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LORD OF THE LIENS: TOWARDS GREATER EFFICIENCY IN SECURED SYNDICATED LENDING

William H. Widen*

INTRODUCTION

Three liens for the syndicated loans, seven for the equipment financier in Stamford, nine for the general unsecured creditors who play ball, and one financing statement to rule them all, and in the darkness bind them.

Recent amendments to Article 9 of the Uniform Commercial Code greatly simplified the process of creating a secured credit transaction.1 Despite these positive developments, we find both the rise of insurance products to compete with security interest legal opinions2 and the decrease in importance placed on legal opinions by rating agencies.3 Meanwhile, lawyers continue to refine security interest legal opinion practices.4 The premise of this article is that a significant reason for

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1 Most jurisdictions adopted a version of revised Article 9 effective July 1, 2001. Unless otherwise indicated, references to Revised Article 9 (Secured Transactions) are to the version promulgated by the National Commissioners on Uniform State Laws as amended and modified through 2001.


these trends is the increasing complexity of secured credit transactions, particularly in large syndicated loans. The recent amendments to Article 9 provide valuable, but only limited, assistance in managing this complexity. Both law reform and contracting techniques have not kept up with the complexity. The rise of insurance and the trend towards legal opinion abandonment are symptoms of the complexity, but not real solutions to manage it.

The goal of this article is to propose a business practice for managing this complexity called the “Lord of the Liens” or “LOTL” structure. The project amounts to an exercise in transaction cost engineering. The approach is to develop a template for debtors to create a reusable transaction infrastructure for executing secured credit transactions that operates within the framework of existing law. It involves a reassessment of the extent to which security interests can operate as permanent features of a debtor’s or borrowing group’s organizational structure, much as subsidiary companies function in a corporate group. It challenges the notion that current law reflects a fundamental distinction between legal entities and other asset partitioning devices, such as security interests.

The article identifies possible changes in law that would enhance the transaction cost engineering project.

5 This claim should not be understood as simply an observation that the complexity of business organizations recently has increased. Complicated business organizational structures have been with us for a long time. See, e.g., FRANK CLARKE ET AL., CORPORATE COLLAPSE (2d ed. 2003) (describing the failures of large business organizations during the last century).

6 The security interest insurance policy is a mechanism for transferring certain transaction responsibilities from the deal lawyer to the insurance company. See Tom Baker, Risk, Insurance, and the Social Construction of Responsibility, in EMBRACING RISK, THE CHANGING CULTURE OF INSURANCE AND RESPONSIBILITY 38 (Tom Baker & Jonathan Simon, eds., 2002). It is unlikely that material risk will be borne by companies that merely perform lien search services. See Puget Sound Fin., L.L.C. v. Unisearch, Inc., 47 P.3d 940 (Wash. 2002) (upholding contractual limitation on liability of UCC filing search firm to search fee when secured creditor suffered significant loss from failure to have a priority position). A law firm may have strict liability for failure to file a financing statement. See Lory v. Parsoff, 745 N.Y.S.2d 218 (App. Div. 2002) (finding malpractice per se).

7 Ronald Gilson proposed that we analyze the role of lawyer as that of a transaction cost engineer. See Ronald J. Gilson, Value Creation by Business Lawyers: Legal Skills and Asset Pricing, 94 YALE L.J. 239, 253 (1984). At that time, his approach was viewed as novel. See OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM 397 (1985). The LOTL project views the evolution of syndicated lending as a device to manage transaction costs in the spirit of Ronald Coase, who suggested that the existence of firms be explained as a device to reduce transaction costs. See generally RONALD N. COASE, THE FIRM, THE MARKET, AND THE LAW (1988). The fundamental problem posed by secured syndicated lending is that this process of cost reduction by ever increasing sophisticated contracting procedures must evolve techniques for efficiently complying with the property law tasks required to complete a secured transaction or the evolution will stop, absent changes in positive law.

