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Efficiency Justifications for Personal Property Security

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I. INTRODUCTION

In February of 1983 Pan American World Airways issued 100 million dollars of convertible secured notes. As security for these notes it put up three Boeing 747 SP aircraft, two 747-100 aircraft, and one McDonnell Douglas DC10-30. The appraised value of

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these aircraft was 157 million dollars.[1] To the extent possible under the law, Pan American made these aircraft subject to the claims of the owners of the new notes. On default, the note holders would have the first claim on these aircraft, would have the right to repossess them outside of bankruptcy, and would have the right to the value of these assets or to the assets themselves in bankruptcy. At least in theory, the effect of the security agreement[2] was to remove the six aircraft from the pool of assets that would have been available to the general creditors of Pan American had it gone into bankruptcy without granting such a security interest. To that extent at least, the general creditors of Pan American, whether they be owners of other Pan American debt securities, trade creditors, employees, or others, now apparently have dimin-

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1. *See* PAN AMERICAN WORLD AIRWAYS, INC., PRELIMINARY PROSPECTUS 1, 31-32 (Jan. 25, 1983).

2. The Uniform Commercial Code defines a security agreement as "an agreement which creates or provides for a security interest." U.C.C. § 9-105(1)(l)(1978). The Code in turn broadly defines a security interest as "an interest in personal property or fixtures which secures payment or performance of an obligation." *Id.* § 1-201(37). Thus, under the Uniform Commercial Code effective in every state except Louisiana, a security agreement is the means by which a debtor may give a creditor greater rights than he otberwise would possess upon the debtor's default. Unless the creditor is in possession of the collateral in which he has been given a security interest, the security agreement must be written, must contain an adequate description of the collateral, and must be signed by the debtor. *Id.* § 9-203(1)(a).

The Uniform Commercial Code provides a secured creditor many rights not enjoyed by the unsecured creditor. For example, upon the debter's default a secured creditor may take possession of the collateral, if he can avoid breaching the peace, and then sell it without judicial process. *Id.* §§ 9-503, -504. In addition, a properly perfected secured creditor will prevail over a host of competing parties claiming the same collateral, including unsecured creditors, judicial lien creditors, certain purchasers from the debtor, and secured creditors that perfected their interests subsequent to his perfection. *See id.* §§ 9-201, -301, -307, -312. Even an unperfected secured creditor will prevail over an unsecured creditor. *Cf. id.* § 9-301.

A properly perfected secured creditor also occupies a preferred position in the event that the debtor files bankruptcy. The trustee in bankruptcy is given only the status of a lien creditor. 11 U.S.C. § 544(a) (1982). Thus, the properly perfected secured creditor will prevail over the trustee and will be entitled to the value of his security up to the amount of his claim; an unsecured creditor generally would not have a similar right. U.C.C. § 9-301(1)(b) (1978); 11 U.S.C. § 506(a) (1982); *see also* 3 W. COLLIER, COLLIER ON BANKRUPTCY ¶ 506.04[1], at 506-13 to 506-14 (L. King 15th ed. 1983); D. EPSTEIN & J. LANDERS, DEBTORS AND CREDITORS 562 (2d ed. 1982). Even when a secured creditor is "crammed down" and thus does not receive the entire value of his claim, he is assured that he will receive at least a greater proportion of his secured claim than an unsecured creditor will receive of his unsecured claim. 11 U.S.C. § 1129(b)(2) (1982).

The Bankruptcy Code is particularly solicitous of secured creditors that possess a purchase money security interest in aircraft or certain parts thereof. *See id.* § 1110. Section 1110 states that the right of these secured parties to take possession of the security upon defanlt is not affected by the section 362 automatic stay, by the section 363 use of collateral provisions, or "by any power of the court" to enjoin unless within sixty days of the relief order the trustee cures the default and agrees to perform all other obligations of the debtor.

ished status just as the purchasers of the notes have enhanced claims.

The conventional justification for granting such secured creditors superiority over unsecured creditors is the assertion that, but for such security, Pan American would not have been able to borrow. Of course, it is not intuitively obvious that Pan American would have been incapable of borrowing or raising the money by other methods had it not been able to give security;[3] nor is it clear that the common welfare has been improved by Pan American's ability to borrow. All who recently have written about these matters have found this conventional justification for security to be too facile.[4] Yet if it is not more efficient to give preferential treatment to secured creditors in bankruptcy, a persuasive justification for security will be hard to find. Secured creditors tend to be well informed, well represented, and powerful. Our traditional notions of fairness and concern for the underdog would suggest that the banks and other secured creditors should not receive better treatment than the general creditors.

Is society better off because bankruptcy law, Article 9 of the Uniform Commercial Code, and common law rules have made the taking and perfection of security simple, inexpensive, and efficacious? I believe that the answer is "yes." First, compared to the theoretical state in which no security interest is recognized in bankruptcy or other default proceedings, it is probably more efficient to grant priority to the claims of secured creditors over the claims of unsecured creditors than to do otherwise. Second, even if one rejects the first conclusion, one should nevertheless adopt the Article 9 position as the most efficient, practical alternative under an economic system that recognizes and protects private rights of ownership.

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3. Pan American's *Preliminary Prospectus*, however, does suggest that alternative sources of credit would have been difficult to locate. It states that "the airline industry has recently experienced an unwillingness on the part of the industry's traditional lenders to make further commitments to provide working capital or finance capital expenditures." PAN AMERICAN WORLD AIRWAYS, INC., *supra* note 1, at 6. The *Preliminary Prospectus* also indicates that with the exception of "small overdraft facilities," Pan American had had no bank credit facilities since September 1981. *Id.* at 5; *see also id.* at 26.

4. *See, e.g.*, D. BAIRD & T. JACKSON, CASES, PROBLEMS, AND MATERIALS ON SECURITY INTERESTS IN PERSONAL PROPERTY 354-67 (1984); A. SCHWARTZ & R.E. SCOTT, COMMERCIAL TRANSACTIONS PRINCIPLES AND POLICIES 560-67 (1982); Jackson & Kronman, *Secured Financing and Priorities Among Creditors*, 88 YALE L.J. 1143, 1158-61 (1979); Schwartz, *Security Interests and Bankruptcy Priorities: A Review of Current Theories*, 10 J. LEGAL STUD. 1 (1981).

II. Efficiency Justifications in General

Those who have examined the efficiency justifications for personal property security generally have limited themselves to a comparison of the total interest cost of a given amount of debt if the debtor were able to grant security with his total interest cost for the same amount of debt if no security were granted. The most rigorous and extensive analysis of the efficiency argument is one published in *The Journal of Legal Studies*[5] by Professor Alan Schwartz of the University of Southern California. Professor Schwartz examines and rejects the four most common efficiency explanations. I will deal at length with only one of those; however, to survey the terrain, it may be useful to review each of the most common efficiency arguments.

First is the argument that granting security reduces monitoring costs.[6] In our case, proponents of this argument would say that those creditors taking a security interest in Pan American's aircraft do so to reduce their risk by keeping Pan American from selling the aircraft and going into a riskier form of business. This theory argues that certain creditors do not need security because their debt is short term and recurring, and because they have such close relationships with the debtor that they have other less expensive means of monitoring the debtor's behavior.

Surely there is an element of truth to this argument. As Professor Schwartz points out, however, and as our Pan American example might suggest, it seems unlikely that this explains all or even most personal property security. It is hard to imagine Pan American going into an even riskier business than the one in which it is already engaged. Moreover, as Professor Schwartz says, short-term secured creditors appear to have much the same characteristics as short-term trade creditors that apparently are able to monitor their debtors through the use of devices other than security. At least some of these devices seemingly would be available to the presently secured short-term creditors as well.[7]

A second explanation for secured debt is that it is a "signal"

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5. Schwartz, *supra* note 4.

6. *Id.* at 9-14.

7. Arguably, short-term trade creditors do not need security because they have significant information about the debtor. Short-term secured creditors, however, have access to the same information. Both types of creditors have continuing contact with the debter and repeated proof, in the form of payment, that he is still solvent. Therefore, "short-term creditors would seldom need to monitor to reduce the odds of significant asset substitutions." *Id.* at 13.

that the particular debtor who is issuing the secured credit is a better risk than others and should enjoy a lower interest cost.[8] Besides directly conflicting with one's intuitive and common understanding—namely, the greater the risk the greater need for security—other difficulties plague the signaling explanation. The theory presupposes that the creditors cannot distinguish among debtors and that debtors presenting lower risks need a device with which to signal creditors that they are at the high end of credit worthiness. Because giving security impedes the debtor's possibility for subsequent borrowing, minimizes its maneuvering room on the verge of default, and gives greater power to the creditor upon default, one can argue that giving security is a greater burden to a high-risk debtor than to a low-risk debtor. That is, if one never defaults on his loan or approaches default, he avoids most of these costs of giving secured credit. If he is constantly on the verge of default, however, he must continually negotiate with his creditors in order to get more credit and to conduct his business. Thus, the argument goes, one signals the belief in the strength of his business by granting secured credit. By so doing one announces to the credit world, "I am so confident of my business, and think the prospect of default so small, I am willing to give secured credit." For a variety of reasons, well described by Professor Schwartz,[9] this argument is unpersuasive. For reasons that he suggests, granting secured credit is likely to be a highly ambiguous signal. The theory itself rests on a variety of empirical assumptions that seem unlikely to be true.[10]

A third efficiency justification is the idea that staggering debt can increase profits. It posits a debtor who will grant secured credit at the outset at a low interest rate and will use the profits saved—equal to the difference between the unsecured interest rate and the secured interest rate—to reinvest in the business. In the words of Professor Schwartz, "If the return earned by investing the difference between the secured and unsecured interest rate exceeds the cost of granting security, the firm will issue secured debt."[11]

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8. Jackson & Kronman, *supra* note 4, at 1149-61.

9. Schwartz, *supra* note 4, at 14-21.

10. *See id.* at 18-21. The "signal" concept rests upon empirical assumptions that are in direct conflict with the typical assumption, namely that debtors who are good credit risks need not give collateral, while those who are poor risks can procure loans only if they grant collateral. At best, therefore, a particular debtor's grant of collateral to procure his loan could be an ambiguous signal, and to many it would be a signal not of his strength but of his weakness.

11. Schwartz, *supra* note 4, at 22.

This argument too fails, for reasons set out by Professor Schwartz. First, many debtors have frequent credit needs; thus, the interval between the granting of the secured credit and the granting of unsecured credit is so short that the investment returns on the difference in interest are likely to be small.[12] Second, the pattern suggested by staggering seems to be inconsistent with the conventional understanding. That is, many debtors first issue unsecured credit, and turn to secured credit only when they find that they can no longer borrow unsecured.[13] The staggering explanation would predict the opposite.

