and even if other law required notice of it.

Although several states have enacted such laws, the most important is Delaware’s “Asset-Backed Securities Facilitation Act” (“ABSFA”).\textsuperscript{182} ABSFA

\textsuperscript{179} Because the bank and broker have no duty to disclose anything, and no relationship with the other lender/acquiror, it is not clear how liability could be established.

\textsuperscript{180} Ironically, this would be true even if V did not otherwise have purchase-money priority, since the possessory security interest in a negotiable instrument will always have priority over any competing interest in the same instrument. U.C.C. §§ 9-330(d) & 9-331(a) (2001).


Louisiana’s Article 9, for example, provides:

The application of this chapter to the sale of accounts, chattel paper, payment intangibles, or promissory notes is not to recharacterize that sale as a transaction to secure indebtedness but to protect purchasers of those assets by providing a notice filing system. For all purposes, in
essentially contemplates a complete opt out of Article 9 (and, if the statute means what it says, any other law that may conflict with the securitization contracts). “Asset securitizations” are generally defined as “the sale of equity or debt instruments, representing ownership interests in [an], . . . income-producing asset or pool of assets. . . structured to reduce or reallocate certain risks inherent in owning or lending against the underlying assets.”

A securitization typically involves at least two parties:

1. The “originator” is the original owner (and creator) of the financial assets (such as accounts receivable, lease payments, credit card receivables or mortgage receivables) that are the subject of the securitization transaction. The originator might, for example, be an equipment leasing company which is owed lease payments from its lessees. The lessee’s payment obligations are an asset of the originator.

2. The “special purpose entity” is the initial purchaser of these eligible assets and is often called an “SPE.”

Like a secured transaction, a major component of a securitization is a property transfer. The goal of a securitization is a “true sale” of financial assets from the originator to the SPE. If the transfer of these assets is a true sale, then the assets should be insulated from the originator’s economic troubles. If, instead, the transfer is not a true sale – but is, for example, a transfer for security (i.e., a disguised financing) – the originator’s bankruptcy estate would retain an interest in the assets. The assets would then be subject to the many provisions of the Bankruptcy Code that constrain third parties from acting with respect to property of the debtor’s estate.

An effective securitization should free the securitization provider (or, more particularly, those holding the securities issued in the transaction) from Bankruptcy Code provisions staying acts to obtain possession of, or collect from, the absence of fraud or intentional misrepresentation, the parties' characterization of a transaction as a sale of such assets shall be conclusive that the transaction is a sale and is not a secured transaction and that title, legal and equitable, has passed to the party characterized as the purchaser of those assets regardless of whether the secured party has any recourse against the debtor, whether the debtor is entitled to any surplus, or any other term of the parties' agreement.


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184 Securitizations may also involve a third entity that purchases the eligible assets from the SPE and issues the securities backed by the income stream they produce.

property of the debtor’s estate, permitting the debtor to use cash collateral, and to cram-down secured claims in a plan of reorganization. Indeed, it is sometimes claimed that the “efficiency” of securitization derives, in part, from separating the debtor (and the debtor’s other creditors) from these assets. Although estimates of the value of the securitization market vary, it is generally viewed as involving in excess of two trillion dollars at any given point in time.

If securitization transactions always involved arms-length, fair-value sales of payment rights (e.g., receivables), they would likely present few problems. However, securitization transactions are often structured in such a way that the originator retains the risk that there will be a default (or other problem) with the underlying assets. For example, the originator may be required to repurchase these assets from the SPE in the event the underlying account obligor defaults. As and to the extent there is recourse to the originator, the transaction looks less like a “true sale” and more like a secured financing.

Although asset securitization is a comparatively recent development in commercial finance, the true sale problem has been around in one form or another for many years. On the one hand, our law has long permitted a buyer to “put” defective assets back to a seller on, e.g., a breach of warranty theory without calling into question the sale character of the transaction. On the other hand,

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187 11 U.S.C. § 363(c)(2)
191 If, in other words, they were not “judgment proofing” devices. See LoPucki, supra note [], at [].
192 Peter V. Pantaleo et al., Rethinking the Role of Recourse in the Sale of Financial Assets, 52 BUS. LAW. 159, 161 (1996); Thomas E. Plank, The True Sale of Loans and the Role of Recourse, 14 GEO. MASON L. REV. 287, 307-08 (1991) (arguing that payment of the full value, not the existence of recourse, should constitute the border between sales of and security interests in accounts and chattel paper); Schwarcz, Structured Finance, supra note [], at 621-27; Peter L. Mancini, Note, Bankruptcy and the U.C.C. as Applied to Securitization: Characterizing a Mortgage Loan Transfer As a Sale or a Secured Loan, 73 B.U. L. REV. 873, 876-77 (1993).
193 See Pantaleo et al. supra note [], at 164 (“Recharacterization [true sale] cases are centuries old. They illustrate that the law may not treat a transaction as a sale just because the buyer and seller labeled it a sale.”)(footnote omitted).
194 In re Grand Union Co., 219 F. 353 (2d Cir. 1914) (seller of accounts agreed that if the accounts were of poor quality, it would repurchase them or pay buyer so as to guarantee a certain rate of return for the buyer); Comm. on Bankr. & Corp. Reorganization of the Ass’n of the Bar of the
transactions in which the “seller” guarantees payment, or a particular return on investment, or the “buyer” has full recourse to the seller are generally viewed as loans, and not sales. At the margins it is – and has for many years – been difficult to distinguish sales from secured loans.

The recent history of true sale is dotted with cases in which courts were reluctant, for one reason or another, to recognize the putative sale of payment obligations. In 1993, for example, the United States Court of Appeals for the Tenth Circuit, in *Octagon Gas Systems v. Rimmer (In re Meridian Reserve, Inc.)*, held that financial assets sold by the debtor prior to its bankruptcy should,


195 *See* Ratto v. Sims (In re Lendvest Mortgage, Inc.), 119 B.R. 199, 200 (B.A.P. 9th Cir. 1990) ("Where the risk of loss is shifted from the investor to the debtor through a contractual guarantee of repayment by the debtor, the transaction is a loan and not a sale").

196 *See* Ables v. Major Funding Corp. (In re Major Funding Corp.), 82 B.R. 443, 445 (Bankr. S.D. Tex. 1987); Castle Rock Indus. Bank v. S.O.A.W. Enters, Inc. (In re S.O.A.W. Enters, Inc.), 32 B.R. 279 (Bankr. W.D. Tex. 1983) (seller originated mortgages, sold certain interests in them to buyer, guaranteed the buyer’s recovery on the mortgages and the buyer’s rate of return on its investment, indicating the transaction was a loan for security and not a sale). *See also* Fireman’s Fund Ins. Cos. v. Grover (In re Woodson Co.), 813 F.2d 266, 271 (9th Cir. 1987) (holding there was no true sale where investors with the debtor, who were alleged to own mortgages originated by the debtor, “were paid interest monthly regardless of whether the original borrower paid [the debtor]. In the event of default, [the debtor] paid the investor the interest and the principal owing on the investor’s [original deposit]”); Merchant’s Transfer & Storage Co. v. Rafferty (In re Gotham Can Co.), 48 F.2d 540, 541-42 (2d Cir. 1931) (“The obligation of [the seller] to repay [the buyer] all advances [on accounts allegedly sold] in full and to pay certain percentages for the use of the money, shows that the transactions were essentially collateral loans, and not sales…”); Peter v. Pantaleo et al., *Rethinking the Role of Recourse in the Sale of Financial Assets*, 52BUS. Law. 159 (1996).

197 *Burford-Toothaker Tractor Co. v. United States*, 262 F.2d 891, 894-96 (5th Cir. 1959) (transferor assigned customers’ installment contracts to bank, but assignment was with full recourse, and bank required periodic payments to be made to the bank by the transferor, whether or not the customers had paid on the installment contracts; court held on these facts that no sale of the installment contracts occurred).

198 The true sale question was also central to the dispute in *Benedict v. Ratner* 268 U.S. 353 (1925). There, Justice Brandeis, writing for a unanimous court, held that a sale of future accounts receivable was really a disguised financing, and therefore a fraudulent conveyance void against the assignor’s bankruptcy trustee. The purchaser’s failure to exercise “dominion and control” over the accounts was a fraud on the debtor’s creditors. *Benedict*, 268 U.S. at 363 (holding that the assignment was fraudulent “because of dominion reserved. It does not raise a presumption of fraud. It imputes fraud conclusively because of the reservation of dominion inconsistent with the effective disposition of title and creation of a lien”). For thoughtful rehabilitations of *Benedict*, see Edward J. Janger, *Brandeis, Progressivism, and Commercial Law: Rethinking Benedict v. Ratner*, 37 BRAND L. J. 63, 74 (1998)(arguing that Benedict reflected Brandeis’ “progressive’ passion for financial accountability”) & Schroeder, *Surrealism, supra* note [], at 527-28 (the “totally subjective” nature of the assignments prevent creation of a complete property interest in the accounts).

199 *See* Gas Sys Octagon., Inc. v. Rimmer (In re Meridian Reserve, Inc.), 995 F.2d 948, 957 n.9 (10th Cir. 1993) (rejecting view that sale of asset, if perfected, removes it from transferor's bankruptcy estate).
in fact, be included in the debtor’s bankruptcy estate. More recently, and more controversially, the court in *LTV Steel* extended the reasoning of *Octagon*, to conclude that the bankruptcy estate of the originator retained an equitable interest in financial and assets and inventory “sold” in a securitization.\(^{200}\)

Parties to securitization transactions have attempted to address the true sale problem with fairly elaborate structures, and lawyers’ “true sale” opinion letters, which ostensibly assuage the bond market and others who invest in securitization transactions. Such structures and opinion letters are not, however, costless. Viewing these costs as excessive, the securitization industry has sought to establish legislative safe harbors.\(^{201}\) The most prominent effort to obtain a statutory safe harbor involved section 912 of the Bankruptcy Reform Act of 2001.\(^{202}\) This provision would have amended the Bankruptcy Code to provide that assets transferred in a qualifying transaction would be deemed not part of the debtor’s estate. In light of the alleged misuse of SPE’s in the Enron case, section 912 was challenged, and eventually pulled from the Bankruptcy Reform Act.\(^{203}\)

Nevertheless, several states have enacted non-uniform statutes which would reach the same result, although they take a more circuitous and troubling route.\(^{204}\) Delaware’s ABSFA is perhaps the most aggressive example of this. It declares legislatively that a true sale will be whatever the parties to the securitization transaction say it is. ABSFA provides that “notwithstanding any other provision of law” any property purported, in the transaction documents, to be transferred in a securitization transaction “shall be deemed to no longer be the property, assets or rights of the transferor.”\(^{205}\) The transfer of property by the originator shall, under ABSFA, be effective notwithstanding bankruptcy, insolvency or any other rights that third parties might assert in the transferred assets. “A transferee in the securitization transaction, its creditors or, in any insolvency proceeding with respect to the transferor the transferor’s property, the bankruptcy trustee… shall

\(^{200}\) *In re LTV Steel Company* 2001 Bankr. Lexis 131, * 20 (February 5, 2001) ("To suggest that Debtor lacks some ownership interest in products that it creates with its own labor, as well as the proceeds to be derived from that labor, is difficult to accept. . . . [T]here seems to be an element of sophistry to suggest that Debtor does not retain at least an equitable interest” in the cash collateral.").