8 See Henry Hansmann & Reinier Kraakman, The Essential Role of Organizational Law, 110 YALE L.J. 387 (2000) [hereinafter Organizational Law] (offering the view that organizational law operates as a superior device for partitioning assets, both to benefit certain creditor classes and to protect owners from liabilities). For a further discussion, see infra Part III.
The cornerstone of the strategy requires that a debtor designate a single trustworthy third party (i) to act as the nominee for all its secured lenders, both in public filings and in certain other security documentation and (ii) to maintain copies of filings and other documents relating to a debtor’s voluntary secured credit transactions and of lien searches. This third party is our “lien lord” who will tell the truth to potential new lenders about the secured credit status of the debtor. Efficiency is enhanced because creditors share the same searches, filings and monitoring information maintained with the nominee, thus reducing steps taken to close individual secured financings. Opportunities exist for creditors to share security documents, thus further reducing contracting costs. Importantly, reducing the number of steps taken to complete a secured credit transaction should significantly reduce the risk of error as well as lowering direct transaction costs. The LOTL structure also allows debtors to create alternative priority orderings. Considering such a structure has value because, in the near term, it may provide practical benefit to debtors and creditors and, in the long term, it may inform the direction that future amendments to Article 9 and other security interest legal regimes should take.

The complexity of modern secured credit transactions arises from three sources. First, Article 9 provides only a partial system for perfecting security interests in personal property. Other laws provide systems for perfecting security interests excluded from Article 9’s scope.9 Further, Article 9 does not cover security interests in real estate, other than fixtures.10 Complexity arises because a creditor must comply both with Article 9 and these other legal regimes to perfect a security interest in all assets of a debtor. Second, Article 9 contains perfection hierarchies that permit creditors to use alternate methods to perfect a security interest in certain asset types.11 Third, complexity arises because, in many cases, the real “debtor” is not a single legal entity but instead is a “borrowing group” consisting of multiple legal entities that are members of a consolidated family of companies. Further, the “creditor” often is not a single lender but, instead, is a syndicate of lenders that desires a blanket lien on all assets of the borrowing group. In contrast, the paradigmatic transaction against which Article 9 and other secured credit legal regimes are framed consists of a single debtor and a single creditor, often with a single asset or asset class serving as

11 See Randall C. Picker, Perfection Hierarchies and Nontemporal Priority Rules, 74 CHI.-KENT L. REV. 1157, 1158 (1999) (suggesting that perfection hierarchies may be efficient in matching creditors to collateral on which they are relying).
collateral. Because Article 9 and these other systems were structured primarily to process simple bilateral transactions between individual legal entities, they do not handle complicated business structures well.

All three types of complexity cause problems in similar ways. First, the searching function is complicated. A creditor must search multiple information sources based on asset type to determine the overall secured credit status of a debtor. If a perfection method (other than filing in a public record) produces priority over a security interest perfected by prior filing in a public record, further inquiry is necessary. The problem is compounded in the case of borrowing groups because the public records for multiple legal entities must be searched. Second, the perfection function is complicated because the creditor must perform multiple ceremonies to obtain a perfected security interest in all assets of a debtor. Again, a borrowing group aggravates the situation. Third, the current system creates complexity for the creditor because monitoring the continuing perfection of a security interest must be done across multiple asset types and, in the case of a borrowing group, across multiple legal entities.

Rather than focusing on small, simple transactions and attempting to draw system wide conclusions about the complexity and efficiency of secured credit, the methodology used here instead concentrates on complex transactions and considers how those transactions stress the secured credit system. Thus, the focus is on large secured commercial loans, rather than on secured consumer finance. Economists often measure the efficiency of a system by measuring the steps it takes to accomplish some goal. Currently, borrowers and lenders take many

12 A similar approach is used to evaluate efficiency of algorithms in which programmers are interested in how large, rather than small, sets of data are processed. See THOMAS H. KORMAN ET AL., INTRODUCTION TO ALGORITHMS 23 (17th ed. 1996).