A final argument in favor of efficiency as the justification for granting personal property security rests upon assumptions about differential risk aversion and heterogeneous expectations of default. This Article deals only with the former.[14] Professor Schwartz illustrates the risk-aversion concept by noting that if two creditors have differential risk aversion, and if the reduction of the risk to the risk-averse party would cause him to grant credit at a risk-neutral rate, then granting security to him would be efficient.[15] Professor Schwartz's criticism of the risk-aversion theory follows:

> The risk-aversion explanation seems plausible, but has two serious difficulties. First, it fails to show why creditors respond to risk aversion by taking security. Taking security is costly, so risk-averse creditors may prefer to buy low risk debt directly rather than buy high risk debt and reduce its risk by mortgages. Since much low risk debt exists, the risk-aversion explanation is incomplete. Second, given what is known about the goals that corporate managers actually pursue, explaining the existence of secured debt as a response to differential levels of risk aversion among creditors seems either mistaken or tautological. To perceive the nature of this difficulty, recall that risk aversion in individuals is explained by the diminishing marginal utility of money theory. This theory provides that each additional dollar a person receives generates less utility for him than the addition of earlier dollars did because later dollars are used to satisfy less urgent needs. Because money has diminishing marginal utility, a person seeking to maximize his or her expected utility would not be indifferent between equal prospects of gain or loss. The per-

12. *Id.*

13. *Id.*

14. The latter concept is basically the recognition that various creditors may view differently the likelihood of default by a given debtor on a certain debt and that whether or not a creditor demands security on a specific debt effectively depends in part on the creditor's unique perception. Professor Schwartz points out that although the theory invokes a prediction that long-term or large debt will be secured more often than short-term or small debt, the issue is not the term or size of the loan per se but rather whether the term or size is extraordinary enough to affect a particular creditor's perception of the probability of the debtor's default. *Id.* at 28. Therefore, the heterogeneous expectations explanation is not necessarily disproved by examples of some creditors often demanding security on small debts or others infrequently securing their loans regardless of the terms or magnitudes. *Id.*

15. *Id.* at 22-23.

son would lose more utility if the loss materialized than he or she would gain if prospects were successful. That is, for an ordinary person the expected utility of being given an equal chance of winning or losing the same amount would be less than the utility of not gambling. The assumptions that individuals maximize expected utility and that money has diminishing marginal utility thus imply individual risk aversion, not risk neutrality.

Many of a firm's business creditors, however, are likely to be corporations that are operated by managers whose scope of operation is to some extent independent of shareholder preferences. What utility function these managers maximize is a controversial and unresolved question. Economists and lawyers commonly assume that the managers try to maximize the market value of the corporation's stock. This goal implies risk neutrality. If managers are assumed to maximize share values, the risk-aversion explanation thus predicts that corporate creditors . . . will lend unsecured at relatively high interest rates so individual risk-averse creditors . . . can become secured at relatively low interest rates. The substantial amount of short-term secured debt held by banks and finance companies thus constitutes a troublesome counterexample to the risk-aversion explanation. Suppose next that the assumption of corporate managers maximizing share values is abandoned. There is no other widely accepted or easily defensible assumption of what goals corporate managers pursue to take its place. Given this theoretical and empirical vacuum, an argument that security is a response to differential levels of risk aversion among creditors becomes tautological: it proves the existence of security by presupposing differential levels of risk aversion, and it proves the existence of differential levels of risk aversion by showing that security exists.[16]

III. The Case for the Efficiency of Security

Although I cannot prove that the granting of personal property security is economically efficient, intuition, the available evidence, and defects in the challenges to security's efficiency make it seem likely that it is efficient. Note first that the various forms of personal property security in accounts, inventory, equipment, farm products, and a variety of other assets have grown up and persisted in a relatively free economy over a long period of time. There has been no obvious compulsion by the government for creditors and debtors to adopt this mode of operation, and it is one that has been tested and refined over decades of practice and through hundreds of thousands of disputes between creditors and debtors. One might ask why it has persisted in a free economy for so long if it is not efficient. Perhaps only because its efficiency and utility seem so obvious are the arguments on security's behalf so poorly developed in the literature. More to the point, those who have questioned the efficiency of security have based their challenges on a variety of assumptions that are probably not true and

16. *Id.* at 23-24 (citation omitted).

have omitted consideration of arguments and evidence that can be marshalled to support the efficiency of security.[17]

Consider four criticisms one can make of the usual arguments against the efficiency of security in general and particularly against differential risk aversion as an efficiency explanation. First, the fundamental premise that forms the basis for the challenge to an

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17. One of the arguments against risk aversion as an efficiency explanation for security is that any given creditor has a variety of low-risk lending alternatives. In the words of Professor Schwartz: "Taking security is costly, so risk-averse creditors may prefer to buy low risk debt directly rather than buy high risk debt and reduce its risk by mortgages." *Id.* at 23; *see supra* text accompanying note 16. In the first place, Professor Schwartz may be overestimating the cost of security. Moreover, assuming without deciding that the taking of security has a measurable and not insignificant cost, a given creditor still may have a number of reasons for lending to a particular debtor on a secured basis rather than investing in an alternative loan.

First, commercial banks have both explicit and implicit obligations to prospective debtors in their communities. *See infra* notes 50-53 and accompanying text. A national bank charter applicant commonly will assert the existence of unmet loan demand in the area in which he proposes to establish his office and thus at least implicitly states that he will meet that demand. The prospective banker in effect is offering to lend to local debtors.

Second, commercial banks and other financial institutions are authorized to invest in only a limited number of assets. For example, commerical banks may not purchase common stock for their own accounts. In addition, although banks may purchase corporate notes, the advantages of tax-exempt debt minimize banks' interest in corporate notes. Specific guidelines that tend to exclude risky debt obligations govern banks in their capacity as trustees of others' money in trust accounts. Moreover, the law imposes a variety of structural limitations upon banks, savings and loan associations, and other state and federally governed financial institutions. Among other things, these limitations require diversification, prohibit investment in land and some other assets, and tend to focus approved lending activities on certain portions of the market. *See infra* notes 54-56 and accompanying text.

Third, the lender may wish to diversify, as recognized by Professors Schwartz, Jackson, and Kronman. Even a lender desiring only low risk loans may not wish to make all of them in one industry or to one group of debtors.

Fourth, tradition well may be a governing force in a creditor's decision of what loans to make. To some extent at least, tradition protects the creditor from making loans in circumstances in which he lacks information. For example, when savings and loans, which traditionally have been mortgage lenders against real estate, obtained the authority to make certain consumer loans against mobile homes, some of these lenders eagerly entered this new market. Many of these, however, apparently lost money because they lent to persons that could not pay and at rates that did not adequately discount the risk of default and the relatively low value of the collateral. If these savings and loans had had a tradition in this market, then these losses clearly might not have occurred. In any event, tradition clearly plays some role, particularly in traditional lending institutions such as banks, savings and loan associations, and credit unions.

Last, as the Pan American example discloses, the presence of security does not necessarily make a loan one of low risk. It may simply reduce the risk from a level that is outrageous to one that is acceptable only to those creditors willing to bear a still considerable degree of risk. For example, though the Pan American bonds are secured, they certainly are not the equivalent of treasury bills or even strong state obligation bonds. The company issued them at 15% when the prime lending rate was 11%. *See* Wall St. J., Jan. 28, 1983, at 43, col. 2; Wall St. J., Jan. 12, 1983, at 3, col. 1.

efficiency argument—namely, that unsecured creditors would lend at lower rates if no one could receive security—may be untrue. If so, the presumed savings from the abolition of security mostly disappear, and a persuasive challenge to the efficiency of security becomes difficult to mount. Second, it is possible to overestimate the cost of granting security. Third, the arguments too narrowly define the efficiency equation by failing to consider benefits other than interest rate differentials—such as an expansion in the total credit granted to risky debtors. Last, by looking to the firm and not to the employee of the firm, Professor Schwartz and others may have focused on the wrong entity in an endeavor to measure risk aversion. Specifically, these commentators have looked to the creditor's overall firm when searching for risk aversion rather than the firm's individual employee who actually decides whether to extend credit in a given situation. Even if the firm is the correct entity, evidence other than the taking of security itself reveals that certain firms are less risk averse than others.

A. Risk of the Unsecured: A Function of Security to Others?

It is fundamental to efficiency analysis of secured credit to assume that the reduction of risk to one creditor, by giving that creditor security, is offset in some roughly proportionate way by the increase in risk to the other creditors, from whom the asset is now foreclosed on default.[18] That assumption is central to Professor Schwartz' criticism of traditional efficiency analysis. He assumes that increased interest paid to unsecured creditors at least will offset any interest savings that the debtor realizes by granting security to other creditors. If that assumption is undermined, the traditional arguments about the efficiency of security are easier to sustain and the challenge becomes more tenuous.

The assumption that granting security always increases the risk to unsecured creditors is inaccurate. Indeed, it is plausible that the assumption is untrue in most cases, both business and consumer. The risk addition assumption would be correct if default consisted merely of the debtor's surrender of his collateral to his secured creditors and the distribution of the remaining assets among his unsecured creditors. However, it is increasingly common both for the hopelessly insolvent consumer and for the firm with the barest prospect of making a recovery to invoke the benefits of

18. Schwartz, *supra* note 4, at 7.

bankruptcy law by filing in Chapter 11[19] or Chapter 7.[20]

When one examines the bankruptcy process, he sees that it is not just a competition between the secured and unsecured prebankruptcy creditors. In the typical consumer bankruptcy (Chapter 7), the bankrupt himself is a competitor who in many states will leave bankruptcy with substantial assets. In the typical business reorganization (Chapter 11), the bankruptcy creditors will have to share the assets with employees, trade creditors, lawyers, accountants, and a variety of others whose claims arise only after the filing of the bankruptcy petition.

Consider first the typical Chapter 7 consumer liquidation. By exercising their rights under the exemption laws provided in section 522 of the Bankruptcy Reform Act of 1978[21] and under the law of all of the states, a typical debtor husband and wife may be able to shelter assets with a value upwards of $20,000 in many cases and, in a few cases, a much larger sum.[22] In addition, under the federal law and the law of most states, the debtor will also be able to exempt a series of itemized assets, subject to no aggregate dollar level.[23] In some states the debtor will have the capacity to

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19. 11 U.S.C. §§ 1101-1174 (1982).

20. *Id.* §§ 701-766.

21. *Id.* § 522. Section 522 reflects the "fresh start" policy of bankruptcy law by allowing an individual debtor to retain certain property not subject to a security interest and by protecting these assets from the claims of most prebankruptcy creditors subsequent to the bankruptcy adjudication. In addition to this general reduction in the pool of assets available for satisfaction of the claims of unsecured creditors, subsection (f) invalidates the blanket security interests that financing companies sometimes take in objectively valueless household or personal items having great subjective value to the debtor. The waiver of bankruptcy exemptions is not permitted. *See* 3 W. COLLIER, *supra* note 2, at ¶ 522.

22. Assuming that both husband and wife elect the federal exemptions and that they have the requisite equity, they can claim a $15,000 exemption for its residence alone. 11 U.S.C. § 522(d)(1). If the residence is mortgaged to the hilt, the family still may use the $15,000 exemption, plus an additional one of $800, to shelter any unencumbered property. *Id.* § 522(d)(5). If the husband and wife each own a car, another $2400 of asset value can be sheltered. *Id.* § 522(d)(2). In addition, each bankrupt debtor may retain up to $4000 of life insurance loan value, *id.* § 522(d)(8), and can shelter pension payments "to the extent reasonably necessary for the support" of the debtor and his dependents. *Id.* § 522(d)(10)(E). Various other subsections—particularly (d)(3)—permit the debtor to "nickle and dime" the unsecured creditor. *See, e.g., id.* § 522(d)(4) ($500 for jewelry); *id.* § 522(d)(6) ($750 for "tools of the trade"). The debtors, however, may elect state exemptions. If, for example, our debtors reside in Ohio and one or both elect state exemptions, they will find a scheme similar to the federal scheme. *See infra* note 27. In Texas, a single debtor may exempt $15,000 of personal property, while a debtor with a family may shelter up to $30,000 worth of personal property. *See* TEX. REV. CIV. STAT. ANN. art. 3836 (Vernon 1966 & Supp. 1982-1983).

23. *See, e.g., In re* Maginnis, 24 Bankr. 146 (Bankr. E.D. Va. 1982) (china and silver flatware valued at more than $2700 exempted under state law allowing exemption of certain unencumbered articles and placing no limit to the aggregate value of articles exempted); *In*

exempt his entire homestead whatever its value.[24] Other states permit this only if the bankrupt is married and elects the state exemptions and thus enjoys the entireties limitations.[25] The Bankruptcy Reform Act of 1978 granted consumer debtors the alternative of exempting certain property described in the federal statute or choosing the state exemptions in the state where they resided when they filed the petition. Since that time at least 35 states[26] have exercised the right given them by the federal law to deprive their own residents of the choice between federal and state exemptions and to require their own residents to assert only the state exemptions. Nevertheless, many states have liberalized their

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re Wahl, 14 Bankr. 153 (Bankr. E.D. Wis. 1981) ($6000 "set" of silverware exempted under 11 U.S.C. § 522(d)(3) because each individual knife, fork, and spoon constituted a separate item worth less than $200).