\(^{204}\) See Lipson, *Enron*, supra note 13.

\(^{205}\) 6 DEL CODE § 2703A(a)(1). The Delaware Act goes on to clarify that the "transferor in the securitization transactions, its creditors [and any] bankruptcy trustee … shall have no rights, legal or equitable, whatsoever to … reclaim … or recharacterize as property of the transferor any property, assets or rights purported to be transferred… ." §2703A(2); and that in "the event of a bankruptcy, receivership or other insolvency proceeding with respect to the transferor … such property, assets and rights shall not be deemed to be part of the transferor’s property, assets, rights or estate," § 2703A(3).
have no rights, legal or equitable, to reacquire, reclaim . . . or recharacterize as property of the transferor any property” transferred in the securitization. For emphasis, ABSFA further provides that if the transferor enters bankruptcy, the transferor’s “property, assets and rights shall not be deemed to be part of the transferor’s property, assets, rights or estate.”

For purposes of the problem of secret liens, the critical language in ABSFA is “notwithstanding any other provision of law.” This presumably means that none of the rules in Article 9, or any other state commercial finance statutes, apply if property is conveyed in a “securitization” (a term pointedly not defined by the statute). To the extent that Article 9 would otherwise require that a securitization transaction be made verifiable by the filing of a UCC-1 financing statement, ABSFA is an exception. ABSFA requires no notice to render a sale effective, and displaces any competing law.

A quick response may be that, as noted above, Article 9 contemplates a growing number of transactions in which property transfers can be effective without notice filing. Security interests in a wide variety of assets – deposit accounts and investment property – can be perfected by control. A sale of payment intangibles is perfected automatically, and thus does not require the filing of a financing statement. To the extent such transactions are even secured transactions, they are perfected automatically, when the security interest attaches. Thus, they would not be publicly verifiable or measurable, even if governed by the more traditional Article 9 regime.

The problem is that ABSFA applies not only to financial collateral, but to “any property, assets or rights purported to be transferred, in whole or in part.” Had it applied to the securitizations in LTV, for example, it would have validated even the transactions involving inventory, obviously not assets typically sold or encumbered in commercial finance transactions. A similar result might obtain in Enron. Indeed, read literally, ABSFA should authorize intentional fraudulent transfers, since it trumps any competing state law. ABSFA’s failure to define a qualifying transaction is equally troubling. ABSFA guarantees true sale treatment “to the extent set forth in the transaction documents.” Thus, a transfer of property can be effected solely by contract, whether or not the transaction bears any resemblance to the common securitization. Any secret lien

206 6 DEL CODE § 2703A(a)(2)
207 6 DEL CODE § 2703A(a)(3).
208 U.C.C. § 9-309(2), (3).
209 Id.
210 6 DEL CODE § 2703A(a)(1) (emphasis supplied).
211 Compare Plank, supra note [].
212 See Lipson Enron, supra note 13.
213 6 DEL CODE. § 2703A(a).
will be effective under Delaware law, so long as “set forth in the transaction documents.”

ABSFA would appear to envision a world in which any property transfer is enforceable, whether or not secret, so long as the transaction documents contain the magic statutory incantation. Notice-filing under ABSFA would appear to be entirely optional. Indeed, it may be counterproductive. In order to discover that a debtor has already sold its assets in a securitization, a potential purchaser or secured party could never rely on a clean lien search. The possibility that a debtor may, in secret, have engaged in a qualifying transaction under ABSFA means that there is simply no way other than contract and diligence – and hope – to know that one is in fact acquiring clean title to, or priority in, the debtor’s property. ABSFA contains no exception for fraud or mistake.

The three classes of secret liens described in this section challenge the basic intuition that property rights come with corresponding notice obligations. These liens are, in theory, discoverable, but only at what appears to be a prohibitively high cost. These liens are inconsistent with a neoclassical vision of property forms that are (or should be) cheaply and readily identifiable, in themselves. It is also inconsistent with the historical tendency to use notice to provide information or control in the absence of more rigorous community structures. It is, nevertheless, where we are.

III. How Did We Get Here?

Why are we increasingly tolerant of secret liens? In simple terms, because we have become convinced that notice-filing is economically unsound. The benefits of notice-filing, we are told, do not justify the costs.

A. The Economic Analysis of Commercial Finance Law

In order to set the table, it might be useful to explain what is meant by economic analysis, and why it matters to commercial finance law. As virtually every breathing academic knows, a certain kind of economic analysis of law – typically associated with the University of Chicago and its eminence grise, Ronald Coase – has altered the way we approach most categories of private law, from anti-trust to bankruptcy. Commercial finance law – and in particular, the

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214 Id.

215 There are, of course, ways that a bankruptcy trustee or disappointed purchaser or secured party could try to get around ABSFA. They could argue, among other things, that based on choice-of-law principles, Delaware law did not apply; that the transaction was not a “securitization” (however defined); or (in the case of bankruptcy) that federal law preempts.

216 See Richard A. Epstein, Law and Economics: Its Glorious Past and Cloudy Future, 64 U. CHI. L. REV. 1167 (1997) (“The magnitude of the intellectual revolution [of economic analysis] is hard to recount today because virtually everyone who works in common law subjects is familiar with the now routine exercise of showing why it is, or has to be, the case that this or that common law rule is, or is not, efficient.”).
law of secured lending – has not been immune from this trend, whose specific
roots are generally located in a 1979 Yale Law Journal article by Professors
Jackson and Kronman which asked a very basic question: Is secured lending
efficient? 217

This seductive problem emanates from the Modigliani-Miller invariance
theory. Economists Modigliani and Miller famously suggested that in a perfect
capital market, the value of a firm could not be traced to the organization of its
capital structure. 218 Thus, if a debtor (D) granted a security interest in its assets in
order to obtain financing from a secured party (SP), other firm investors – in
particular, shareholders and unsecured creditors – should charge more, reflecting
the increased risks associated with the security interest. Whatever D might save
in reduced interest costs charged by SP should be at least offset by an increased
rate of interest charged by unsecured creditors. Firm value – and in particular, the
cost of capital to the firm – would not vary by virtue of the use of secured
financing.

The persistence of secured lending puzzled economically-oriented writers
because, although secured transactions were (and are) far from costless to engage
in, they should produce an economic wash internally, and may create greater
social costs through negative externalities. This is because, among other reasons,
many creditors – unsophisticated trade creditors, tort creditors, terminated
employees, taxing authorities, etc – cannot in fact charge higher rates of interest.
Having not “chosen” to extend credit, these “non-adjusting” creditors could not

217 Thomas H. Jackson & Anthony T. Kronman, Secured Financing and Priorities Among

218 Modigliano & Miller, supra note []]. Cf. David Gray Carlson, On the Efficiency of Secured
Lending, 80 VA. L. REV. 2179, 2219 (1994)(economic analysis of secured lending “emanates from
a peculiar misunderstanding of the famous Modigliani-Miller model . . . ”). According to
Carlson, “[t]he Modigliani-Miller model died in 1976, when Michael Jensen and William
Meckling pointed out that Modigliani and Miller assumed that corporate structure never changes
debtor behavior.” Id. (citing Michael C. Jensen & William H. Meckling, Theory of the Firm:
Managerial Behavior, Agency Costs and Ownership Structure, 3 J. Fin. Econ. 305, 332-33
(1976)). Jensen and Meckling identified the problem of agency cost – the cost imposed by the risk
that X will act, wittingly or not, to the disadvantage of Y. Jensen and Meckling, supra. Carlson
writes as if proponents of the economic approach were ignorant of the contribution of Jensen and
Meckling. It is, however, clear that its earliest proponents – Jackson and Kronman – well
understood their contribution, and the more general problem of agency costs. See Jackson &
Kronman, supra note [] at 1149 – 1161.

While the Modigliani-Miller theory may have many flaws, it remains an important tool in
caseconceptualizing the microeconomics of firm of organization. Professor Schwarcz, for example,
purports to have “solved” the puzzle of secured lending, given certain assumptions, using
Modigliani & Miller. Steven L. Schwarcz, The Easy Case for the Priority of Secured Claims in
charge correspondingly higher rates of interest (or otherwise protect themselves from loss of recourse to the debtor’s assets). Thus, while a secured creditor would have access to all of a debtor’s property, those in the most vulnerable position would not. This would, in turn, create perverse managerial incentives to disregard risks thus externalized. The debtor that gave full priority in its assets to a particular secured creditor would have externalized all losses onto those in the worst position to protect themselves. Since the transaction costs associated with secured lending were presumed greater than the transaction costs associated with other methods of financing many academics followed the lead of Jackson and Kronman in asking why rational market actors would engage in such transactions. Asking and answering the questions posed by the Modigliani-Miller puzzle, as writ small in commercial finance law, became an enormously attractive enterprise for legal academics.

219 The term “nonadjusting creditors” is generally associated with Bebchuk and Fried, who use it in Lucian Arye Bebchuk & Jesse M. Fried, The Uneasy Case for the Priority of Secured Claims in Bankruptcy, 105 YALE L.J. 857, 864 (1996). Bebchuk and Fried take the term one step further, and apply it to all creditors for whom adjustment may either be costly or implausible, such as small-dollar trade creditors, or creditors who extended unsecured credit before the debtor granted the security interest.

220 Bebchuk & Fried supra note [], at 934 (arguing that the rule of full priority “causes excessive use of security interests, reduces the incentive of firms to take adequate precautions and choose appropriate investments, and distorts the monitoring arrangements chosen by firms and their creditors”). Other contributions to this body of literature are collected in Lipson, Remote Control, supra note 120, at 1403, n. 403.