14 See, e.g., Daron Acemoglu & Simon Johnson, Unbundling Institutions (Nat'l Bureau of Econ. Research, Working Paper No. 9934, 2003) (discussing relative efficiencies of common law and civil law jurisdictions as they relate to contract law and property law institutions); Hernando De Soto, The Mystery of Capital (2000) (discussing inefficiencies in real property recording systems as an obstacle to economic growth in Third World countries); World Bank Study (relating to contract enforcement and efficiency), at http://wbi.worldbank.org/DoingBusiness/Methodology/ContractEnforcement.aspx (last visited Feb. 26, 2004). In all these studies, steps required to achieve some goal are counted, with more steps being a proxy for lowered efficiency. The procedure of counting "steps" is an imprecise
steps to complete a secured credit transaction. Efficiency in secured lending would be enhanced if the number of steps taken to close an individual secured loan could be reduced. These steps may be reduced by creation of "transaction infrastructure" in the form presented in this article.

Before considering the LOTL structure in detail, Part I of the article considers how the syndicated loan market currently uses contracting techniques to reduce steps taken in loan transactions. Part II of the article describes how to implement the LOTL structure within current law and secured lending practices, indicating obstacles where they exist. Part III of the article discusses possible objections to use of the LOTL structure. Part IV of the article explores how the LOTL structure might be used to address certain big picture criticisms leveled against the current system of secured credit by academic observers. Part V of the article concludes with an appeal for a second look at use of security interests as asset partitioning devices. It identifies the parameters of favorable property law rules that allow transaction cost engineers to make further progress toward managing the challenges posed by increasing transaction complexity.

I. WHAT HAPPENS NOW

In a typical large secured credit transaction, an individual creditor does not lend to an individual borrower. Instead, numerous lenders, represented by one or a small number of agents, form a syndicate. The agent likely arranges the syndicate at the request of a borrower to raise a specified sum. The agent negotiates the terms of the credit agreement with the borrower at the request of a borrower to raise a specified sum. The agent negotiates the terms of the credit agreement with the borrower for the syndicate. Neither is the borrower likely to be a single legal entity. Rather, the borrower is a group of companies that reports financial results on a consolidated basis.\textsuperscript{15} The segment of the

\textsuperscript{15} A recent count of the top twenty-five companies in the Fortune 500 list that are users of subsidiaries in tax haven jurisdictions reveals an average of approximately 660 total subsidiaries (of which an average of approximately fifty-seven were formed in tax havens). This reflects an increase from the 1997 average of approximately 310 total subsidiaries (of which an average of approximately sixteen were formed in tax havens). See Citizen Works, \textit{25 Fortune 500 Corporations with the Most Offshore Tax-Haven Subsidiaries}, at http://www.citizenworks.org/
syndicated loan market in which security interests are most likely to be used is the non-investment grade borrower market.\textsuperscript{16} This is the environment for which application of the LOTL structure is designed.

A common explanation for the syndication process is that, when sums get large, individual lenders lack the funds necessary to supply all the credit needs of a borrower or do not want to supply those funds because of a desire to diversify investments. The lenders, thus, must band together so that collectively the sums required by the borrower may be advanced.\textsuperscript{17} Another explanation for the syndication process relates to efficiencies created by agent signaling. If an agent holds a significant portion of the syndicated loan, other potential syndicate members view the large retained position in the loan as a signal that the credit represents a good loan investment. Based on this signal, syndicate members participate in the loan after conducting more limited due diligence than they would conduct in the absence of the signal. In effect, the participants join syndicates based on the brand name of the agent, thus saving them costs.\textsuperscript{18} These explanations tell only part of the
Syndication is also a technique for minimizing the direct transaction costs associated with the contracting process. Instead of a borrower separately negotiating with multiple lenders for the funds needed in its specific operations, multiple negotiations at the borrower level are replaced by a single negotiation for the benefit of the borrower, with the agent acting for the syndicate. The details of these contracting efficiencies is important. We must consider both how a set of individual debtors becomes a borrowing group and how a set of individual lenders becomes a syndicate.