24. In Texas, for example, a debtor with a rural homestead may exempt up to 100 acres if he is single or up to 200 acres if he has a family, plus any improvements thereon. Even an urban debtor may exempt the proportion of the lot's present value equal to $10,000 divided by the lot's value when it was designated a homestead and apparently may exempt entirely any improvements on the lot. Thus, a debtor with a $200,000 house on a $30,000 lot worth $15,000 when it was designated a homestead can exempt the entire value of his house, heing an improvement on the lot, and $20,000 for the lot itself. *See* TEX. REV. CIV. STAT. ANN. arts. 3833-35 (Vernon 1966 & Supp. 1982-1983). *See also* Whiteman v. Burkey, 115 Tex. 400, 282 S.W. 788 (1926); Hoffman v. Love, 494 S.W.2d 591 (Tex. Civ. App. 1973); Steenland v. Texas Commerce Bank Nat'l Ass'n, 648 S.W.2d 387, 390 (Tex. Ct. App. 1983).

25. *See, e.g.*, Michigan Nat'l Bank v. Chrystler (*In re* Trickett), 14 Bankr. 85 (Bankr. W.D. Mich. 1981); *In re* Lunger, 14 Bankr. 6 (Bankr. M.D. Fla. 1981); *In re* Thacker, 5 Bankr. 592 (Bankr. W.D. Va. 1980); *In re* Ford, 3 Bankr. 559 (Bankr. D. Md. 1980), *aff'd sub nom.* Greenblatt v. Ford, 638 F.2d 14 (4th Cir. 1981).

Only the 17 states that exclude a debtor's interest in tenancy by the entirety property from process, however, provide this exemption opportunity. *See* Ackerly, *Tenants by the Entirety Property and the Bankruptcy Reform Act*, 21 WM. & MARY L. REV. 701, 703 (1980).

26. *See, e.g.*, ALA. CODE § 6-10-11 (Supp. 1983); ALASKA STAT. § 09.38.055 (1983); ARIZ. REV. STAT. ANN. § 33-1133(B) (Supp. 1983-1984); ARK. STAT. ANN. § 36.210 (Supp. 1983); COLO. REV. STAT. § 13-54-107 (Supp. 1983); DEL. CODE ANN. tit. 10, § 4914 (Supp. 1982); FLA. STAT. ANN. § 222.20 (West Supp. 1983); GA. CODE ANN. § 51-1601 (Supp. 1982); IDAHO CODE § 11-609 (Supp. 1983); ILL. ANN. STAT. ch. 52, § 1 ¶ 101 (Smith-Hurd Supp. 1983-1984); IND. CODE ANN. § 34-2-28-0.5 (Burns Supp. 1983); IOWA CODE ANN. § 627.10 (West 1983-1984); ME. REV. STAT. ANN. tit. 14, § 4425 (Supp. 1983-1984); MD. CTS. & JUD. PROC. CODE ANN. § 11-504(g)(Supp. 1983); MO. REV. STAT. § 513.427 (Supp. 1984); MONT. CODE ANN. § 31-2-106 (1983); NEV. REV. STAT. § 21.090(3) (1982); N.H. REV. STAT. ANN. § 511:2-a (1983); N.Y. DEBT. & CRED. LAW §§ 282-284 (McKinney Supp. 1983-1984); N.C. GEN. STAT. § 1C-1601(f) (1983); N.D. CENT. CODE § 28-22-17 (Supp. 1983); OHIO REV. CODE ANN. § 2329.662 (Page 1981); OKLA. STAT. ANN. tit. 31, § 1(B) (West Supp. 1983-1984); OR. REV. STAT. § 23.305 (1981); S.C. CODE ANN. § 15-41-425 (Law Co-op. Supp. 1983); S.D. COMP. LAWS ANN. § 43-45-13 (1983); TENN. CODE ANN. § 26-2-112 (1980); UTAH CODE ANN. § 78-23-15 (Supp. 1983); VA. CODE § 34-3.1 (Supp. 1983); W. VA. CODE § 38-10-4 (Supp. 1983); WYO. STAT. § 1-20-109 (Supp. 1983).

exemption laws as part of the process.[27]

27. One such state is Ohio. Its exemption statute now provides:

(A) Every person who is domiciled in this state may hold property exempt from execution, garnishment, attachment, or sale to satisfy a judgment or order, as follows:

(1) The person's interest, not to exceed five thousand dollars, in one parcel or item of real or personal property that the person or a dependent of the person uses as a residence;

(2) The person's interest, not to exceed one thousand dollars, in one motor vehicle;

(3) The person's interest, not to exceed two hundred dollars in any particular item, in wearing apparel, beds, and bedding, and the person's interest, not to exceed three hundred dollars in each item, in one cooking unit and one refrigerator or other food preservation unit;

(4) (a) The person's interest, not to exceed four hundred dollars, in cash on hand, money due and payable, money to become due within ninety days, tax refunds, and money on deposit with a bank, building and loan association, savings and loan association, credit union, public utility, landlord, or other person. This division applies only in bankruptcy proceedings. This exemption may include the portion of personal earnings that is not exempt under division (A)(13) of this section.

(b) Subject to division (A)(4)(d) of this section, the person's interest, not to exceed two hundred dollars in any particular item, in household furnishings, household goods, appliances, books, animals, crops, musical instruments, firearms, and hunting and fishing equipment, that are held primarily for the personal, family, or household use of the person.

(c) Subject to division (A)(4)(d) of this section, the person's interest in one or more items of jewelry, not to exceed four hundred dollars in one item of jewelry and not to exceed two hundred dollars in every other item of jewelry.

(d) Divisions (A)(4)(b) and (A)(4)(c) of this section do not include items of personal property listed in division (A)(3) of this section. If the person does not claim an exemption under division (A)(1) of this section, the total exemption claimed under division (A)(4)(b) of this section shall be added to the total exemption claimed under division (A)(4)(c) of this section and the total shall not exceed two thousand dollars. If the person claims an exemption under division (A)(1) of this section, the total exemption claimed under division (A)(4)(b) of this section shall be added to the total exemption claimed under division (A)(4)(c) of this section and the total shall not exceed one thousand five hundred dollars.

(5) The person's interest, not to exceed an aggregate of seven hundred fifty dollars, in all implements, professional books, or tools of his profession, trade, or business, including agriculture;

(6) (a) The person's interest in a beneficiary fund set apart, appropriated, or paid by a benevolent association or society, as exempted by section 2329.63 of the Revised Code;

(b) The person's interest in contracts of life or endowment insurance or annuities, as exempted by section 3911.10 of the Revised Code;

(c) The person's interest in a policy of group insurance or the proceeds of such a policy, as exempted by section 3917.05 of the Revised Code;

(d) The person's interest in money, benefits, charity, relief, or aid to be paid, provided, or rendered by a fraternal benefit society, as exempted by section 3921.18 of the Revised Code;

(e) The person's interest in the portion of benefits under policies of sickness and accident insurance and in lump sum payments for dismemberment and

Because of these generous exemption laws, debtors retain

other losses insured under such policies, as exempted by section 3923.19 of the Revised Code.

(7) The person's professionally prescribed or medically necessary health aids;

(8) The person's interest in a burial lot, including, but not limited to, exemptions under section 517.09 or 1721.07 of the Revised Code;

(9) The person's interest in:

(a) Moneys paid or payable for living maintenance or rights, as exempted by section 3304.19 of the Revised Code;

(b) Worker's compensation, as exempted by section 4123.67 of the Revised Code;

(c) Unemployment compensation benefits, as exempted by section 4141.32 of the Revised Code;

(d) Aid to dependent children payments, as exempted by section 5107.12 of the Revised Code;

(e) Poor relief payments, as exempted by section 5113.01 of the Revised Code.

(10) (a) The person's right to a pension, benefit, annuity, or retirement allowance and to accumulated contributions, as exempted by section 145.56, 146.13, 742.47, 3307.71, 3309.66, or 5505.22 of the Revised Code, and the person's right to benefits from the policemen and fireman's death benefit fund;

(b) The person's right to receive a payment under any pension, annunity, or similar plan or contract, not including a payment from a stock bonus or profit sharing plan or a payment included in division (A)(6)(b) or (A)(10)(a) of this section, on account of illness, disability, deatb, age, or length of service, to the extent reasonably necessary for the support of the person and any of his dependents, except if all the following apply:

(i) The plan or contract was established by or under the auspices of an insider that employed the person at the time his rights under the plan or contract arose;

(ii) The payment is on account of age or length of service;

(iii) The plan or contract is not qualified under the Internal Revenue Code of 1954, 68A Stat. 3, 26 U.S.C. 1, as amended.

(11) The person's right to receive alimony, child support, an allowance, or maintenance to the extent reasonably necessary for the support of the person and any of his dependents;

(12) The person's right to receive, or moneys received during the preceding twelve calendar months from any of the following:

(a) An award of reparations under sections 2743.51 to 2743.72 of the Revised Code, to the extent exempted by division (D) of section 2743.66 of the Revised Code;

(b) A payment on account of the wrongful death of an individual of whom the person was a dependent on the date of the individual's death, to the extent reasonably necessary for the support of the person and any of his dependents;

(c) A payment, not to exceed five thousand dollars, on account of personal bodily injury, not including pain and suffering or compensation for actual pecuniary loss, of the person or an individual for whom the person is a dependent;

(d) A payment in compensation for loss of future earnings of the person or an individual of whom the person is or was a dependent, to the extent reasonably necessary for the support of the debtor and any of his dependents.

(13) Except as provided in section 3113.21 of the Revised Code, personal earnings

many assets apparently destined for the general creditors in liqui-

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of the person owed to him for services rendered within thirty days before the issuing of an attachment or other process, the rendition of a judgment, or the making of an order, under which the attempt may be made to subject such earnings to the payment of a debt, damage, fine, or amercement, in an amount equal to the greater of the following amounts:

(a) If paid weekly, thirty times the current federal minimum hourly wage; if paid biweekly, sixty times the current federal minimum hourly wage; if paid semimonthly, sixty-five times the current federal minimum hourly wage; or if paid monthly, one hundred thirty times the current federal minimum hourly wage which is in effect at the time the earnings are payable, as prescribed by the "Fair Labor Standards Act of 1938," 52 Stat. 1060, 29 U.S.C. 206(a)(1), as amended.

(b) Seventy-five per cent of the disposable earnings owed to the person.

(14) The person's right to specific partnership property, as exempted by division (B)(3) of section 1775.24 of the Revised Code;

(15) A seal and official register of a notary public, as exempted by section 147.04 of the Revised Code.

(16) Any other property that is specifically exempted from execution, attachment, garnishment, or sales by federal statutes other than the "Bankruptcy Reform Act of 1978," 92 Stat. 2549, 11 U.S.C. 101 et seq., as amended.

(17) The person's interest, not to exceed four hundred dollars, in any property, except that this division applies only in bankruptcy proceedings.

(B) As used in this section:

(1) "Disposable earnings" means net earnings after the garnishee has made deductions required by law, excluding the deductions ordered pursuant to section 3113.21 of the Revised Code.