221 As Bebchuk and Fried explained—

The fact that security interests may be used to transfer value from nonadjusting creditors under a full-priority rule means that security interests may be used even when they give rise to inefficiencies. As our analysis will demonstrate, the ability to use security interests to divert value from nonadjusting creditors tends to distort the borrower's choice of contractual arrangements with its creditors, giving rise to certain efficiency costs.

Bebchuk & Fried, supra note [], at 965.

There have been a number of responses which develop reasonably plausible claims that secured lending under certain circumstances can be efficient. See, e.g., David Gray Carlson, On the Efficiency of Secured Lending, 80 VA. L. REV. 2179, 2219 (1994); Homer Kripke, Law and Economics: Measuring the Economic Efficiency of Commercial Law in a Vacuum of Fact, 133 U. PA. L. REV. 929 (1985); Schwarcz, Easy Case, supra note []; Paul M. Shupack, Solving the Puzzle of Secured Transactions, 41 RUTGERS L. REV. 1067 (1989).

222 See, e.g., Jackson & Kronman, supra note [], at 1154 & n.46; Schwartz, Current Theories, supra note [], at 1052-55; Shupack, Solving the Puzzle, supra note [] A curious feature of the economic analysis of commercial finance law – the “puzzle literature” – is its obsession with Modigliani and Miller, to the apparent exclusion of other economic concerns. See William W. Bratton, Jr., Corporate Debt Relationships: Legal Theory in a Time of Restructuring, 1989 DUKE L.J. 92,124 n.40 (“Oddly, the irrelevance hypothesis has had a stranglehold on commercial-law theory.”). There is, as David Gray Carlson and others have observed, more to the economic story than simply a price-theory explanation of firm capitalization. Carlson, Efficiency, supra note [] 2198, 2211 (summarizing critiques); see also Warner, Antibankruptcy Act, supra note [], at 12 (“although the economic analysis is useful in analyzing questions of allocative efficiency, it does not provide much insight into questions of distributive efficiency”).

2198, 2211 (summarizing critiques); see also Warner, Antibankruptcy Act, supra note [], at 12 (“although the economic analysis is useful in analyzing questions of allocative efficiency, it does not provide much insight into questions of distributive efficiency”).
B. Economic Theories of Notice-Filing

Economic analysis of commercial finance transactions expanded beyond this foundational puzzle, to take on various attributes of these transactions, including notice filing. Intuitively, we might think that notice-filing is an efficient method of conveying information about property, especially to those outside of the debtor’s immediate community. Yet this is not how our thinking has developed.

1. Revenue Theory

The crudest argument against notice-filing involves the upfront, direct costs of the systems: namely, that these systems are covert sources of revenue for the government. There are many who view all schemes to require the recordation of interests in personal property as little more than state confiscation. This is because most such regimes require the payment of a filing fee when the interest is recorded. Professor Bowers, for example, has characterized the filing system under Article 9 as “little more than a rip-off” because “[t]he market for information could probably efficaciously do whatever the filing system bureaucracies do and at a lesser aggregate resource cost.” On this view, the UCC-1 system is simply the worst form of rent-seeking, plagued by incompetent and indifferent bureaucrats who happen to the brothers-in-law of politicians, or obligees of political favors.

There is no question that these systems are important sources of revenue for the states and localities that maintain them, and this has long been true. Some of the earliest recordation statutes were enacted largely (if not wholly) on the theory that they would feed the public fisc. One of the earlier recording statutes, the Statute for the Enrollment of Bargains and Sales promulgated under Henry VIII, requiring the recordation of transfers of title to real property, was allegedly intended as a revenue statute. Professor Mooney has indicated that the same can be said of the first fraudulent conveyance statute, the Statute of 13 Elizabeth. This statute provided that transfers with the 'intent [ ] to delay, hinder or defraud creditors and others' were void, and provided for recovery of the 'whole value of .

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223 See Alces, Abolish Filing, supra note [], at 680. See also Peter A. Alces & Robert M. Lloyd, An Agenda for Reform of the Article 9 Filing System, 44 OKLA. L. REV. 99 (1991)(the UCC-1 system is “the very foundation of the personal property security law in the United States.”) (footnote omitted); Bowers, supra note [].

224 See Bowers, supra note [], at 724.

225 See Bowers, supra note [], at 725. Bowers argues both that notice-filing itself is little more than a tax on secured lending (id., at 733 (“The filing system consequently operates as if it were a tax on secured transactions”)) and that, if any notice system were appropriate, the market would better provide this information than the government. Id. at 734 (“A properly privatized system, for example, encourages those who own the system to adopt any advantageous technologies, without a legislative mandate.”)

226 Paul M. Shupack, On Boundaries and Definitions: A Commentary on Dean Baird, 80 VA. L. REV. 2273, 2273 n.1 (1994) (indicating that under former Article 9, UCC-1 filing system produced net gain to states of between $300,000,000 and $400,000,000 annually).

227 See Bowers, supra note [], at 731-32 (citing 27 Hen. VIII, c. 16 (1535)).
. goods and chattels' transferred, to be shared by the Crown and aggrieved parties (such as creditors), and provided for criminal sanctions against the parties to the transfer. 228 The statute was, according to Mooney, “intended in large part as a revenue measure.” 229

To characterize filing as a deal tax is, of course, to stigmatize it. Most commercial lawyers view taxes suspiciously, regardless of the value one might ascribe to good government. Yet the proper question is not whether filing imposes costs— it imposes many— but whether it is worth the price paid. It is easy to imagine facts in which filing may be economically optimal, or perform other socially useful functions. It is just as easy to model facts in which filing fails to satisfy these (or similar) criteria.

In any case, sub rosa taxation cannot be a complete explanation for the rise and persistence of public notice systems. First, if raising revenue were the only or most important goal of filing systems, one would expect that legislatures would never enact the revisions to Article 9 or the securitization facilitation acts, all of which tend to reduce or eliminate the obligation to file (revenue generating) notice in commercial finance transactions. Indeed, one of the reasons Article 9 is viewed as a triumph of efficiency is the fact that it reduced the obligation to file financing statements in multiple states or on a county-by-county basis (often required under former law) — which necessarily reduce aggregate revenue to the state filing authorities. 230

Second, and perhaps more important, there are as discussed below, a number of plausible substantive rationales for requiring public recordation of security interests. It is difficult to imagine that legislatures are able to enact covert revenue regimes without any supporting principle. These rationales may have more and less force, but they suggest that raising revenue alone cannot explain why public notice is adjunct to certain types of property transfers.

2. Rational Apathy – Charlie Don’t Surf

A second argument against notice-filing focuses on the benefit side of the equation, and argues that few actually care about notice-filing — especially those

228 13 ELIZ., CH. 5 (1570).

229 See Mooney, Myth, supra note 68, at 726, n 162 (citing 1 G. GLENN, FRAUDULENT CONVEYANCES AND PREFERENCES §§ 61b, 61c, at 89-93 (rev. ed. 1940)).

230 As discussed above, prior law -- including earlier iterations of Article 9 -- were generally viewed as having required more filings in more offices than revised Article 9. This is partly because former Article 9’s choice of law rules were organized around the physical location of the debtor, rather than the state in which the debtor was incorporated. Under former Article 9, a security interest could be perfected by filing in [the debtor’s principal place of business, which was often a difficult factual determination to make]. The prudent course of action under prior law was therefore to file everywhere the debtor might have been doing business. Revised §§ 9-301 & 307, by contrast, provide that, for debtors that are “registered organizations” – corporations, LLCs, etc – the only place to file is the state in which the debtor was formed (e.g., the state of formation under applicable corporate law) Similarly, former law occasionally required that financing statements be filed not only at the state level, but also by county. See U.C.C. § 9-401 (2000).
historically characterized as its principal beneficiaries: unsecured trade creditors. Except for actual or potential secured creditors – those who formally “rely” on the debtor’s property -- the general population of creditors is apathetic to the information provided by the notice-filing system – and rationally so.

Professor White, for example, has argued that the presumed audience for financing-statement information could, in fact, care less:

Neither the plumber, carpenter, accountant, Commonwealth Edison nor any other thousands of general creditors check the files to determine who has a financing statement on file before it decides whether it will extend unsecured credit in the form of the sale of goods or services. In the words of the trade, these are "non-reliance creditors" and are not entitled to protection of a lack of filing because they would not rely on it in any case.231

Baird similarly claims that “the notice-filing system of Article 9 provides virtually no assistance to unsecured creditors. Parties without ownership interests in the debtor’s property rarely check the filing system, and if they do, they rarely learn anything.”232

Lynn LoPucki has offered a slightly more systemic gloss, arguing that unsecured creditors often do little more than “cash-flow surf.”233 Cash-flow surfing happens when unsecured creditors make small, short-term extensions of credit, hoping against hope that the debtor will be able to pay the debt from cash flow in the ordinary course.234 These creditors may reason that the debtor’s assets are already fully encumbered, or that they are worth nothing, or that it is simply not worth making a credit decision based on such complex analyses. Apathy to the information produced by the system is rational, because learning about what is out there costs more than it’s worth. The unsecured creditor expects to be repaid not because it relies on the value of any particular assets, but as the result of “a combination of nonlegal pressures on the debtor.”235 And the involuntary creditor

231 See White, Wasteful Litigation, at 827. Baird makes a similar claim. See Baird, Ostensible Ownership, supra note 19, at 66-67 (“the Code’s notice-filing system addresses principally only one kind of ostensible ownership problem – the one arising from competition between secured creditors.”).

232 See Baird, Ostensible Ownership, supra note 19, at 55.


234 Id. at 1924.

235 LoPucki, Creditor’s Bargain, supra note [], at 1941. This is not to say that verification has no role in the world of cash-flow surfing. LoPucki argues, however, that monitoring will occur not by virtue of the UCC financing statement system, but instead through informal communications about the debtor’s financial condition:

[If the debtor does not seasonably pay its unsecured creditors, that fact will be transmitted through credit reporting and other information channels to the debtor's secured creditors, employees, suppliers, customers and other trading partners. If the reports get bad enough, others will refuse to deal and the debtor will be unable to remain in business. In this conception, unsecured debt is likely to be short term and restricted to amounts that are small in relation to the creditor's portfolio. The unsecured creditor monitors the debtor through
the tort claimant or terminated employee – is certainly not going to care much, ex ante, about what the public record says about nonpossessory interests in the debtor’s property. Having not chosen to extend credit, involuntary (“non-adjusting”) creditors can hardly be said to have relied on a debtor’s assets. 236

Those who assert a general indifference to filed notice are often quick to distinguish between two hypothetical audiences. While trade and other “simple” creditors will not consult the record, other more sophisticated creditors – in particular, secured creditors -- will. 237 The claim is thus not that the notice-filing system should be dismantled entirely, only that it should not be geared to an audience that does not use it. 238 Notice should matter only to “reliance” creditors, who are presumed to be those who have taken security (or similar) interests in a debtor’s property. 239

Professor Baird has thus argued that “general creditors rely only in part on the debtor’s assets when extending credit. General creditors base their decision to lend on the debtor’s general financial health, of which a present or potential encumbrance of the debtor’s property is only one factor.” 240 Moreover, he claims, “[c]ases in which creditors decide to lend because of their mistaken belief that an asset is unencumbered are rare.” 241 Thus, he concludes, “[t]he needs of general credit reports and other sources of information and evaluates the risk that the business will be discontinued. The unsecured credit will be short term because the extender’s recourse, in the event it deems the risk too great, is to withdraw. The unsecured creditor will have the leverage to withdraw only so long as the debtor continues to value its reputation for payment. If the business closes, it is usually a foregone conclusion that the unsecured debt will not be repaid.

Id. at 1941 (footnotes omitted).

236 Nor is this a new claim. Professor Gilmore, a reporter for Article 9, has observed that some of the drafters suggested that no one – not even lenders – truly relied on the pre-Code notice filing systems. Rather, the decision to extend credit was based “not on public records, but on financial statements – balance sheets and profit and loss statements.” Gilmore, supra note [], at § 15.1, p. 463. In his view, the “[p]ublic files . . . will be rarely consulted.”

237 See sources cited in note [], supra.

238 See citations at note [] supra.

239 As Douglas Baird argues

[T]he notice-filing system of Article 9 provides virtually no assistance to unsecured creditors. Parties without ownership interests in the debtor’s property rarely check the filing system, and if they do, they rarely learn anything. Article 9’s filing system principally serves the interests of secured creditors. ...A notice-filing system... sorts out property claims among those who have or seek property claims; its function is not to give the world at large notice of security interests.”

Baird, Ostensible Ownership, supra note [], at 55.

240 Id. at 60.

241 Id. at 60.
creditors neither justify the costs of the present filing system nor explain its contours. 242

Arguments against notice-filing based on claims about who does (or does not) rely on it are curious and troublesome, for at least three reasons. First, these are often empirical claims about actual behavior, in the real world. As such it would seem possible to test them. These claims have not, to date, been tested, at least in any rigorous and public way. Were we, as some have argued, to abolish a system supported by deep intuition and hundreds of years of practice, we might wish to know a little bit about who might be affected by the change, and how.

Second, there is reasonably good anecdotal evidence that many beyond traditional lenders use the system, and for a variety of purposes. In certain transactions, parties may use these systems as bulletin boards to ward off those who might try to take an interest in the debtor’s property, even though the filers themselves have no such interest. Edwin Smith, a leading practitioner, has indicated that a lender benefiting from a “negative pledge” might file a financing statement, even though such a transaction would not necessarily result in the staking of a claim by the lender. 243

Paul Shupack has suggested that in certain contexts, trade creditors rely on a clean record in deciding whether to ship to a debtor who has promised not to encumber its inventory. 244 Trade creditors might, Shupack suggests, “view the debtor’s use of inventory as security as a public statement of the debtor’s financial distress, particularly if the debtor had not previously done so.” 245 Others have suggested that equipment lenders would “trawl” the financing statement records,

242 Id. at 62.

243 Smith explains --

I have seen this technique used on various occasions for negative pledge agreements and subordination agreements. In the case of a negative pledge agreement, of course, it is in the interest of the creditor in whose favor the negative pledge is granted to put other creditors on notice of the existence of a negative pledge. In the case of a lender filing a subordination, it is in the interest of the debtor to provide comfort to a new senior creditor extending credit to the debtor that the senior creditor will in fact be senior. Although neither example fits squarely into the original purposes of the Article 9 filing system, it seems to me that the commercial “bulletin board” approach, by providing even additional information about the debtor than that required by the Article 9 filing system, is useful. And, as the examples indicate, can benefit either the creditor or the debtor depending on the particular circumstances. See Alces, supra note [], at 696. (quoting letter from Edwin E. Smith, Bingham, Dana & Gould, to Professor Peter A. Alces, Marshall-Wythe School of Law, The College of William and Mary 1-2 (July 31, 1991)).


245 Id. at 806. This makes sense only if the trade creditors do not understand purchase-money priority, or rationally conclude (for any number of reasons) that the mechanics involved in obtaining that “super” priority are not worth the effort. Shupack suggests that certain trade creditors may not find purchase money priority attractive because, among other things, “these sellers have a visceral feeling that the inventory should be ‘theirs’ because they supplied it . . . .” Id. at 805.
looking for financing statements that were about to expire. Reasoning that the
loans covered by the financing statements were about to expire, they might then
contact the debtors indicated in those financing statements, in order to “sell”
replacement financing. Professor Carlson has argued that the notice-filing
system performed a kind of antitrust function, preventing local lenders from
gaining a strangle-hold on borrowers, to the exclusion of national lenders.

Third, and perhaps most important from a policy perspective, there are
reasons other than current actual usage for the filing. While some of these include
the communal and behavioral effects of notice-filing, discussed in part IV, infra, it
would seem axiomatic that many public systems perform important but indirect
functions. Even if non-bank creditors do not perform UCC-1 searches, they may
consult credit reporting services like Dun & Bradstreet. These services provide
(or attempt to provide) analyses of companies as to such matters as timeliness of
payment, credit history, and so on. One component of the Dun and Bradstreet
analysis would appear to be an assessment of publicly recorded interests in the
debtor’s property, such as UCC-1 financing statements and judgment liens.
Thus, even if most unsecured creditors do not directly rely on the public record,
the services upon which they rely for this information may. Notice-filing may

246 See email from Howard Ruda, attorney, to author, July 21, 2003 ("There was a time (and
perhaps still is) when UCC (and predecessor) records were searched for marketing information")
on file with author.

247 Professor Carlson explains:

By providing information to the national credit market, Article 9 filing improves competition
in the credit market generally. Thieves are deprived of their economic rents, and creditors are
prevented from pocketing the savings. This is an ethically attractive program from many
perspectives, but, once again, it is arbitrary and meaningless to a welfare economist. No a
priori conclusions for welfare economics can be drawn from what has been said. All that can
be said clearly is that Article 9 redistributes wealth from one class to another. These
redistributions will probably affect prices – although this too is an empirical matter – but
merely changing prices cannot be viewed as a priori good or bad.

Again, the rationale for public access to Article 9 filing information is that the system
socialized a useful screening function, thus depriving local creditors of an advantage over
national creditors. But this rationale presumes a context that may no longer be empirically
correct. For example, where it is generally known that assets are always encumbered by
security interests, a filing system may simply cost too much, as many now allege. In these
context s, filing systems might violate the logic upon which they are founded, in which case
reform is in order.

Carlson, Debt Collection, at 831.


249 The full force of Dun & Bradstreet services as a verification and measurement system were
There, the bankruptcy court for the District of Delaware concluded that the review of a Dun &
Bradstreet report was sufficient “notification” of the assignment of a claim to defeat a right of
setoff, as provided in U.C.C. § 9-404(a), which limits an account debtor’s right to setoff against an
account if the debtor has assigned the account, and the account debtor has notice of it. The
account debtor in Communication Dynamics was deemed to have notice of the assignment its
account because credit officer for the account debtor had obtained a Dunn & Bradstreet report
provide part of the informational foundation on which these systems are built because all creditors may indirectly rely on it for information about credit decisions.

3. Redistribution Theory

Perhaps the greatest reason to challenge the view that creditors are apathetic is that it is disingenuous. That is, the real concern of those who grouse about the notice-filing system is not that creditors ignore it, but that the penalty for failing to comply with it is excessive. As discussed above, this penalty derives from the “strong-arm” power of Bankruptcy Code § 544(a), which provides that the bankruptcy trustee “shall have . . . the rights and powers of, or may avoid any transfer of property of the debtor . . . that is voidable by—(1) a creditor that . . . obtains . . . a judicial lien” on the property in question.250 As noted above, this power has often been used arbitrarily, in the sense that a lender might lose its lien even though there was in fact no real information failure. Thus, Professor Bowers writes, “[t]here is good reason to believe that bankruptcy legislation is intended mainly to chisel secured creditors out of their bargains.”251 Notice filing has

about the debtor (the account debtor’s creditor) indicating that a secured party had a lien on the debtor’s accounts receivable:

[Account debtor] T & B argues that it did not receive an authenticated notice because third party private information providers, such as D & B, are not substitutes for the affirmative acts of signing or executing required of the assignee/assignor. The Debtor responds that a writing transmitted directly from a debtor or a secured party to an account debtor is not required to satisfy the authentication requirement of the statute . . . . Using this analysis, we conclude that the delivery of the D & B report to T & B, which included a statement that the Lenders had a lien in all accounts receivable, meets this requirement. Such reports are often relied upon by parties in determining whether such liens exist. In fact, Mr. Burks testified that T & B does rely on D & B’s comprehensive reports for information about its customers. Therefore, we conclude that, having received authenticated notice of the Lenders’ liens on May 1, 2002, T & B’s right to setoff does not have priority over the Lenders’ liens under section 9-404 of the UCC.

Id. at 224- 225.

I note parenthetically that the Communications Dynamics opinion would appear to have erred in its interpretation of section 9-404(a)(1). That section provides that the rights of an assignee (e.g., a secured party) are “subject to . . . (2) any other defense or claim of the account debtor against the assignor [debtor] which accrues before the account debtor receives a notification of the assignment authenticated by the assignor or the assignee.” While the Communications Dynamics court discusses the meaning of the term “authentication” (300 B.R. at 225), it failed to recognize that a D&B report is not authenticated by the debtor. The mistake may have been in the court’s assumption that financing statements are signed by debtors. Id. (“we do not go so far as T&B in concluding that [U.C.C. § 9-404(a)] means actual delivery of a signed copy of the financing statement . . . .”). Despite this obvious mistake, the court ultimately came to the correct result, recognizing that the account debtor retained a right of recoupment under U.C.C. § 9-404(a)(1) regardless of the notice that it did (or did not) have.