(2) "Insider" means:

(a) If the person who claims an exemption is an individual, a relative of the individual, a relative of a general partner of the individual, a partnership in which the individual is a general partner, a general partner of the individual, or a corporation of which the individual is a director, officer, or in control;

(b) If the person who claims an exemption is a corporation, a director or officer of the corporation; a person in control of the corporation; a partnership in which the corporation is a general partner; a general partner of the corporation; or a relative of a general partner, director, officer, or person in control of the corporation;

(c) If the person who claims an exemption is a partnership, a general partner in the partnership; a general partner of the partnership; a person in control of the partnership; a partnership in which the partnership is a general partner; or a relative in, a general partner of, or a person in control of the partnership;

(d) An entity or person to which or whom any of the following apply:

(i) The entity directly or indirectly owns, controls, or holds with power to vote, twenty per cent or more of the outstanding voting securities of the person who claims an exemption, unless the entity holds the securities in a fiduciary or agency capacity without sole discretionary power to vote the securities or holds the securities solely to secure to debt and the entity has not in fact exercised the power to vote;

(ii) The entity is a corporation, twenty per cent or more of whose outstanding voting securities are directly or indirectly owned, con-

dation. If, for example, a secured creditor takes and perfects a security interest in the debtor's automobile, he will get that automobile on the filing of the Chapter 7 liquidation. On the other hand, if the creditor does not take a security interest, the debtor is likely to leave bankruptcy with the automobile under either state law[28] or section 522(d).[29] If one assumes the typical consumer debtor is not wealthy and that all of his assets have a value of less than the probable exemptions, the unsecured creditor will be indifferent to the presence of secured claims on the debtor's assets, for in bankruptcy he will receive nothing from the estate in any event.

The status of the business creditor in bankruptcy is less obvious. No exemptions exist here, but other considerations nonetheless may cause assets apparently destined for the hands of the unsecured creditor to fall to others. The others are postpetition sellers of goods and services who may provide them for cash or on credit. Consider the typical Chapter 7 liquidation that is preceded by a Chapter 11 reorganization.[30] In such case the business must continue. To do so it must use assets that it currently possesses to

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trolled, or held with power to vote, by the person who claims an exemption, or by an entity to which division (B)(2)(d)(i) of this section applies;

(iii) A person whose business is operated under a lease or operating agreement by the person who claims an exemption, or a person substantially all of whose business is operated under an operating agreement with the person who claims an exemption;

(iv) The entity operates the business or all or substantially all of the property of the person who claims an exemption under a lease or operating agreement.

(e) An insider, as otherwise defined in this section, of a person or entity to which division (B)(2)(d)(i), (ii), (iii), or (iv) of this section applies, as if the person or entity were a person who claims an exmeption;

(f) A managing agent of the person who claims an exemption.

(C) For purposes of this section, "interest" shall be determined: In bankruptey proceedings, as of the date a petition is filed with the bankruptey court commencing a case under Title 11 of the United States Code; (2) In all cases other than bankrutpcy proceedings, as of the date of an appraisal, if necessary under section 2329.68 of the Revised Code, or the issuance of a writ of execution.

An interest, as determined under division (C)(1) or (2) of this section, shall not include the amount of any lien otherwise valid pursuant to section 2329.661 [2329.66.1] of the Revised Code.

OHIO REV. CODE ANN. § 2329.66 (Page 1981).

28. Texas, for example, allows the debtor to retain either all passenger cars and light trucks not used for the production of income or up to two motor vehicles used for income production. TEX. REV. CIV. STAT. ANN. art. 3836(a)(3) (Vernon 1966 & Supp. 1982-1983). By contrast, Ohio provides a $1000 motor vehicle exemption. OHIO REV. CODE ANN. § 2329.66(A)(2) (Page 1981).

29. 11 U.S.C. § 522(d)(2) (1982).

30. *See infra* note 32 and accompanying text.

pay employees and to purchase goods and services. Moreover some assets will inevitably be expended not just for routine goods and services but also for accountants, lawyers, and other professional experts in the operation of the bankruptcy process itself. Many of these goods and services will be purchased for cash and by the direct expenditure of assets that the business otherwise might use to pay off prepetition creditors. That is so because no one will be anxious to lend money to a business already in bankruptcy. Nevertheless, section 364 provides for borrowing and in some cases, for the grant of "super priority,"[31] thus, some lenders will continue to extend credit to the bankrupt firm.

Although the data are sparse, it appears that a large percentage[32] of all business bankruptcies that start out as Chapter 11 reorganizations prove to be unsuccessful and conclude either as Chapter 7 or Chapter 11 liquidations. Moreover, some destined for liquidation from the outset are operated temporarily under section 721.[33] Without exception, one can assume that the unsuccessful re-

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31. 11 U.S.C. § 364(c) (1982).

32. *See, e.g.*, Air Transport Ass'n of America v. Professional Air Traffic Controllers Org. (*In re* Professional Air Traffic Controllers Org.), 699 F.2d 539, 540 n.1 (D.C. Cir. 1983); Roslyn Sav. Bank v. Comcoach Corp. (*In re* Comcoach Corp.), 698 F.2d 571, 573 (2d Cir. 1983); Kopelman v. Halvajian (*In re* Triangle Laboratories, Inc.), 663 F.2d 463, 465 (3d Cir. 1981); Earl Realty, Inc. v. Leonetti (*In re* Leonetti), 28 Bankr. 1003, 1006 (Bankr. E.D. Pa. 1983); Levine v. First Nat'l Bank of Lincolnwood (*In re* Evanston Motor Co.), 26 Bankr. 998, 999 (Bankr. N.D. Ill. 1983).

One study shows that out of 45 firms which filed for reorganization, 19 converted to Chapter 7. *See* M. White, Bankruptcy Liquidation and Reorganization, Table 34.5 (unpublished manuscript). Professor L. Pucki found an even higher rate of failure in his study of Chapter 11 cases in the Western District of Missouri. Out of 48 cases, only 11 were "successful." That is, the debtor had obtained confirmation of a plan and was still in business at the time of the survey in only those 11 cases. In 7 of the remaining cases, the debtor filed a liquidating plan; the rest either were converted to Chapter 7 or were dismissed. L. Pucki, *The Debtor in Full Control— Systems Failure Under Chapter 11 of the Bankruptcy Code?* 57 AM. BANKR. L.J. 99, 109 (1983). The cases that eventually were converted or dismissed spent an average of six months in Chapter 11. *See id.* at 123.

As one pair of commentators has noted,

> [i]t is very easy for a debtor to claim to be in the process of reorganization and for a 'reorganization-minded' bankruptcy judge to support that claim. But saying so does not make it so—and it seldom is. We believe that the record shows an abysmally low correlation between petitions and [actual] reorganizations.

Moss & Berger, *Bankruptcy: The Creditor and Chapter 11*, MORTGAGE BANKING, June 1983, at 52, 53.

In Utah, for example, reorganization plans were confirmed in only 43 of the 261 cases—16%—filed and pending for more than six months as of September 30, 1982. Most likely, the remaining 84% of the cases were eventually converted to liquidation. *See In re* Colonial Ford, Inc., 24 Bankr. 1014, 1022 n.18 (Bankr. Utah 1982).

33. "The court may authorize the trustee to operate the business of the debtor for a limited period, if such operation is in the best interest of the estate and consistent with the

organization attempt will have dissipated some of the assets that might otherwise have been distributed to creditors had liquidation occurred upon default. In such an unsuccessful attempt the business will have been losing money and will continue to do so but, since it is in bankruptcy, the business will bear the notoriously expensive burden of paying lawyers, accountants, and others to operate the Chapter 11 process.[34]

If the reorganization-to-liquidation scenario is the common mode of business bankruptcy, or even if it is a frequent but not the most common outcome, a rational prepetition unsecured creditor will be indifferent to others' taking of security. The assets allocated to the secured creditor will not be available in bankruptcy to the unsecured creditor anyway. If the scenario described is likely to be played out in only one-third or one-half of the business defaults, but the creditor is incapable of identifying that group prior to default, the presumed benefit to the unsecured creditor from prohibiting security still would be significantly smaller than the cost to the secured creditors who are deprived of security. To summarize, if the paradigm unsecured creditor expects to get little or nothing out of a business bankruptcy because he correctly fears that any assets available will be dissipated in a fruitless attempt to operate the business, he is indifferent whether a second prepetition secured creditor takes those assets or a postpetition purveyor of goods and services takes them. Thus, the foundation of the challenge to the efficiency of security founders because the principal savings presumed to arise from a prohibition of security—reduced interest costs from secured creditors—may not exist.

B. The Cost of Security

A second important ingredient in the challenge to the efficiency of security is the cost it imposes on the debtor. The analysts of this issue all correctly point out that costs associated with grant-

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orderly liquidation of the estate." 11 U.S.C. § 721 (1982).

34. The court in *In re* Liberal Market, Inc., 24 Bankr. 653 (Bankr. S.D. Ohio 1982), noted that "[t]raditionally the practice of corporate and commercial law, the essence of most Chapter 11 proceedings, has been compensated with highly competitive salaries above those chargeable by the average practitioner." *Id.* at 659. In *Liberal Market*, in which the debtor was a supermarket chain with initial assets of $20 million, the court allowed more than $500,000 in attorneys' fees and expenses.

In *In re* White Motor Co., a reorganization case filed in September 1980, attorneys' fees totaled $12.7 million and accountants' fees were up to more than $3 million as of early April 1984. The bankrutpcy judge administering the case estimated that attorneys' fees ultimately could total $20 million. *See* Nat'l L.J., Apr. 9, 1984, at 3, col. 1.

ing secured debt exist that are not present in granting unsecured debt. These expenses include the cost of filing and searching the files, the cost of negotiating and drafting a security agreement, and perhaps some cost associated with taking an inventory and making an appraisal of the assets that are given as collateral.[35] Because these additional costs are a central point in the argument that a nonsecurity state may be more efficient, one should not make facile assumptions about them. If they are small or trivial, the system of granting security can offer equally small savings and yet be no less efficient than a non-security state.

If the Pan American notes were unsecured, would the cost have been lower? It seems unlikely. The principal expenses in that case were the lawyers' fees and other costs associated with writing a loan agreement and complying with the SEC rules, and the underwriters' fees incurred in selling the notes. The security agreement likely added trivial costs. Furthermore, I suggest that the additional cost that a security grant imposes is trivial in *many* cases. For example, any creditor, secured or not, who lends a large sum to a closely held corporation, will demand a detailed loan agreement. The creditor will make an investigation of the income and assets of the debtor. Adding a five dollar filing fee and a few standardized clauses to the agreement to make it a security agreement would be a trivial addition to the cost in such a case. Precisely because Article 9 is so simple, taking and perfecting a security interest in most personal property is inexpensive. In most cases, all that is necessary is a signed security agreement together with the filing of a financing statement.[36] Even in consumer cases the costs are small

35. The costs associated with workout and defaults, however, which undoubtedly are imposed upon the debtor, are not obviously greater in a security arrangement than in a nonsecurity arrangement. All loan agreements impose limits on the debtor's freedom, and all defaults are likely to result in negotiation costs and other transaction expenses, but these costs may be the same whether or not the debtor grants security.

36. Secured creditors may perfect their interests by one of three ways. Certain security interests, the most important of which is the purchase money security interest in consumer goods, are automatically perfected. U.C.C. § 9-302 (1978). The secured creditor *must* take possession of some type of collateral to perfect his security interest therein, whereas possession is an *alternative* means of perfecting in some other situations. *Id.* § 9-305. The third and most common method of perfection is the filing of a financing statement.

Perfection by filing is neither expensive nor difficult since it requires merely a short financing statement containing a reasonable identification of the collateral, the names and addresses of the parties, and the debtor's signature. Filing a copy of the security agreement suffices if the copy contains this information. *Id.* § 9-402(1). The Code specifies the proper place to file, which frequently will be in the office of the Secretary of State. *See id.* § 9-401(1). In addition, the secured creditor who errs in his filing may still receive protection. For example, if his description of the collateral is faulty but not seriously misleading, the

because the parties use form contracts. Thus, the cost of granting security easily can be overestimated. With respect to many loans, the costs of security are trivial.

C. *The Benefits of Granting Security Among Creditors with Differential Risk Aversion*

If the assumption that all creditors are risk-neutral is not accurate, a simple challenge to the efficiency of security falters, and the factors that must be considered in any equation to measure efficiency are expanded substantially. Professor Schwartz himself concedes that if a distribution of risk aversion exists among creditors, it is probably efficient to give security to those creditors displaying the greatest risk aversion.[37] By granting security to the highly risk-averse creditors, a debtor can reduce the aggregate interest cost for a given amount of debt. A creditor who will charge a large premium for high risk will charge a disproportionately smaller premium on a low-risk loan.[38] Thus if risk-averse creditor *A* would demand fifteen percent unsecured, while risk-neutral creditor *B* would make the same loan at twelve percent, but each would lend secured at seven percent, then giving security to *A* will reduce the total interest cost to the debtor. In the words of Professor Schwartz, "Security is used to reduce a firm's net cost by shifting risks to less risk-averse creditors."[39]

An even more significant consequence of a distribution of relative risk aversion among various creditors exists in the form of expansion of the total credit sold. It is my thesis that if a distribution of risk aversion exists among various potential creditors, the power to grant security and thus to reduce the risks to some of those creditors will expand the credit granted to risky debtors. That is so for two reasons. First, at some rate, each debtor will be incapable of generating enough revenue on the borrowed money to repay the principal and interest and thus will choose not to borrow at or

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security interest will remain effective. *Id.* § 9-402(8). Similarly, a financing statement filed in the wrong place is effective against other creditors that have knowledge of the contents of the financing statement. *Id.* § 9-401(2). *See generally* J. WHITE & R. SUMMERS, HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE §§ 23-5 to 23-16, at 918-64 (2d ed. 1980) (description of ways to perfect).

37. *See* Schwartz, *supra* note 4, at 22-23; *see also* text accompanying note 16.

38. Presumably all creditors, whether of high or low risk aversion, will make a risk-free loan at the same price. As the risk increases, however, the premium that the risk-averse creditor demands increases because the marginal value to him of each dollar of profit decreases.

39. Schwartz, *supra* note 4, at 23.

above that rate. Assume, for example, that risk-averse creditor *A* wishes a payment of twenty-two percent to lend unsecured to Pan American but that creditor *B* will lend secured at twelve percent. If Pan American concludes that it cannot earn a return in excess of twenty-two percent on the money borrowed, then in a nonsecurity system it would choose not to borrow. Some of the money in the market simply would be too dear for Pan American to buy it. Consequently, it would have to generate revenues elsewhere, reduce its operation, or liquidate.

Continuing the assumption of differential risk aversion, there is a second and related reason why the amount of credit granted to risky debtors may decline if the debtor cannot give security. This reason pertains to risks to the creditor neither discounted in the interest rate nor disclosed to the debtor. In our hypothetical case, Pan American might have been willing to borrow at twenty-two percent and might have concluded that it would be economical for it to do so. Notwithstanding that fact and notwithstanding that creditor *A* agreed that the proper discount for the risk offered was twenty-two percent, *A* nevertheless might choose not to lend to Pan American at that rate. To an economist that idea is heretical. We have assumed that the appropriate price is twenty-two percent, yet our creditor has chosen not to sell. Why so? I would maintain that this is so because of the existence of risks, not discounted by the interest rate and undisclosed by the creditor, in such circumstances. These are the risk to the specific employee that he will suffer demotion or loss of his job and the risk to the firm that it will suffer adverse consequences with agencies such as the Comptroller of the Currency, the Federal Reserve, or the FDIC upon inspection if any such risky loans go bad.[40] One might respond that we simply have not calculated the risk correctly. This example assumes, however, that the risk-averse party has correctly concluded that lending to this debtor at twenty-two percent will bring the same return as lending secured to that party at nine percent and hypothesizes that the creditor will make the nine percent loan but not the twenty-two percent loan. That is not because the return will not be the same, but because, on failure of the loan, consequences to the creditor's employee within his organization and to his organization with respect to the supervisory agencies may be severe.[41]

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40. *See infra* notes 41 & 57.

41. The bulk of commercial bank earnings traditionally comes from lending. Thus, the

In either event the inability to reduce a risk-averse creditor's risk by giving him security will keep loans from being made that otherwise would be made to risky debtors. In the hypothetical, creditor *A* presumably would lend elsewhere, and the total number of potential lenders to our hypothetical firm would decline. Of course, a decline in the total number of lenders willing to lend to a specific debtor or group of debtors would not ensure that the total credit granted to those firms would decline. Other creditors, seeing the opportunity and being risk-neutral, might make the loans unsecured that formerly would have been made by the risk-averse lenders who now have looked elsewhere. Yet it is also plausible that a significant reduction in the number of lenders willing to consider a specific group of debtors would diminish the total supply of credit available to those debtors at the interest rate that prevailed previously and that the same amount of credit would be available to them only at an increased cost because of a modification in the available supply.

If either of the two considerations described above or a combination of them translates into a reduced amount of credit granted to risky debtors in a nonsecurity system, the efficiency equation discussed above must be altered. It is no longer sufficient simply to

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profitability and security of a bank's operations are to a large extent dependent upon the effective management of its loan portfolio. *See* K. COHEN & S. GIVSON, MANAGEMENT SCIENCE IN BANKING 319 (1978). Even the failure of a loan relatively small in comparison with the bank's total portfolio can have a significant effect. For example, if a bank with an aggregate loan portfolio of $1,000,000 earning $120,000 makes a $100,000 loan that goes bad, the loss will constitute nearly all of that portfolio's earnings for the year. Once the creditor takes into account other costs such as opportunity costs and the cost of the talent and other resources required to administer weak credits, the price of loan failure is clearly quite high. *See* Mueller, *The Most Challenging Issues Facing Bank Lending*, in CLASSICS IN COMMERCIAL BANK LENDING 406, 411 (W. Sihler ed. 1981). In addition, failure of too many of a bank's loans may bring various levels of FDIC sanctions that in some instances ultimately may result in the closing of the bank. *See* J. SINKEY, PROBLEMS AND FAILED INSTITUTIONS IN THE COMMERCIAL BANKING INDUSTRY 28-32 (1979); *see also infra* note 59.

The personal consequences to the individual who actually authorizes a bad loan also can be severe. Lending officers have substantial discretion and concomitant reponsibility in the approval and denial of loan applications. *See* Mott, *Establishing Criteria and Concepts for a Written Credit Policy*, in CLASSICS IN COMMERICAL BANK LENDING, *supra*, at 421; White, *The Present Value Approach to Selecting Bank Customers*, in MANAGEMENT SCIENCE IN BANKING, *supra*, at 336. As one commentator stated, "A is the passing grade for lending officer performance." Mueller, in CLASSICS IN COMMERCIAL BANK LENDING, *supra*, at 411. If a loan goes bad, a lending officer may lose his job through dismissal or forced resignation. *See* F. SCHERER, INDUSTRIAL MARKET STRUCTURE & ECONOMIC PERFORMANCE 34 (2d ed. 1980); A. THOMPSON, ECONOMICS OF THE FIRM 326 (2d ed. 1977); *see also infra* note 44. At the very least, he must face the embarrassment of having his loan cited as a "bum" loan and a clear example of unsatisfactory work. *See* Mueller, *Learning from Lending*, in CLASSICS IN COMMERCIAL BANK LENDING, *supra*, at 6-10.

net and compute interest costs. Now one must speculate about the use to which a nonsecurity system debtor would have put the money compared to the use of the debtor who actually receives it under our security system, and about the consequences of the use of that money for the employees, shareholders, and other members of society. The formula becomes complex, and it is no longer possible to make relatively simplified judgments about security's efficiency.

D. Evidence of Differential Risk Aversion

But what is the evidence of heterogeneous risk aversion among creditors? I suggest that those observers asserting homogeneity have overlooked at least two pieces of evidence. First, when searching for differential risk aversion, these commentators have examined the firm when they should have been focusing on the employee. Second, they have ignored substantial evidence of differential risk aversion among lending institutions themselves.

With respect to the first error, it is traditional to assume that the managers of a corporation will be risk-neutral, for in that manner they maximize the profits to the shareholders.[42] This assumption, however, is incorrect. Substantial theory and data now suggest that the typical employee makes an individual judgment about risk analysis.[43] While this judgment is not unrelated to maximizing the profits of the firm, it is often inconsistent with that goal. For example, assume a case in which a large corporation is divided into "profit centers." An individual employee's advance-

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42. *See* D. BAIRD & T. JACKSON, *supra* note 4, at 357; Schwartz, *supra* note 4, at 23-24.

43. For example, my examination of contractual behavior in the chemical industry during a time of shortage indicated that company representatives were more concerned with protecting their individual positions in the company than with complying with legal niceties. As one representative pointed out, "shorting" the president of another division would not be wise since the representative might be working for that individual in the next year. *See* White, *Contract Law in Modern Commercial Transaction, An Artifact of Twentieth Century Business Life?*, 22 WASHBURN L.J. 1, 13, 15-18 (1982). *See also* S. CULBERT & J. MCDONOUGH, THE INVISIBLE WAR: PURSUING SELF-INTERESTS AT WORK (1980); R. CYERT & J. MARCH, A BEHAVIORAL THEORY OF THE FIRM (1963); J. MARCH & H. SIMON, ORGANIZATIONS 65, 81-82 (1958); F. SCHERER, *supra* note 41, at 340; A. THOMPSON, *supra* note 41; O. WILLIAMSON, THE ECONOMICS OF DISCRETIONARY BEHAVIOR: MANAGERIAL OBJECTIVES IN A THEORY OF THE FIRM (1964).

As a practical matter, even an employee seeking only to implement the firm's judgment regarding risk likely would be thwarted by the organizational complexity present in most firms. Because of the many hierarchical layers through which any instruction must pass, distortion of the message to suit the prejudices and fears of the various intermediate transmitters is inevitable. *See* F. SCHERER, *supra* at 31. A firm may not even be capable of formulating an unambiguous organizational goal. *Id.* at 34.

ment may depend upon the profit of his profit center even though he enjoys and achieves that profit at a cost to other intrafirm profit centers. To say that such an employee acts to maximize the benefit of the shareholders is to ascribe to that employee and to his supervisor not only altruistic interests but also perspectives that they may not have.

If one assumes that each employee operates autonomously to some extent, his acts as an employee may be risk-averse for precisely the same reason that an individual may be risk-averse—namely, the last incremental dollar of profit achieved from a successful but risky investment does not outweigh the cost of the loss of that dollar if the loan is unsuccessful. Why is that? It is my hypothesis that those employees who make loans that are later—perhaps by hindsight—deemed risky are likely to suffer demotion or discharge in circumstances in which successful loans of the same kind would not produce comparable increases in salary or status. For example, the failure of the Penn Square Bank and the default on a variety of energy industry loans held by Seafirst and Continental Illinois have caused dismissals and demotions at both of those latter banks.[44] Of course, one cannot be sure about the fired employees' prospects for promotions and increases in income based on risky but successful loans, but it seems unlikely that even substantial increases in pay outweigh the cost of dismissal.[45]

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44. Continental Illinois National Bank & Trust Company first placed its officer responsible for business with Penn Square "on special assignment" for an unspecified period of time. Wall St. J., July 15, 1982, at 14, col. 2. Following an internal investigation, the bank fired the officer because, according to a Continental Illinois spokesman, the bank "no longer ha[d] any confidence either in his managerial or lending abilities." Wall St. J., Aug. 31, 1982, at 2, col. 3. The officer promptly denounced the bank for attempting to make him a scapegoat. *Id.* Continental Illinois also requested the departures of two of the officer's superiors; one resigned while the other took early retirement. In addition, several officers responsible for monitoring the loan retired or resigned, and the bank gave another officer a "new assignment." *Id.*

Seafirst replaced its two credit managers responsible for the Penn Square loan; one resigned while the other took early retirement. A Seafirst spokesman stated that the latter officer "felt it was best for himself and the bank that he step down . . . ." Wall St. J., July 19, 1982, at 6, col. 1. At Chase Manhattan, another large holder of Penn Square loans, the two officers reponsible for accepting the loan resigned "of their own volition." Wall St. J., July 20, 1982, at 40, col. 3. Other officers connected with the loan also received dismissals. Wall St. J., July 21, 1982, at 2, col. 2.