251 Id.
existed “mostly [as] insurance against bankruptcy”\textsuperscript{252} or as a “bankruptcy tax” on secured transactions.\textsuperscript{253}

There is no question that the strong-arm power to redistribute wealth imposes costs on certain parties. The important question, however, is whether the costs imposed by the strong-arm power exceed the benefits that might flow from compliance with the notice-filing rules. I think here the balance sheet becomes difficult to assess, especially where there has in fact been no secret lien. Where the community of creditors knows or has reason to know that a debtor’s property is encumbered, it is difficult to see the efficiencies that would result from ex post avoidance on purely technical grounds. By definition, cognizant creditors would have chosen to extend credit informed of the economic risks that the secured party had priority; it is not clear how society benefits economically if these creditors were not required to internalize these risks (because a court later avoids the security interest for technical reasons not apparent or relevant to the parties).

Conversely, where a secured party or other investor has priority in the debtor’s assets that it is not known, the more formal attributes of the notice-filing system become important, for the same basic reasons. Voluntary creditors that extend credit based on significant information asymmetries – who do not know the data or intellectual property is encumbered, and have no realistic way to find out – are being forced to transfer value to secured creditors who should have no rational incentive to make their property interests known. This is because the holder of the secret lien should want its debtor to acquire as much property as possible from creditors who would not otherwise choose to lend or sell on credit if they knew their true economic risks.

In any case, what is clear, and what will be developed in part IV, is that observations about community, and the role that information plays in communities, provide important lessons on the role of both notice-filing system and the strong-arm power, which may help cure distortions in both.

4. Economic Theory – Signaling and Priority

Arguments about the ex post redistribution of a debtor’s property are not limited to the problem of notice-filing. Rather, questions about balancing the rights of pre-bankruptcy entitlement holders (e.g., secured creditors) against those of other claimants (e.g., unsecured creditors) are fundamental to bankruptcy and commercial finance policy.\textsuperscript{254} Because, as noted at the outset of this part of the

\textsuperscript{252} See White, supra note [], at 531. This statement is a bit tendentious, because filing is insurance only against one form of loss – due to the strong-arm power. But secured creditors lose their collateral – or its value – all the time. The ordinary course rules expressly contemplate the loss of rights in collateral by “cutting off” security interests when there has been a complying (e.g., “ordinary course”) disposition. UCC §§ 9-320 & 9-321. Similarly, the security interest itself is worth only as much as the underlying property. While collateral itself may insur against the risk that the debtor will not have sufficient unencumbered assets to service the debt, there is little about filing that “insures” the value of the security interest.

\textsuperscript{253} See Bowers, supra note [], at 733.

article, it has been so difficult to develop a satisfactory explanation of the persistence of secured credit on traditional price theory, a number of economically oriented writers suggested that the real virtue of secured credit lay in the informational value of these, as distinct from other, financing transactions.

Varieties of this theory appear in the work of, among others, Thomas Jackson & Anthony Kronman,255 Frank Buckley,256 Alan Schwartz,257 Barry Adler,258 Saul Levmore,259 and George Triantis.260 All have suggested that secured credit plays an important part in solving information asymmetries among a debtor and its various constituents and, implicitly, that information may play some role in assessing the efficiency of secured lending.261 As Professor Triantis has explained “[t]here is little doubt that when a firm secures a larger portion of its debt than similarly situated firms it communicates information of some sort to the market.”262

(a) Signaling

Alan Schwartz initially suggested (but later rejected) the idea that a security interest would be a kind of “signal.”263 Schwartz reasoned that a security interest might be such a signal because it would “restrict future borrowing opportunities,

255 Jackson & Kronman, supra note [].
259 Saul Levmore, Monitors and Freeriders in Commercial and Corporate Settings, 92 YALE L.J. 49 (1982).
262 Triantis, supra note [], at 255.
263 Professor Buckley developed a related view that secured lending performs a “screening” function. See Buckley supra note []. Buckley observed that if a debtor had only unsecured creditors, lenders would have to examine a debtor carefully to determine its liquidation value in a bankruptcy. This would be costly because, among other reasons, that would have to know of one another’s claims. Inserting a secured creditor into the mix, however, would reduce the screening costs of unsecured creditors, because they would assume that they would recover nothing if the debtor liquidated. Id. at 1424 (where unsecured creditors assume that they recover nothing in bankruptcy, the “need not estimate how many other claims will be made on bankruptcy.”).
give secured creditors greater leverage over firm behavior, and make it more
difficult for a firm to reschedule debts in the event of hard times.” A security
interest is an efficient signal to the world that the firms believes that its prospects
justify these costs. “The apparent property of a secured debt to communicate
accurately to creditors a firm’s true estimate of its expected earnings indicates that
the existence of secured debt may be explained as a signaling phenomenon.”
Secured lending may thus be “a way” for debtors to “sort[] themselves out by risk
class.”

Schwartz nevertheless had doubts about the signaling explanation. First, he
correctly observed that the strength of the signaling explanation depended on the
knowledge that other creditors have of the risk preferences of the owners and
managers of the debtor. But there is no particular reason to imagine that
creditors will know this, or that such information is necessarily cheap and easy to
obtain. Second, the signal may itself be ambiguous as to the quality of firm
projects. If so, these informational ambiguities would infect the equilibrium
obtained from viewing security interests as signals. The signal-to-noise ratio may
not, in general, be great enough to justify the externalities created by secured
lending.

(b) Contractual Priority

For purposes of this paper, Schwartz’s principal contribution on the
information costs of secured lending appears in a 1989 article in which he argued
that notice-filing had little value as a means of verifying and measuring property
interests in commercial finance transactions, at least so far as other creditors
might be concerned. This followed from his view of the capital structure that
rational parties would choose ex ante. Schwartz surmised that such parties would,
absent legal intervention, choose highly rigid capital structures, which would
always give the first lender priority in the debtor’s assets (subject to a limited
purchase-money carveout), whether or not the parties characterized the loan as
being secured.

Schwartz began his analysis by surveying form books and practitioner guides,
which indicate that lenders often ask borrowers to agree to restrictive covenants
that forbid later borrowing, subject to certain agreed-to exceptions for, e.g.,

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264 Id. at 15.
265 Id.
266 Id.
267 Id. at 17
268 Id. at 17-18.
269 Id. at 18 (“If a security-interest signal . . . actually tells creditors little about the riskiness of
firm projects, too much signaling could occur in equilibrium; the total costs that firms incur in
sending signals will exceed the total social gain generated by more appropriate credit
extensions.”).
270 See Schwartz, Theory supra note [], at 213 (“The UCC should give initial financers first
priority, whether or not they are secured, except for a reduced purchase-money priority.”).
ordinary course trade debt.  

From the existence of these covenants, Schwartz concluded that the “optimal contract” would give first financers priority over all (or most) later non-ordinary course lenders. That is, the law should recognize what he called a “true first in time (FT)” rule, “which confers senior rank on the initial financer who just enters into the loan contract.” The problem with such a system, Schwartz observed, was informational: How would later creditors learn that the earlier creditor had priority? How, in other words, would later creditors verify and measure other interests affecting the debtor’s property?

Schwartz argued that in a true FT system, later creditors would learn of prior interests because debtors would want to inform them. Schwartz reasoned that “sensibly conservative” lenders would assume that all or most debtors are “bad,” and should therefore pay a high rate of interest. Truly “good” debtors – those that should receive a low rate of interest – would therefore have an incentive to distinguish themselves. “Good debtors,” Schwartz suggested, “could avoid paying the high interest rates that uninformed lenders would charge by informing the lenders that they had little or no prior debt.”

The “key question,” Schwartz observed, was whether borrowers could “make credible communications of their debt status at acceptable cost.” He also observed that firms that borrow take the interest cost deduction. A simple review of any given borrower’s income tax return would therefore reveal the existence significant prior debt. Moreover, to the extent that a debtor was required to report under federal securities law, material indebtedness would likely be reported. In any case, he argued,

[B]ecause private disclosure seems both cheap and common, there is no good case for retaining current law on the sole ground that implementing a new

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271 Schwartz, Theory, supra note [], at 216-18.
272 Id. at 218-19.
273 Id. at 219.
274 “The question is whether to adopt a true FT rule and thereby permit parties to create secret liens or to incur the expense of a new filing regime.” Id. at 219 (footnote omitted).
275 Id. at 220.
276 Id. at 220.
277 Id. at 220. He was thus not concerned with demarcating priority clearly, as might happen with a notice-filing system. “A true FT system probably would date priority from when the initial loan contract was legally effective. This almost always will be when it is signed.” Id. at 222-223, n. 24. This is a curious claim for a number of reasons. First, loan agreements are typically effective only for certain purposes at the time they are signed (or otherwise executed) by the parties. The lender, for example, typically retains the right to decline to fund the loan until a number of conditions precedent are satisfied. Should priority then date to the time of the closing or signature? Second, in revolving loans, it is difficult to know from time to time how much is owed on a given loan. A subsequent lender would have some difficulty in determining how much – if any – property of a debtor would be available in the event of a default. Indeed, given the first lender’s permanent priority, a subsequent lender should never arise, because it would always be at risk of being “primed” by subsequent advances from the first lender.
278 Id. at 220-21.
279 Id. at 221.
priority scheme would prohibitively increase the necessary costs of notifying creditors of the existence of prior claims in a borrower’s property. . . . The expense to the parties of observing the borrower’s books, which is the primary marginal cost of a true [first in time] rule, seems cheaper than the costs of a new public system.”

It is not clear how a notice-filing regime would work in a system with a true FT rule. On the one hand, Schwartz seems to believe that a true FT rule could peacefully coexist with the extant notice-filing regimes. While notice-filing may no longer be necessary vis-à-vis other creditors, it would, on his view, continue to perform an important function as to buyers of a debtor’s assets. Indeed, it could even persist as to creditors, although it would not likely have much value. On the other hand, it is not clear why creditors would bother to take security in a world in which it was always possible (and perhaps probable) that the debtor had a true FT creditor who would trump the (later) secured party. In a world with a true FT rule, secured creditors would be few and far between.

Schwartz recognized that a true FT rule has the potential to create a secret lien problem. If a true FT creditor always trumps later firm investors, later firm investors will always run the risk that the debtor has concealed the existence of such a creditor. Although Schwartz does not speak of the true FT system as if it created liens, it would nevertheless have the potential to create the functional equivalent. There would be potential, undisclosed prior interests in a debtor’s property that would have to verified and measured in order to make a rational credit (or other investment) decision.