45. Even if an individual receives a salary increase or bonus if a risky loan is successful, he is not likely to see much correlation between his particular actions and the relative size of his reward, especially as compared with stockholder gains. Therefore, he probably will prefer the more secure profits associated with lower risk endeavors. *See* F. SCHERER, *supra* note 41, at 31, 34; A. THOMPSON, *supra* note 41, at 326; Roberts, *Increasing Bank Profitability by Modifying Loan Officer Performance*, J. COM. BANK LENDING, Feb. 1983, at

In short, if the real question that the loan officer asks is not "Should I make this loan at this rate to maximize the profits of the shareholders?," but "How does the approval or rejection of this loan relate to my personal advancement?," that tells us that some distribution of risk aversion will exist. Not only will each loan officer be responding to the circumstances in his particular firm but also each officer will be responding to his innate willingness to take risk, to the joy he derives from it, and to the fear it causes him. Given these additional considerations, it seems improbable that each loan officer will have an identical view of risk and that each will be risk-neutral. More likely, various views of risk will be spread over some spectrum.

Even if one concludes that the correct body to study is the firm and not the individual employees of the firm, evidence exists

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Psychological studies of decisionmaking also support this conclusion that individual employees' risk aversion affects the firm's decision whether to lend in a given situation. Risky choices are not made objectively; rather, the threat of loss has greater impact on the decision than does the possibility of equivalent gain. Consequently, decisionmakers generally are risk-averse and tend to favor routine over innovative behavior. *See* Kahneman & Tversky, *The Psychology of Preferences*, SCI. AM., Jan. 1982, at 160, 164.

The evidence and traditional views concerning bank ideas about promotion, pay, and seniority also support this view of the bank loan officer's probable risk assessment. *See* Metzger, *Bank Compensation: The Next Major Change Forced by Deregulation*, J. RETAIL BANKING, Spring 1983, at 1, 1; Nadler, *Should I Suggest a Career in Banking?*, BANKERS' MONTHLY MAG., Sept. 15, 1983, at 8, 10-11. Commercial banks traditionally pay employees comparatively low salaries but also grant substantial security and large perquisites. *See* H. CROSSE & G. HEMPEL, MANAGEMENT POLICIES FOR COMMERICAL BANKS 286-90 (3d ed. 1980); Collage, *Trends in Bank Compensation and Executive Remuneration*, MID-CONTINENT BANKER, July 1982, at 54, 54; Metzger, in J. RETAIL BANKING, *supra*, at 1, 1; Albert, *Banks Catch Up in Giving Execs Cash Bonuses*, Am. Banker, Aug. 10, 1983, at 3, col. 1.

Bank compensation policies, however, have become somewhat more generous in recent years. For example, M.B.A.'s starting out in commercial lending now can earn more than $30,000 at some banks. *See* Runde, *The Bull Market in Financial Services Jobs*, MONEY, July 1983, at 96, 97. Indeed, salary increases in the banking industry as a whole are outstripping salary increases in other industries. *See* Am. Banker, Dec. 14, 1983, at 24, col. 2. Many banks are moving from fixed salaries to variable pay determined by the performance of each officer's personal portfolio. *See* Collage, *Emerging Bank Executive Compensation Trends*, BANKERS MAG., July-Aug. 1983, at 8, 8; McKelvey, *Commercial Lenders Most Wanted: 'Hot Spot' Remains in Sun Belt*, MID-CONTINENT BANKER, May 1983, at 8, 11; Albert, *supra*, at 3, col. 1. Some banks now offer greater challenge, diversity, and responsibility to loan officers. *See* D. HAYES, BANK LENDING POLICIES 86-88 (2d ed. 1977).

When the bank officer's salaries and bonuses are compared to the payment schemes for similar functional positions and levels of responsibility in other industries, however, the bank officer does not fare so well. Bank bonus plans include relatively few employees and award much less money, and salaries also tend to be lower. *See* Metzger, *supra*, at 1, 1-5. *But see* D. HAYES, *supra*, at 87-88. Similarly, M.B.A.'s from top schools still receive lower starting salaries in banking than their colleagues that go in to industry receive. *See* D. HAYES, *supra*, at 83; Metzger, *supra*, at 1, 2.

of differential risk distribution among various firms. Compare the relative positions of commercial banks, sales finance companies, insurance companies, and general nonbank business lenders. The most important and pervasive lenders in our society are commercial banks.[46] They lend both long- and short-term in virtually every segment of the economy from the consumer to the largest business, and they are located in every city in the country.[47] Captive sales finance companies such as General Motors Acceptance Corporation (GMAC) and Ford Motor Credit Corporation are also significant lenders, but their lending is confined typically to the financing of inventory and to consumer purchases of that inventory.[48] Insurance companies are more likely to be long-term lenders, often securing their loans with real estate. The lending of general finance companies such as Walter Heller may be regarded as a substitute for the commercial lending that banks perform. The comparison reveals evidence of differential risk aversion among these institutions as institutions, without regard to the particular risk aversion of their employees.

Consider first the commercial bank. One does not simply open a commercial bank. He first must procure a charter from the Comptroller if it is to be a national bank[49] or from the comparable

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46. *See* H. CROSSE & G. HEMPEL, *supra* note 45, at 7. Approximately 15,000 commercial banks are in operation today. Seven of the ten largest lenders in the United States and fifteen of the top twenty-seven are bank holding companies. While nonbanking firms have made significant inroads into the banking market in recent years, on balance, the aggregate share of the financial services market that banks hold remains the same. Banks continue to account for the lion's share of outstanding commercial and industrial loans. *See* KAUFMAN, MOTE, & ROSENBLUM, THE FUTURE OF COMMERCIAL BANKS IN THE FINANCIAL SERVICES INDUSTRY 19-22, 40 (1983) (a revised and expanded version of a paper prepared for the 64th American Assembly). Banks are also the largest single source of credit generally. Analysts estimate that commerical banks provided $130 billion of the total $515 billion credit supply in 1983, while life insurance and pension funds, government, and individuals were the next largest sources, each providing an estimated $90 billion of credit. *See* MORGAN GUARANTY TRUST CO., CREDIT MARKETS IN 1983, MORGAN GUARANTY SURVEY 9, 10 (Jan. 1983).

47. *See* H. CROSSE & G. HEMPEL, *supra* note 45, at 37-42; O. WOOD, COMMERICAL BANKING 1-2 (1978).

48. The General Motors Acceptance Corporation and Ford Motor Credit Corporation are finance subsidiaries of their parent automobile manufacturers. GMAC and Ford Motor Credit finance automobiles at both the wholesale and retail levels. *See* SENATE COMM. ON THE JUDICIARY (S. Boyle), 93d Cong., 2d Sess., A REORGANIZATION OF THE U.S. AUTOMOBILE INDUSTRY 213 (Comm. Print 1974). Boyle estimates that the short-term financing of franchise holders' inventory purchases represents from 75% to 80% of the business of the finance subsidiaries. Moreover, "well more than half of all sales to dealers are financed, at least in the short run, by the production companies themselves." *Id.* at 215.

49. The principal provisions regarding the chartering of a national bank appear in 12 U.S.C. §§ 21-27 (1982). Sections 21 and 22 require articles of association and an organization certificate. Section 26 provides that the Comptroller of the Currency will determine whether

state authority if it is to be a state bank. As a part of that chartering process he must make extensive disclosure to the chartering agency and must assure the agency that he is capable of running a bank and that the bank he proposes is likely to succeed. Typically the parties wishing to open a bank must show that they have banking expertise or that they will employ someone who is an experienced commercial banker. They must show the "need" for loans in the market in which they propose to open the bank and must convince the chartering agency that they are upstanding individuals who will be responsive to the rules and regulations and will not operate the bank in an "unsafe and unsound manner."[50]

The chartering process itself contains a series of implicit promises about the performance of the bank.[51] One implicit promise made to the agencies, including the FDIC as insurer, is that the insurer will not need to come to the rescue of this bank. A second implicit promise is that the bank will meet local demand for loans and that it will not serve simply as a device to collect deposits and carry them off to New York City or some more distant point.[52] A third implicit promise is that of subservience to and respect for the rules and regulations of the chartering agency. I suggest that these implicit assurances that are given as part of the chartering process

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the association can commence business. If the Comptroller approves, he will issue a certificate of authority to commence banking—a charter—under section 27.

In deciding whether to grant the charter, the Comptroller considers future earnings prospects, general character of management, adequacy of capital structure, convenience and needs of the community, and the financial history of the bank. 12 C.F.R. § 5.20(b)(1)-(5) (1983).

50. *See* 12 C.F.R. § 5.20(c)(1)(ii) (1983). "If the evaluation shows that a proposed bank has less than reasonable prospects for success or is not likely to be operated in a safe and sound manner, the application will be disapproved." *Id.*

Furthermore, the statute directs the Comptroller to consider whether the bank will operate in a manner consistent with the purposes of the Federal Deposit Insurance Act (FDIA). *Id.* § 5.20(b)(6). Section 1818 of the FDIA states that if an insured bank engages in unsafe or unsound practices, then the FDIC may terminate the bank's coverage. 12 U.S.C. § 1818 (1982).

51. For example, the operating plan, which the bank must file as part of its application,

> must demonstrate that the proposed bank will have reasonable earnings prospects, that it will be able to hire and retain competent executive officers . . . that it will maintain adequate capital, that it will offer services responsive to community needs and that it will be operated in a safe and sound manner in compliance with applicable laws.

12 C.F.R. § 5.20(c)(3) (1983).

52. 12 U.S.C. §§ 2901-2905 (1982). Financial institutions have a continuing affirmative obligation to help meet the credit needs of the local communities in which they are chartered. *Id.* § 2901. "[T]he appropriate Federal financial supervisory agency shall—(1) assess the institution's record of meeting the credit needs of its entire community, including low- and moderate-income neighborhoods . . . ." *Id.* § 2903.

are equivalent to an explicit promise stating that the bank will not engage in risky activity and that the agency will not be embarrassed by chartering the bank and will not be called upon to put out good cash to save it.

Once a commercial bank is in operation it is subject to a series of explicit regulations and rules that tend to make it more, not less, risk-averse. First is the rule that prohibits lending more than fifteen percent of the bank's total capital to any one customer.[53] Part of the reason for this rule is to spread the largesse around the community, but an additional and important reason is to spread and thus reduce the risk of bank collapse resulting from the failure of a particular debtor. Second is the rule that prohibits loans to affiliates in excess of twenty percent of the bank's capital.[54] This rule presumably fosters the same policies as the first prohibition. Third are the rules found in section 24, 7th of the National Banking Act and in the comparable provisions of state law that limit banks to the "business of banking."[55] Unlike the typical corporation, a bank may not engage in any business activity that seems profitable. The bank may engage only in the "business of banking" and matters incidental to that business. Although courts have stretched the concept of the business of banking in recent years, it remains highly restrictive.[56] For example, the rules may permit a

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53. *Id.* § 84(a)(1).

54. *Id.* § 371c(a)(1)(B).

55. *See id.* § 24 (1982). National banks have the power to exercise:

> all such incidental powers as shall be necessary to carry on the business of banking; by discounting and negotiating promissory notes, drafts, hills of exchange, and other evidences of debt; by receiving deposits; by buying and selling exchange, coin, and bullion; by loaning money on personal security; and by obtaining, issuing, and circulating notes according to the provisions of this chapter.