Schwartz argued that a true FT system would not, in fact, create a secret lien problem because borrowers would, in the aggregate, choose to disclose accurately and honestly the existence of a true FT lender. First, “borrowers know that to commit fraud would require them to sustain credible lies against skilled inquirers

280 Id. at 222.

281 Id. at 223 (“The conclusion that a true FT rule is preferable to creating a new filing system does not imply that the existing filing system should be abolished.”)

282 Id. (“Consequently, the FT rule should apply only to creditor disputes, and the filing system should be retained to regulate conflicts between financers and later buyers.”).

283 Id. at 223-24 (“A [...] reason to retain the filing system is that filing has been considered a necessary condition to the perfection of security interests. There is no good reason to ban security interests . . . .”)

284 The practical problems of such a system would be considerable. If a debtor had a true FT creditor, its effective interest in the debtor’s property would correspond to the amount of credit extended, which would presumably be an amount that could vary over time, as the creditor made subsequent advances, as interest and other costs accrued, and as the debtor made principal and interest payments. If a later creditor sought to take a security interest in an item of equipment it was selling to the debtor, it could never know for certain that the true FT would not made a subsequent advance that effectively primed the secured party. Nor is it clear how common corporate transactions would affect the analysis. If two debtors, each with a true FT lender, sought to merge, what rule would determine the priority of the lenders? The same problem would obtain if a debtor sold its assets.
for a considerable period of time,” he suggested.  

Second, he reasoned that borrowers want to preserve good will; incorrect disclosures about the existence (or not) of a true FT lender would harm the debtor’s reputation. Third, if the loan market were competitive, a separating equilibrium would develop in which the pooling rate of interest would tend to price in the assumption that borrowers had prior true FT debt. Truly debt-free borrowers would have an incentive to disclose credibly their debt-free status, or risk “punishment” in the form of the higher pooling rate.  

Unless the cost of disclosure were enormous, he reasoned, it would be in the interest of borrowers to convey accurately the truth about the interests that others had in their property.

Of the prominent economic writers, Schwartz’s analysis has the virtue of being most forthright about its contempt for notice-filing, and its indifference to the problem of secret liens. Schwartz’s position suffers, however, from the optimism that tends to afflict much hard economic analysis of commercial finance law. There is simply no reason to believe that debtors and creditors would behave in the ways that he predicts in a true FT system. If nothing else, recent corporate scandals suggest that very sophisticated people can make serious mistakes about the real value of complex firms. People can – and apparently will -- use this complexity to conceal true firm value. It has not been demonstrated that a true FT system would address and modify such behavior.

Economic analysis of this sort is no longer cutting edge.  Much of the “low hanging fruit” promised by the economic study of law has been captured, devoured, in some cases digested and in other cases regurgitated. Still, it is highly likely that economic thought has influenced the legislative trend away from notice-filing. A principal goal of revised Article 9 and the securitization statutes appears to be to reduce transaction costs arising in commercial finance transactions.

Yet it would appear that these economic arguments often ignore the difficult problem of understanding how information about property actually flows in merchant communities, and whether the rules we have (or are developing) are likely to produce an optimal mix of information. They may reduce one category of costs (or costs to certain participants), but may inadvertently create others.

IV. Perfection in a World of Imperfect Information - Community and Behavioral Observations about Notice Filing

We can see thus far that the trend in commercial finance law ignores the intuitive link between property, information and community – the idea that

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285 Id. at 224.
286 Id. at 224.
287 Id. at 224-25.
288 See Epstein, supra note [].
289 For example, Professor Mooney – one of the reporters for Revised Article 9 – has been known to engage in economically-oriented analyses. See generally Mooney, supra note 68.
290 See note [CROSS X EFFICIENCY CITES], supra.
property rights come with notice obligations – and increasingly tolerates secret liens. For the most part, these developments have been rooted in economic thinking about commercial finance law and the role that notice-filing might play in it. The aggregate costs of notice-filing exceed its benefits.

This section suggests that there are other ways to understand the role of notice-filing. These other understandings – rooted in the ways that information functions in commercial communities, and the behavioral consequences of notice-filing – might better explain the proper role of notice-filing – and why it should not be abandoned or diminished lightly.

A. Community Norms

It is easy to forget that notice-filing systems were an outgrowth of systems intended in part to shape communities. As discussed in Part I.B., the title registry systems used in Massachusetts before the Revolution existed both to deal with fraudulent conveyances and to regulate the admission of new members to the community. Notice-filing can be seen in part as a response to the community transgression that separates property from information about it. But community also implies a set of understandings about the development and distribution of information. Those within a community, the idea seems to be, will have access to and the means of interpreting certain kinds of information. Those who are not members of the community will not.

We know something about how at least some contemporary communities deal with information about the property rights of their members. The work of writers such as Robert Ellickson and Lisa Bernstein suggest that community structures can often be a proxy for more formal information-generating rules which might govern notice-filing.

Consider Ellickson’s study of ranchers in Shasta County, California. Ellickson studied what may be the seminal form of verification and measurement problem: Boundary disputes among adjacent landowners, specifically the ranchers and farmers that Coase posited in his landmark 1961 article, The Problem of Social Cost. In attempting to find out how a particular group of

291 See discussion at notes [ ]-[ ], supra.
294 See Coase, supra note [ ].
individuals addressed the problem of social cost, Ellickson found that neither traditional doctrine nor received economic wisdom would predict behavior accurately. Ellickson studied the ranchers and farmers of Shasta County California in the early 1980s.\textsuperscript{295} As the title of the book suggests, Ellickson found that members of this fairly close-knit community often declined to resort to formal legal action when boundary disputes arose amongst members of the community.

But that is not to say that formal law had no role in resolving disputes in Shasta County. Ellickson observes that when the cattle wandered off the fields, and onto the highway, California tort law – and not the communal norms of cooperation – would likely resolve any dispute that arose between the owner of the cow and the driver of the car that might have occupied the same point in space and time.\textsuperscript{296} While the ranchers may not have fully understood the nature of their liability – they believed, despite repeated losses, that “’the motorist buys the cow in open range’”\textsuperscript{297} – the rest of world did. And this liability was determined not the norms of the Shasta county community, but by California law on negligence, animals and insurance.

Based on this, among other things, Ellickson developed an intuitively appealing hypothesis: “members of a close-knit group develop and maintain norms whose content serves to maximize the aggregate welfare that members obtain in their workaday affairs with one another.”\textsuperscript{298} In simpler terms, Ellickson observed, this meant that “members of tight social groups will informally encourage each other to engage in cooperative behavior.”\textsuperscript{299} But, the corollary would have to be that informality or norms-governed rule-making would be inappropriate when these conditions – principally the social cohesion condition – did not obtain. Among other things, he recognized that normatively influenced systems of control might tend to externalize costs to those outside the community. “[N]orms that add to the welfare of the members of a certain group commonly impoverish, to a greater extent, outsiders to that group,” he observed, citing, among other things, the treatment of African Americans in the presence of norms of racial discrimination.\textsuperscript{300}

Ellickson did not discuss the financing of cattle in Shasta county, so it is not clear whether a more insular, norms-based system applied to the resolution of debtor-creditor disputes, or the more formal legal rules were assumed to apply. The suggestion seems to be that within the community, the norms-based regimen

\textsuperscript{295} Ellickson, Order, supra note [].
\textsuperscript{296} Id. at 82.
\textsuperscript{297} Id. 103
\textsuperscript{298} Id. at 167 (emphasis in original).
\textsuperscript{299} Id. Ellickson recognized that this position resonated with works of writers as divers as Alexander Bickel, Lon Fuller, Frederick Hayek, Thomas Schelling, “and similar scholars who in diverse ways have kept alive Burkean notion that decentralized social forces contribute importantly to social order.” Id. (citations omitted).
\textsuperscript{300} Id. at 169.
would apply. Thus, he observed “When a notorious informal debt has been repaid, the party who has been made whole bears an informal duty to tell others that accounts have been squared.”

But outside the community, the suggestion seems to be that more traditional, baseline rules of law do and should apply. The informal methods of rule generation and enforcement within the community do not necessarily obtain outside the community. It would be difficult, for example, to imagine that agricultural lenders would rely solely on reputation, gossip, and informal social control to enforce their loans, or to make a decision to extend credit. Within the group, informal measures may be adequate proxies for obtaining information about a debtor’s property. It is hard to see that the same would be the case outside the group.

Lisa Bernstein’s study of diamond merchants yields a similar suggestion. Bernstein sought to understand why diamond merchants, especially those in the New York Diamond Dealers Club, rarely resorted to established legal mechanisms to create contracts or to resolve disputes over them. Unlike Ellickson, Bernstein does discuss the role that credit and financing play in the diamond trade. Credit was an important component of sales among diamond merchants, where “bargaining over the term of payment became an important and contentious stage in contract negotiations.” According to Bernstein, payment terms (other than cash on delivery) were often 30- or 60- days. These periods often corresponded to the time involved in finishing the stone, so Bernstein surmised that “sellers generally finance most, if not all, of the buyer’s (manufacturer’s) cash gap.”

Bernstein discusses the mechanics of external financing only indirectly. She observes that a fairly small number of banks were involved in the diamond industry, because valuing diamonds was often beyond the expertise of most bankers. While diamonds may be valuable property, it would appear that the value of this property plays only an incidental role when banks decide to extend credit to insiders in the diamond industry. Rather than collateral value, per se, lenders in Bernstein’s study were more concerned with merchant reputation.

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301 Id. at 232.
302 Id. at 283 (“As prior investigators have found in other contexts, disputants are increasingly likely to turn to legal rules when the social distance between them increases . . . .”).
303 Bernstein, Diamond Industry, supra note [], at 116 (“the diamond industry is unique in its ability to create and, more important, to enforce its own system of private law.”)
304 She characterizes diamond markets as both a commodities market and an “implicit capital market.” Id. at 131
305 Id. at 131
306 Id. at 131.
307 Id. at 154, n. 67. She notes that at that time Merchants Bank of New York was attempting to develop an in-house group of gem experts with access to important intraindustry reputation information. Id at 132, n. 38.
308 Id. at 154, n. 67 (quoting banker as observing “in terms of extending credit a bank has to look at the three C’s – Capital, Culpability and Character. At our bank, we think that character is the most important C.”)
“[A]lthough defaulting on a loan would hurt any businessman’s credit rating,” Bernstein observes, “the damage to a diamond dealer is more severe since there are only a few industry lenders and banks must rely to greater extent on dealers’ reputation in valuing assets.”

One might infer from this that information-generating rules on such things as notice-filing did not matter. But it would appear that notice-filing does play a part in the financing of diamond transactions, especially vis a vis those outside the “community,” such as banks. Bernstein observed that many transactions within the industry took the form of consignments – sales where the seller retains title under the buyer resells or returns the goods in question. As under current law, the UCC in the early 1990s provided that a consignor would protect its interest in consigned goods if it filed an effective UCC-1 financing statement adequately describing the goods. If the consignor failed to file an effective financing statement, however, it would lose its rights in the goods as against a competing bankruptcy trustee (under the strong-arm power) or a bank with a perfected security interest in the buyer’s inventory.

As an historical matter, Bernstein found that consignment agreements were always concluded orally. However, Bernstein observed, this began to change as dealers discovered that they would lose their interest in the consigned goods if the buyer got into financial trouble. Thus, the legal counsel to the DDC advised dealers that the UCC “will give you protection if you adequately describe your diamonds and file a UCC-1 Financing Statement . . . . this will give you a legal leg to stand on if you unfortunately have to seek the return of your merchandise from a bank or a trustee in bankruptcy.”

Thus, consignment agreements – and in larger transactions UCC-1 financing statements – became part of the diamond industry.

Bernstein suggested that the formal consignment agreement served two important functions, one internal, the other external. Internally, the consignment agreement would function like a bill of sale, providing evidence of what the transaction was supposed to have been in the event of a later dispute. Externally, the formal consignment agreements were critical to demonstrating the intentions of the parties to a court. “Without them,” Bernstein noted “courts tend to interpret the meaning of an intraindustry consignment agreement in ways that

309 Id. at 154-55, n. 67.
311 This is another example of the “strong arm” power, discussed in part [], above. A recent example of this appears in In re Valley Media, Inc., 279 B.R. 105,212-125 (Bankr. D. Del. 2003) (“unperfected” consignment sellers lose priority to bankruptcy trustee).
312 Id. at 155, n. 69 (quoting S. Herman Klarsfeld, Legal Gems N.Y. Diamonds, May 1988, at 63).
313 Id. at 155 (“when a dealer gives goods on consignment, a formal consignment memorandum that satisfies the requirements of the [UCC] is now sometimes drawn up to ensure that the [consignment seller’s] title to the goods will be recognized by the legal system.”)(footnote omitted).
314 Id. at 155.
are strongly at odds with industry custom and the intent of the original contracting parties.\textsuperscript{315}

Like the ranchers of Shasta County who collide with outsiders, Bernstein’s study suggests that informal, community-based methods of setting rules and remedies may be appropriate within a group, but not necessarily outside of it. Community can be a proxy for more formal methods of gathering and disseminating information, such as notice-filing systems. Notice-filing may not matter to diamond merchants inter se, since they know (or believe they know) all that is important to know about one another in order to trade internally. But the possibility that their transactions will have to be explained to an outsider judge or bank suggests that more formal informational mechanisms are still important. Put another way, while the community of diamond-merchants may elect to adopt or reject certain commercial conventions inter se, there seems to be no doubt that more formal rules will govern the interface between those within the community and those outside of it. Notice-filing may be an informational bridge to the outside world.

The work of Ellickson and Bernstein has two important lessons for the role of notice-filing. First, where information about property and other credit-related matters (e.g., reputation for trustworthiness) is readily available to all members of the relevant community, it is not clear that more formal notice-filing systems are necessarily useful. If all creditors of a debtor know that the debtor’s assets are fully encumbered by a first-priority security interest, is there any legitimate basis for avoiding the security interest if the financing statement perfecting the interest is somehow technically deficient? If there is no secret lien in fact, who benefits from avoiding the security interest?

Second, and perhaps more important, where there is no information-rich community, in which the existence and extent of property (and other) interests are reasonably well understood, the more formal methods of generating and disseminating information about property – e.g., notice filing – become increasingly important. Thus, in simpler times, when communities were more closely knit, cruder signals about property were or should have been acceptable. On this view, the nonpossessory security interest in \textit{Clow}\textsuperscript{316} and the factor’s lien in \textit{Ryttenberg}\textsuperscript{317} should have survived challenge. Neither case suggests that anyone – within or without the community – lacked knowledge of the security interests in question.

But as things become more complex, community structures may break down. Thus, the downstream buyer or licensee of data or intellectual property should not have to worry about the security interest of a lender several generations prior in the chain of interest, which is not known to the buyer’s general community and

\textsuperscript{315} Id. at 156.


\textsuperscript{317} Recall that \textit{Ryttenberg} avoided a factor’s lien despite the posting of a sign at the debtor’s warehouse. \textit{See} discussion of \textit{Ryttenberg}, supra notes [1]-[1].
which would not be discoverable by even a reasonably diligent search. Similarly, it is not clear how to address the rights and expectations of those who may come into conflict with a control-perfected security interest. The equipment vendors of the world may be sophisticated enough to understand that their borrower’s banks have a right of setoff, which is akin to the bilateral form of control discussed in part II.B., above. But would they necessarily understand that they can lose the casualty value of their collateral to an undisclosed third party (e.g., in a trilateral control agreement)? Should they not at least have the option to know ex ante the risk they are taking?

A similar analysis might inform our thinking about the role of notice-filing in asset securitization. Where a transaction is well-publicized – and generally understood by the debtor’s community of creditors – it is not clear that notice-filing adds much. But the complexity of these transactions suggests that even if they are public, they may not be well understood. While notice-filing will not necessarily explain much about the intricacies of the transaction – it will say very little about it – it provides some basic information to those outside the community, who may be the parties with the least information about, and poorest understanding of, the deal. It will at minimum create the possibility that they will inquire further.

B. Behavioral Implications of Notice-Filing

If community is proxy for notice-filing, what should inform our rules about information generation in the absence of community? To date, the analysis has been dominated by the economic discussions set forth in part III above. While these analyses have produced both heat and light, they also have significant limitations. Perhaps the most important shortfall stems from their assumptions about human behavior. Economic analysis in general has been dominated by rational choice theory, the view that human beings are logical maximizers of self-interest. Rational choice theory describes “how people would behave if they followed the dictates of a series of logical axioms, [and] posits that people make outcome maximizing decisions.”

\[318\] See, e.g., Schwarcz, Complexity, supra note \[\].

\[319\] See, e.g., Thomas S. Ulen, Firmly Grounded: Economics in the Future of the Law, 1997 Wis. L. Rev. 433, 436 (“The single most important contribution that law and economics has made to the law is the use of a coherent theory of human decision-making (‘rational choice theory’) to examine how people are likely to respond to legal rules.”).


Herbert Simon describes the “economic man” who is perfectly rational as follows:

This man is assumed to have knowledge of the relevant aspects of his environment which, if not absolutely complete, is at least impressively clear and voluminous. He is assumed also to have a well-organized and stable system of preferences, and a skill in computation that enables him to calculate, for the alternative courses of action that are available to him, which of these will permit him to reach the highest attainable point on his preference scale.

Perhaps the most important incursion into the rational choice fortress has come from the field of behavioral economics, sometimes called cognitive theory. Emanating from the work of Daniel Kahneman and Amos Tversky, behavioral economists – and the many legal academics who trail in their wake – have demonstrated that human beings often make significant mistakes in judgment and analysis which would be inconsistent with the rational actor model. While we may attempt to be rational, we often engage in what Mark Seidenfeld has aptly called “cognitive loafing” – we find mental shortcuts (“heuristics”) that help us make decisions. These heuristics, however, often lead to results that are demonstrably at odds with what rational self-maximizers would choose. In particular, these cognitive errors “plague many financial decisions,” including those involving extensions of credit.

1. Cognitive Errors

Cognitive theory literature has thus made a significant contribution to our understandings of borrowing behavior. Professor Rachlinski recently catalogued three related cognitive biases that might lead to overinvestment in the form of taking on too much debt: (i) the “availability” heuristic, (ii) anchoring and (iii) overconfidence. The availability heuristic holds that we will more likely remember instances of overcoming hardship to pay debts than the failure to do so. Anchoring means that a borrower would root her decision to borrow today in her past ability to satisfy obligations. Overconfidence means that borrowers


325 Rachlinski, supra note [], at 1183.

326 Id. at 1183 (citations omitted).

327 Id. (citations omitted).
may tend to overstate their ability to foresee unfavorable economic circumstances which might lead to default.\textsuperscript{328} Together, these biases create “vulnerability to excess indebtedness” that might influence how we develop rules governing the rights and remedies of debtors and creditors.\textsuperscript{329}

The problem of cognitive error has been studied in the context of securities law,\textsuperscript{330} commercial law (e.g., sales),\textsuperscript{331} and contract law.\textsuperscript{332} However, there has to date been no attempt to understand what these phenomena might imply for notice-filing in commercial finance transactions. What might the behavioral effects of notice-filing be?

First, the financing statement might counter the irrational optimism that comes from the collective force of the availability, anchoring and overconfidence biases. As the warning that alerts a creditor to further investigate various competing claims to a debtor’s property, the financing statement might slow the otherwise exuberant creditor from making a precipitous decision. It might inject a level of caution and deliberation, forcing the creditor to consider more carefully the full ramifications of the credit decision.

This will more likely be true if creditors as a whole have confidence in the notice-filing system. If creditors believe that the system gives them information about the debtor that materially aids a decision to extend credit, the system itself will develop a self-reinforcing authority. Creditors will be able to use the

\begin{footnotesize}
\begin{enumerate}
\item Id. (citations omitted).
\item Id.
\item \textsuperscript{332} Melvin Aron Eisenberg, \textit{The Limits of Cognition and the Limits of Contract}, 47 STAN. L. REV. 211, 213-14 (1995); Subha Narasimhan, \textit{Of Expectations, Incomplete Contracting, and the Bargain Principle}, 74 CAL. L. REV. 1123, 1142-49 (1986) (showing that contracting parties rely on the "representativeness" and "availability" heuristics, which lead them to overestimate the likelihood that the terms of the contract will be performed); Russell Korobkin, \textit{The Efficiency of Managed Care "Patient Protection" Laws: Incomplete Contracts, Bounded Rationality, and Market Failure}, 85 CORNELL L. REV. 1 (1999) (arguing that cognitive errors in consumers justify imposing mandatory terms in health insurance contracts).
\end{enumerate}
\end{footnotesize}
presence – or absence -- of a filed financing statement as a kind of heuristic for assessing the debtor’s credit worthiness.