Id. As a result, national banks may not underwrite security issuances and the Comptroller limits purchases of stock for the bank's own account. *Id.*

The rationale for these limitations on bank activities is the protection of the public. *See* Harfield, *Sermon on Genesis 17:20; Exodus 1:10 (A Proposal for Testing the Propriety of Expanding Bank Services*, 85 BANKING L.J. 565, 579 (1968)). "The public interest requires a sound banking system safely operated. For this reason, and this reason alone, it is improper for a bank to engage in those activities that involve risks other than credit risks." *Id.*

56. *See, e.g.*, Arnold Tours, Inc. v. Camp, 472 F.2d 427, 432 (1st Cir. 1972) (travel agency services not incidental to business of banking; must be convenient or useful to traditional bank activities and directly related to performance of express powers); National Retailers Corp. of Arizona v. Valley Nat'l Bank, 411 F. Supp. 308 (D. Ariz. 1976) (national bank cannot provide data processing services to public), *aff'd*, 604 F.2d 32 (9th Cir. 1979); M & M Leasing Corp. v. Seattle First Nat'l Bank, 391 F. Supp. 1290 (W.D. Wash. 1975) (personal property leasing permissible in some circumstances), *aff'd in part, rev'd in part*, 563 F.2d 1377 (9th Cir. 1977), *cert. denied*, 436 U.S. 956 (1978); Georgia Ass'n of Indep. Ins. Agents, Inc. v. Saxon, 268 F. Supp. 236 (N.D. Ga. 1967) (national bank cannot act as insur-

bank to lease as a substitute for secured lending, but it can not run a Hertz rental agency. A bank may serve as a stockbroker in some limited ways, but it can not operate a manufacturing concern. In short, all of the activities of a bank must be either banking per se or incidental to banking. The purpose of such rules is partly to avoid an undue concentration of power, but it is also to minimize risk. The hypothesis of the drafters of such law is that banks ought not engage in speculative activities such as the development of real estate or the purchase and sale of stock for their own accounts.

In addition to the chartering process' implied promises and the statutorily imposed operational rules, banks must cope with one more outside constraint that fosters risk aversion. Institutions who must bear a significant part of the cost and blame for a bank's failure but who derive no particular benefit from its extraordinary success supervise and examine the banks. These institutions are the state and federal agencies, such as the FDIC, who insure each account and bear losses up to $100,000 per account. The duty of these agencies' examiners is to root out "unsafe and unsound" banking practices. Routinely they examine loan portfolios with a fine tooth comb and insist that certain loans be written off and others be written down. Occasionally they chastise banks or put them on a "black list" for having made too many risky loans.[57] Nowhere is it recorded that a bank examiner ever praised a bank for making a risky but successful loan.

I maintain that the combination of laws explicitly designed to minimize risk taking by banks, regulations to carry out those laws, and the presence of examiners whose principal interest is to fulfill Congress' conservative mandate ensure that commercial banks will not be risk-neutral but instead will be risk-averse. Compare their statute with that of a commercial financial company[58] or a captive

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ance agent in cities of over 5,000 inhabitants), *aff'd*, 399 F.2d 1010 (5th Cir. 1968).

57. *See* 1982 FDIC ANN. REP. art. 9:

> The FDIC maintains a list of current banks . . . having unsafe or unsound conditions and a relatively high possibility of failure & . . . . The FDIC imposes specific corrective measures on such banks and in most cases, the banks' problems are corrected over a period of time and the institutions are removed from the list.

Id. At the end of 1982, 369 banks were on the FDIC list. The FDIC considers the following factors to indicate "problems:" Poor earnings, inadequate capital, inadequate liquidity, asset deficiencies resulting from mismanagement, and insider abuses. 1978 FDIC ANN. REP. 7.

58. The commercial finance company evolved primarily to finance receivables and to meet the other financing requirements of the business community that the banks were not meeting. *See* M. LAZERE, COMMERCIAL FINANCING 13 (1968). For example, sales finance companies provide credit for the distribution and sale of consumer durables such as cars, radios, and refrigerators. Finance companies also may handle consumer installment sales of goods

sales finance company, such as GMAC. A commercial finance company has the authority under the general corporate law to engage in any form of lending that its charter permits. It must make the routine disclosures to the SEC, but it is subject to no restrictions of the kind one finds in the state or federal banking laws. In addition, commerical finance companies are not subject to examination by bank examiners or to the supervision of an insurer such as the FDIC. The same lack of outside restraint characterizes a sales finance company, but in its case its relationship to its parent actually may stimulate certain forms of risky behavior. If, for example, a General Motors dealer is in serious financial trouble, GMAC, as a good corporate brother, might take a risk in making a loan to such a dealer that an independent bank or third party would not take. By the same token, in order to facilitate the production and sale of automobiles by its parent, GMAC might choose to make consumer loans in circumstances in which others would not.

These institutional and personal considerations—quite apart from the actual taking of security—point to a distribution of risk aversion among various creditors. The facts suggest that the commercial banks are on the conservative end of the risk-sensitivity spectrum that extends from them through other regulated financial institutions to commercial finance companies, factors, and other unregulated lenders that more nearly conform to the efficiency critics' risk-neutral norm.[59]

If one concludes that creditors are spread across a spectrum of risk aversion, it lightens the load of one who would show that granting personal property security is efficient. First, if one believes Professor Schwartz' assertion that "[r]isk aversion generally

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such as encyclopedias, appliances, and clothing.

According to Lazere, "[t]he consumer finance field runs the normal risks of fictitious receivables and conversion." *Id.* at 135. The dealer may retain customer payments that rightfully belong to the financer or may assign the account before he delivers the merchandise. The customer is also a risk factor since his dissatisfaction with the product may result in no payment for the financer. *Id.* at 135-36.

59. Commercial finance companies make loans to retailers, wholesale distributors, and manufacturers. Receivables and inventory typically secure these loans. A small business might borrow from a commercial finance company in addition to or as a substitute for obtaining a bank loan. Commercial finance companies usually are willing to make riskier loans than a bank will make. *See* M. LAZARE, COMMERCIAL FINANCING 35 (1968). For example, Westinghouse Credit Corporation in 1983 provided inventory financing for approximately 12,000 consumer durable dealers. *See* Moody's Bank and Finance Manual, vol. 2, at 3184-85 (1983). The inventory that these dealers used as collateral included televisions, furniture, pianos, and electronics equipment. Westinghouse Credit Corporation has $2,796,400,000 of receivables outstanding at the end of 1982. *Id.* at 3158 (*Receivables Outstanding, Dec. 31, 1982 (Dollars in millions)*).

varies with the degree of risk,"[60] and that thus a creditor who charges a large premium for a high risk will charge only the same amount as a risk-neutral person at a low risk,[61] a debtor always saves money by securing highly risk-averse creditors. Second, if one posits a debtor who poses a risk beyond the level that many creditors are willing to assume, security expands the credit likely to be available to him.

IV. ARTICLE NINE'S EFFICIENCY COMPARED WITH THE EFFICIENCY OF THE MOST LIKELY ALTERNATIVES

Those who discuss the abolition of the priority in bankruptcy that now is granted to perfected secured creditors often do so on the assumption that the secured creditor could be reduced to the level of a general creditor. It is not clear that Congress would or could enact a law that would successfully deprive secured creditors—or their proxies under a new system—of priority.[62] It is my thesis that if Congress indeed were successful in constitutionally abolishing security, then formerly secured creditors would search

Receivables Outstanding	Dec. 31, 1982	(Dollars in millions)
	Amount	Percent of total
Industrial Equipment	$862.6	30.8
Financial Services	588.8	21.1
Business Financing	746.1	26.7
Real Estate	598.9	21.4

The risks that commerical finance companies typically assume may be explained as follows:

> The problem, analysts say, is that big banks aren't used to the quirks of the secured lending that characterizes commercial finance; lenders must keep careful track of a borrower's inventories—to make sure they really are there—and know the value of assets pledged as collateral. As one C.I.T. official says: "You have got to know the value of a shrimp boat off New Orleans, or some earth-moving equipment, and know how and where to sell it if necessary." An additional problem is that finance-company earnings are more strongly affected than bank earnings by interest-rate changes.

Wall St. J. Feb. 6, 1984, at 18, col. 5.

60. Schwartz, *supra* note 4, at 23.

61. *See supra* text accompanying noto 15.

62. Such legislation not only would modify radically the substantive law concerning ownership interests but also would override the explicit contractual agreement of the debter and creditor. This would constitute a significant intrusion into property law governing the rights of privato parties, an area traditionally left to the states. Moreover, a law effectively eliminating a creditor's existing rights in security would be open to challenges based on several constitutional grounds, the most obvious being the fifth amendment's "taking" clause, due process, and equal protection. For a more detailed discussion of these arguments, see White, *The Recent Erosion of the Secured Creditor's Rights Through Cases, Rules and Statutory Changes in Bankruptcy Law*, 53 MISS. L.J. 389, 424-26 (1983).

for security alternatives. If, contrary to my suggestion, today's Article 9 secured creditors were to choose not to resort to security alternatives, but rather to become general creditors lending at higher interest rates, then the argument would break down. What leads one to conclude that secured creditors would search for security alternatives rather than settling for the status of general crediotrs? The answer is three-fold.

First, acceptance of the above risk-aversion analysis, with its proposition that certain creditors have relatively low risk ceilings above which they will not lend, would lead the parties to search for a device by which debtors that presented risks above that ceiling could reduce their riskiness and thus be acceptable to a relatively risk-averse creditor. Second, at least initially, secured creditors would search for security alternatives because of tradition. Banks and many other creditors are notoriously traditional and unreceptive to change. Creditors who are accustomed to having security in certain circumstances and to pursuing that security in times of difficulty would not readily accept an economist's suggestion that it would be more efficient in the long run for them simply to raise their interest rates and lend unsecured to the same debtor. They are practical people who know the consequences of their past behavior and are skeptical of theoretical departures from it. If one adds to this consideration of tradition the element of personal risk aversion—how better to get fired than to advocate a radical departure than proves to be costly?—it seems likely that one who is risk-averse would conform as closely as possible to old ways. A third reason why the secured creditor likely would turn to a security alternative as opposed to totally unsecured credit is that that is what his lawyers would tell him to do.[63] A typical lawyer would not make the kind of analysis that we are considering here, but nonetheless would search for alternatives that conform as closely as possible to the past practice. The most clever of the lawyers might even devise something that looks like a lease or other nonsecurity arrangement but performs like a security agreement. Indeed, the cases offer ample evidence of this form of innovative behavior.[64]

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63. *See, e.g.*, Koch, *Bankruptcy Planning for the Secured Lender*, 99 BANKING L.J. 788, 790-96 (1982).

64. For example, prior to the adoption of the Uniform Commercial Code, a series of personal property security devices came into general use in response to expanding commercial needs for credit. Among the oldest devices employed were the common law pledge and the statutory chattel mortgage. In a continuing effort to protect their clients' positions, lenders' lawyers came up with increasingly inventive security devices. The resulting com-

Given that creditors would search for an alternative to security in the event of security's abolition, the relevant determination is of the device or devices that these creditors would adopt. The limited inroads on the perfected secured creditor's rights that the Bankruptcy Reform Act of 1978[65] has made have started a movement that likely would become a migration with the attempted abolition of security interest priority. This movement is the trend of erstwhile secured creditors to become lessors of goods to the debtor on the one hand, or buyers of assets[66] of the debtor—factors—on the other. Regarding the recent popularity of leasing, as long as the Bankruptcy Code recognizes that parties who lease goods to another have a right either to the contracted payment or to the return of the goods upon the lessee's default, it will be possible for a would-be lender closely to approximate a secured debt by arranging his transaction as a lease. In tax cases,[67] banking power cases,[68] and bankruptcy cases,[69] the courts long have dealt with the question whether a given document constitutes a lease or a security agreement. Under the current law, one receives quite different treatment in bankruptcy if he is regarded as a lessor rather than as a secured creditor.[70] It is clear that he cannot make the same deal

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plexity of financing transactions led legislatures to enact more statutory provisions to deal with various gaps that the piecemeal development of security devices had left. *See generally* U.C.C. § 9-101 comment (Article 9 supersedes prior legislation dealing with security devices such as chattel mortgages, conditional sales, trust receipts, factor's liens and assignments of accounts receivable); 1 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY §§ 1-9 (1965); Leary, *Secured Transactions—Revolution or Evolution,* 22 U. MIAMI L. REV. 54, 60 (1967) (UCC evolved from the common law, where lawyers had put old concepts and precedents to new uses); Stroh, *Peripheral Security Interests—The Expanded Net of Article 9,* 22 U. MIAMI L. REV. 67 (1967) (Article 9 preempts the application of law outside the UCC and may extend to chattel acquisitions, leases, and contracts for sale of personalty).