If, by contrast, the system is viewed as unreliable, creditors may be expected to react with excessive caution. If creditors or purchasers or others who care about the debtor’s property have reason to believe that undisclosed interests in that property may be asserted against them, they will likely discount the value of that property, and the value of the debtor as a potential trading partner. Whether a rational response to a lemons problem,\textsuperscript{333} or a biased response that impedes self-interest, the lack of confidence in the system should, over time, affect the informational value of the system. If no one believes it is accurate, no one would rely on it.

2. The Reflexive Function of Notice-Filing

Another behavioral implication of the notice-filing system would look not at the effect that giving notice has on the presumed audience for the information (creditors and other investors), but instead how notice-filing obligations channel and possibly improve the behavior of those obligated to file. This has been an especially important and controversial topic in the securities law context, where disclosure per se – while voluminous – has not necessarily produced more intelligent decision-making.\textsuperscript{334} There is nevertheless a view that forcing corporate actors to divulge information about the firm and themselves will affect their behavior with respect to the firm and third parties.\textsuperscript{335} This claim has, for example, been made where there are social or environmental consequences to corporate action that might be affected or altered by disclosure.\textsuperscript{336} This “reflexive”\textsuperscript{337} function of disclosure focuses on the ways that behavior may be shaped by forced disclosure. Reflexive theories of disclosure capitalize on the idea that if we are

\textsuperscript{333} George A. Akerlof, \textit{The Market for ‘Lemons’: Quality Uncertainty and the Market Mechanism}, 84 Q.J. ECON. 488, 500 (“the difficulty of distinguishing good quality from bad is inherent in the business world.”).

\textsuperscript{334} Troy A. Paredes, \textit{Blinded by the Light: Information Overload and its Consequences for Securities Regulation}, 81 WASH. U. L. Q. 417, 419 (2003) (“the provocative implication of information overload is that the federal mandatory disclosure system might be more effective if it were scaled back-- that is to say, if less were disclosed, not more.”); Schwarcz, \textit{Complexity}, supra note [].


\textsuperscript{337} Reflexive law “attempts to influence decision-making and communication processes with required procedures.” Hess, \textit{supra} note [], at 51 (citing \textit{ERIC BREGMAN & ARTHUR JACOBSON, ENVIRONMENTAL PERFORMANCE REVIEW: SELF-REGULATION IN ENVIRONMENTAL LAW, IN THE CONCEPT AND PRACTICE OF ECOLOGICAL SELF-ORGANIZATION} 211 (Gunther Teubner et al. eds., 1994)).
forced to tell the world what we are doing, we may reflect more carefully on our than actions than would otherwise be the case.\footnote{338}

How might this play out when applied to the UCC-I financing statement? A debtor and secured party (or securitization financer) who have no obligation to inform the world that one of them (the debtor) is conveying some property to the other will likely treat that property differently than if disclosure, no matter how discursive, were required. The property may, actually or metaphorically, be held out as an inducement to third parties of one sort or another (akin to reliance considered so distressing by the court in \textit{Clow v. Woods}, discussed at the outset of this article). The debtor and the secured creditor may tolerate dissipation of the property, or carelessness with its maintenance. If, however, the relationship has been disclosed, behavior might change.


The reflexive function of disclosure is, Professor Malloy recently observed, likely more powerful when disclosure rules are “fuzzy” rather than “binary.”\footnote{339} A binary disclosure system is one in which compliance is “a black or white state of affairs.”\footnote{340} Either disclosure has been given according to the prescribed rules or it has not. Fuzzy disclosure, by contrast, establishes “a gray relationship between an indeterminate standard and an uncertain factual situation.”\footnote{341} Malloy has argued that in the presence of ambiguity, binary disclosure rules tend to undercut the reflexive effects that disclosure might otherwise produce, creating opportunities for strategic noncompliance. “Binary disclosure provisions simply task [a] manager with answering the same question all over again.”\footnote{342} Fuzzy disclosure rules, by contrast, “challenge[] the individual to think more closely about the position taken than would be the case absent the disclosure obligation.”\footnote{343}

The U.C.C. notice-filing system as it has developed can certainly be seen as a binary system. As discussed in part I.B, above, the slightest technical errors in the giving of notice have often been used to avoid security interests entirely. Where notice has been required, especially under prior law, the notice was either effective or it was not. The survival of the security interest was a black and white matter that did not turn in any meaningful sense on the actual knowledge of those

\begin{footnotes}


340 Id.

341 Id. (citing BART KOSKO, \textit{NEURAL NETWORKS AND FUZZY SYSTEMS} 3, 33 (1992); MICHAEL SMITHSON, \textit{IGNORANCE AND UNCERTAINTY} 108-18 (1988)).

342 Id. at 46.

343 Id. at 53
\end{footnotes}
transacting with the debtor. This has not surprisingly led those who craft disclosure rules – the drafters of revised Article 9 and the securitization facilitation statutes, for example – to formulate rules that are as easy as possible to comply with. The easiest disclosure rule to comply with, of course, is none at all, which is where our commercial finance law seems to be headed.

A fuzzier tolerance for the real distribution of information in any given situation might encourage more reflexive behavior on the part of those required to file these notices (i.e., the debtor and secured party). In particular, Professor Malloy has argued, fuzzy disclosure rules may lead to greater individual accountability. This may cause greater cognitive dissonance for those responsible for the filing, but may also lead them to consider more carefully the full effects of the course of action. This is, Malloy observes, especially important when disclosure might involve multiple audiences with potentially conflicting responses to the information in question.\footnote{Id. at 54-55. Malloy’s examples involve the conflicting disclosure pressures of federal environmental and tax laws.} Fuzzy disclosure rules would, at least potentially, require individuals to “engage in [a] more sophisticated evaluation of the alternative positions than under a binary disclosure scenario.”\footnote{Id. at 55. There are, Malloy notes, important limits to this analysis. Among other things, “accountability in the complex context of the business firm and regulatory environment is still quite young.” Id. at 56.}

Fuzzier disclosure rules might therefore reduce the incidents of arbitrary avoidance, while still channeling and perhaps improving the behavior of those primarily responsible for generating and filing notice. If secured parties, in particular, were more concerned about who actually knew of their interest in the debtor’s property, and less concerned with satisfying the binary rules of notice-filing that have developed to date, they might be less inclined to engage in strategic but meaningless compliance. If, for example, a secured party could pursue data or intellectual property in the hands of remote parties only when the remote party actually knew (or had reason to know) of the proceeds security interest, the secured party would take steps to assure that that remote party had knowledge. If a security interest in a bank account would be enforceable only if other creditors of the debtor had some actual or constructive knowledge of the bank’s interest in it, the secured party and debtor will take meaningful action to assure that it is known. Fuzzier rules would permit the easy transfer of property interests envisioned by revised Article 9 and the securitization facilitation statutes with a reduced possibility of secrecy. Fuzzy rules may permit liens while inhibiting secrets.

There are undoubtedly other behavioral implications of notice-filing. The important point here is that the system may have behavioral consequences that have not been fully internalized by those proposing changes in policy.

Conclusion

This article has investigated the causes and effects of the elimination of notice-filing from common commercial finance transactions, including those
involving data, intellectual property and bank and brokerage accounts. The principal cause appears to be excessive (or misplaced) concerns with economic efficiency. The principal effect will be increased incidence of secret liens. This article has suggested that secret liens may be a problem because they challenge deeply held intuitions about the relationship between property rights and notice obligations, reflected in both recent theoretical developments and long mercantile history.

This article has suggested that notice-filing systems may perform at least two important informational functions not fully considered by critics of these systems. First, they will act as proxy for the information that might otherwise be generated within tightly-knit merchant communities. Second, they may have important behavioral consequences for both those required to provide the notice and the audience for the information thus provided.

We may never fully understand the relationship between property, information, community and investment (credit) decisions. It is, however, important to remember that informational systems like the notice-filing system of the Uniform Commercial Code perform a variety of functions which should not be discarded lightly.

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Annex A

UCC FINANCING STATEMENT
FOLLOW INSTRUCTIONS (front and back) CAREFULLY

A. NAME & PHONE OF CONTACT AT FILER [optional]

B. SEND ACKNOWLEDGMENT TO: (Name and Address)

Granada Bank and Trust Co., N.A.
25 South Harbor Street
Boston, MA 02110

THE ABOVE SPACE IS FOR FILING OFFICE USE ONLY

1. DEBTOR'S EXACT FULL LEGAL NAME – insert only one debtor name (1a or 1b) – do not abbreviate or combine names

1a. ORGANIZATION'S NAME

Maimonedes Medical Finance Services LLC

1b. INDIVIDUAL'S LAST NAME

1c. MAILING ADDRESS
60 Boston Street
Baltimore, MD 02101

1d. TAX ID #: SSN OR EIN
ADD'L INFO RE ORGANIZATION DEBTOR

1e. TYPE OF ORGANIZATION

LLC

1f. JURISDICTION OF ORGANIZATION

Delaware

1g. ORGANIZATIONAL ID #, if any

NONE

2. ADDITIONAL DEBTOR'S EXACT FULL LEGAL NAME – insert only one debtor name (2a or 2b) – do not abbreviate or combine names

2a. ORGANIZATION'S NAME

2b. INDIVIDUAL'S LAST NAME

Principal
Peter

2c. MAILING ADDRESS
622 University Avenue
Baltimore, MD 02120

2d. TAX ID #: SSN OR EIN
ADD'L INFO RE ORGANIZATION DEBTOR

2e. TYPE OF ORGANIZATION

2f. JURISDICTION OF ORGANIZATION

2g. ORGANIZATIONAL ID #, if any


3. SECURED PARTY'S NAME (or NAME of TOTAL ASSIGNEE OF ASSIGNOR S/P) – insert only one secured party name (3a or 3b)

3a. ORGANIZATION'S NAME

Granada Bank and Trust Co., N.A.

3b. INDIVIDUAL'S LAST NAME

3c. MAILING ADDRESS
25 South Harbor Street
Boston, MA 02110

4. This FINANCING STATEMENT covers the following collateral:

Equipment, inventory, chattel paper, accounts, general intangibles

5. ALTERNATIVE DESIGNATION [if applicable]: □ LESSEE/LESSOR □ CONSIGNEE/CONSIGNOR □ BAILEE/BAILOR □ SELLER/BUYER □ AG. LIEN □ NON-UCC FIL.

6. □ This FINANCING STATEMENT is to be filed [for record] (or recorded) in the REAL ESTATE RECORDS. Attach Addendum (if applicable)

7. Check to REQUEST SEARCH REPORT(S) on Debtor(s) [ADDITIONAL FEE] [optional] □ All Debtors □ Debtor 1 □ Debtor 2

8. OPTIONAL FILER REFERENCE DATA