65. 11 U.S.C. § 101 (1982).

66. *See* Koch, *supra* note 63, at 790-96.

67. *See, e.g.,* Frank Lyon Co. v. United States, 435 U.S. 561 (1978).

68. *See, e.g.,* M & M Leasing Corp. v. Seattle First Nat'l Bank, 391 F. Supp. 1290 (W.D. Wash. 1975), *aff'd in part, rev'd in part,* 563 F.2d 1377 (9th Cir. 1977).

69. *See, e.g., In re* Fashion Optical, Ltd., 653 F.2d 1385 (10th Cir. 1981); *In re* Coors of the Cumberland, Inc., 19 Bankr. 313 (Bankr. M.D. Tenn. 1982); *In re* Winston Mills, Inc., 6 Bankr. 587 (Bankr. S.D.N.Y. 1980); *In re* Pacific Sunwest Printing, 6 Bankr. 408 (Bankr. S.D. Cal. (1980); Adelman v. GMAC (*In re* Tulsa Port Warehouse Co.), 4 Bankr. 801 (Bankr. N.D. Okla. 1980).

70. The rights of a lessor when his lessee files bankruptcy are specified in section 365 of the Bankruptey Code. While the lessee or his trustee has the right either to assume or to reject the lease, he must meet the terms of the lease as written if he decides to assume it. Every existing default must be cured, and all subsequent payments mnst be made at the time and in the amount provided in the lease. *See* 11 U.S.C. § 365 (1982). In contrast, the dehtor or his trustee may argne that a secured creditor's collateral is worth less than the creditor says it is and can force the secured creditor to accept lower payments or payments

with his debtor as he would as a secured creditor and still be regarded as a lessor, but he can make a close approximation of it.

At the other end of the spectrum is the "factor," one who buys accounts receivable from a debtor at a discount and without recourse. He, too, is the functional equivalent of a lender who enjoys nearly all of the rights of a secured creditor. He lacks only the recourse right if his "collateral" proves to be inadequate to satisfy the "debt." It seems doubtful that Congress could or would enact a law that would deprive a "debtor" of the power of selling his assets. Failing that, it cannot bar true factoring. Presumably, if Congress were to avoid sales of accounts receivable for new value and without recourse, it also would be willing to avoid ordinary course sales of assets of other kinds. Therefore, a ban upon true factoring is extemely unlikely. Moreover, the application of such rules only to transactions within some period preceding bankruptcy would ensure that all potential financers would treat any debtor in trouble like a leper, and thus would send him sliding down the slope into bankruptcy with precipitous speed.

If the law specified that secured creditors under Article 9 had no greater rights in bankruptcy than general creditors, one would expect secured lenders on the purchases of automobiles and equipment to become lessors, and accounts receivable lenders to become factors. The current cast of secured creditors, complying with Article 9 by signing security agreements and filing financing statements, might be replaced by another group of substantially similar composition.

Would such a system be more or less efficient, more or less costly, than the Article 9 system? One cannot be certain, but it appears likely that such a system of leasing, factoring, and other more ingenious schemes would be more expensive than our current system. With respect to factoring, first the factor still might have to do a filing.[71] Second, the factor would have to take possession of all of the physical attributes of the accounts receivable. Third, since no right of recourse would exist, the factor, who by hypothesis is relatively risk-averse, would demand a discount that would

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extended over a longer period. *See id.* § 1129.

71. *See* U.C.C. § 9-102 (1978). Under Article 9, even a financer that buys an account and can make some argument that the arrangement was not intended for security eventually will find tbat its transaction falls within the ambit of Article 9. *See id.* § 9-102(1)(b). Thus, the prudent factor should file to protect its position outside of bankruptcy, particularly since the mere act of filing creates no presumption regarding the true nature of the arrangement. *See id.* § 9-408.

exceed the interest rate it otherwise would charge to make up for being unable to assert a deficiency claim against the debtor.[72] Fourth, the factor would have to set up a system to notify the account debtors and to collect the accounts.[73] Since this would cause some duplication of effort—the debtor probably also would have a collections department—it presumably would be less efficient than having the debtor simply make the collections.[74] Last, because no right of recourse would exist, the buyer of the accounts would wish to be certain that he is buying only good accounts, and thus would have a greater interest in examining the accounts in detail to determine which are good and which are not. This is an expense that the creditor might avoid in a recourse arrangement.

Lease arrangements as alternatives to security also probably would be more expensive than the current personal property security system. This greater cost would result primarily because the lessor, to be certain of receiving "lease" treatment in bankruptcy, would have to bear the risk that the collateral would have a lower value at the end of the lease than the parties contemplated at the beginning. Assume, for example, that equipment worth $1,000,000 is leased for three years with the expectation that it will be worth

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72. The inability of the factor to assert a deficiency claim conceivably could lead to corresponding savings for the general creditors. Without the factors having access to a right of recourse, assets that otherwise would go to a secured creditor in satisfaction of his deficiency claim would be available to the general creditors.

73. If the accounts receivable serve as security for a loan, then the credit customers need not be notified, and collection is left to the debtor. In the factoring context, however, the debtor continues to solicit orders from customers in the usual manner, but then he must submit these orders to the factor prior to acceptance for a determination of whether the debtor may extend credit to each potential customer. If the factor determines that a particular account is an acceptable credit risk and, thus, is willing to buy the account, it will, for a fee, advance the debtor cash against the account receivable. The factor usually notifies the debtor's customers of the arrangement and instructs them to send all subsequent payments directly to the factor. The factor is also responsible for undertaking all necessary collection efforts. *See* Moore, *Factoring—A Unique and Important Form of Financing and Service*, 14 BUS. LAW. 703, 708 (1959), *reprinted in* R. SPEIDEL, R. SUMMERS, & J. WHITE, COMMERCIAL & CONSUMER LAW 207-09 (3d ed. 1981); *see also* J. VAN HORNE, FINANCIAL MANAGEMENT & POLICY 487, 489-92 (5th ed. 1980), *reprinted in* A. SCHWARTZ & R. SCOTT, *supra* note 4, at 515-19.

74. The debtor also might have a collections department because it might not have factored all of its accounts receivable. In addition to the duplicative costs of a factor setting up a collection system, another administrative expense of the factoring device is the fee of between one and three percent of the face value of the purchased accounts that the factor generally receives as compensation for servicing the receivables and bearing the risk that they will turn out to be uncollectable. In addition, if the debtor wants to draw on its account before the receivables actually are collected, factors charge higher interests than banks taking security interests in accounts would charge. *See* J. VAN HORNE, *supra* note 73, at 487, 490, *reprinted in* A. SCHWARTZ & R. SCOTT, *supra* note 4, at 517-18 (1982).

$300,000 at the end of three years. The lessor would have to bear the risk that the equipment would be worth less than $300,000; if he did not bear that risk, a court might well describe the "lease" as a security agreement and the "lessor" as a general creditor.[75] The requirement that he bear that risk, of course, would increase the total amount of risk that the creditor/lessor would have to bear in the transaction and would cause him to raise the fee by comparison with the interest charge that he would have made on a comparable Article 9 loan. In addition, because the lessor would bear the risk of this depreciation, he might spend more time supervising and investigating the lessee's maintenance and care. Furthermore, he would have to maintain a facility through which he could dispose of the leased goods upon their return to him at the end of the lease.[76] As a result of these additional risks and costs, in certain markets the lessor's exposure would be substantially greater than his exposure would be if he were merely a secured creditor. For example, in a lease arrangement in the rapidly advancing computer industry, the lessor and not the debtor/lessee would bear the risk of obsolesence. Of course, such a lessor would establish a price accordingly. In short, because of these risks and costs, and because by hypothesis our secured creditors are relatively risk-averse compared to general creditors, it is plausible that a lease mimic of a comparable security transaction would be more costly.

If personal property security were abolished, one cannot predict with absolute certainty how today's secured creditors would behave. It seems likely, however, and history suggests that these creditors would search for the least expensive security alternatives. Some form of leasing and factoring is probably the least expensive alternative for risk-averse creditors. Such forms are probably more expensive than the current Article 9 system, yet there is good reason to believe that today's secured cretitors would engage in those

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75. *See, e.g., In re* Coors of the Cumberland, Inc., 19 Bankr. 313, 316-17 (Bankr. M.D. Tenn. 1982); *In re* Pacific Sunwest Printing, 6 Bankr. 408 (Bankr. S.D. Cal. 1980); Adelman v. GMAC (*In re* Tulsa Warehouse Co.), 4 Bankr. 801 (Bankr. N.D. Okla. 1980).

76. If a bank received goods at the expiration of a lease and then had to dispose of them, this activity might not be within the "business of banking." In M & M Leasing Corp. v. Seattle First Nat'l Bank, 563 F.2d 1377 (9th Cir. 1977), the court permitted the bank to lease motor vehicles since the activity was "incidental to the 'loan of [sic] money on personal security.' " *Id.* at 1382 (quoting 12 U.S.C. § 24 (Seventh) ("loaning money on personal security")). The court, however, added that "our holding manifestly is not intended to authorize leases which impose significant financial risks on national banks more onerous than those incident to loans . . . . To engage in the business of renting personal property would permit the assumption of risks not permitted national banks." *Id.* at 1383-84.

forms of lending. Unless lawmakers can find a way within our system of private property of abolishing all possibility of factoring, leasing, and more exotic alternatives, society likely would wind up with a less effective system of lending upon the abolition of Article 9 than exists today. Thus, even if one concludes that there is no prima facie efficiency argument for recognizing priority claims of secured creditors, it may still be efficient to maintain our current Article 9 system because that is the most inexpensive means of accommodating the world as we find it.

V. CONCLUSION

It is always more interesting to challenge the received wisdom than to defend it. Yet in this case, a careful analysis of the facile assertions about the expansion of credit by the granting of security and about the other presumed efficiencies of security produces arguments and evidence that strengthen rather than weaken the efficiency arguments. In the first place, it appears that the granting of security does in fact expand the credit granted to risky debtors and thus that any efficiency equation must consider the probable benefits of such expansion. Second, a close examination of the actual experience not only of consumer lenders but also of business lenders in bankruptcy indicates that our basic assumption about the relationship between the presence of secured credit and the reduction of the value of the unsecured creditors' claims may be inaccurate. If the improvement of the creditor's position by granting security carries with it no corresponding reduction in the status of other unsecured creditors, the basic challenge to the efficiency of security is undermined. Finally one must consider the alternatives that would prevail in a society that nominally prohibited personal property security. I suggest that less efficient security substitutes such as leasing and factoring would grow up and that we would be left with most of the inefficiencies inherent in those security substitutes. While I concede that I have not proven security to be efficient, a careful consideration of the arguments and evidence set out above makes security's efficiency more likely than the critics have suggested. Dismal as such a prospect is, the facile assertions about the efficiency of security may be accurate.