A. Of Borrowing Groups

The concept of a "borrowing group" is important to understand. A paradigmatic corporate structure starts with a top-tier holding company owned by multiple investors. In turn, this top-tier holding company owns 100 percent of a second holding company. This second holding company owns multiple subsidiaries. The lending syndicate makes loans to the second holding company as the "primary debtor."
The top tier holding company provides a downstream guarantee of the loans. The subsidiaries provide upstream guarantees of the loans. The primary debtor borrows money from the syndicate and transfers the loan proceeds to those members of the consolidated group that need funds. Typically, the primary debtor transfers funds to other legal entities in the group by making inter-company advances or loans, though sometimes transfers may be made as capital contributions. This system of guarantees and advances breaks down the boundaries of limited liability created by the myriad legal entities in a consolidated group of companies and creates a single economic unit. In a secured financing, each member of the borrowing group (other than the borrower) grants a security interest in its assets to secure repayment of its guarantee. The borrower grants a security interest in its assets to secure directly repayment of the loans.

In substance, the lending syndicate sees itself as making loans to the borrowing group rather than to individual legal entities. Ideally, this synthetically created "group borrower" is co-extensive with all the legal entities whose results are reported in the consolidated financial statements of the top tier holding company.

A guarantee structure, such as that described above, is a form of transaction engineering but does not constitute "transaction infrastructure" in the sense intended here. Other than in the case of keepwell or net-worth maintenance arrangements typically provided by a parent company to an individual financing subsidiary, a borrowing group puts a guarantee web structure in place on a transaction-by-transaction basis. When the guarantee web is supported by collateral the borrowing group similarly puts in place the security agreements, security interest filings, legal opinions and related matters on a transaction-by-transaction basis. Because consolidated companies typically recreate a guarantee web for each transaction, they do not rely on "transaction infrastructure" as envisioned by this article.

Beyond documenting the guarantee web, three legal problems plague the structure: (i) the first, a preferential transfer problem, was arguably addressed by an amendment to the Bankruptcy Code; (ii) the single external source. The primary borrower allocates funds to group members rather than an external capital market. See Triantis, supra note 20. At some point, the internal monitoring costs of allocating capital will increase to such an extent that the size of the firm is limited. Cf. V. Cerasi & S. Daltung, The Optimal Size of a Bank: Costs and Benefits of Diversification, 44 EUR. ECON. REV. 1701 (2000) (explaining how internal management costs at a bank increase and thus limit the size to which a bank will grow).

23 The guarantees are structured as guarantees of payment, rather than guarantees of collection.

24 The ideal match typically does not occur if foreign subsidiaries are held in the borrowing group because a primary debtor does not let its foreign subsidiaries provide guarantees lest adverse tax consequences flow from the guarantee. See note 27 infra.

25 See Levit v. Ingersoll Rand Fin. Corp., 874 F.2d 1186 (7th Cir. 1989) (the "Deprizio")
second, a fraudulent transfer problem, is addressed by contract provisions that recite the burdens and benefits of the guarantee, but otherwise ignored; and, (iii) the third, a tax problem, remains open.

In certain other areas of law, reporting responsibility and liability take a functional, group approach, rather than being limited by boundaries set by the legal entity. The laws affecting secured lending, however, do not yet allow for this functional approach. The existing legal apparatus requires that each legal entity be dealt with separately when collateral is provided. However, procedures that appear efficient for a single debtor entity appear less efficient when the relevant "borrower" actually is a family of companies. Legal entity boundaries still matter in secured lending, but it might be a more efficient world if they did not matter to the same extent. One method to manage this transaction complexity would be for borrowing groups to invest in permanent transaction infrastructure that reduces the steps that are needed to implement a typical secured loan to a borrowing group as discussed in Part II of this article.

B. Of Lending Syndicates

Bank lending has evolved from single lender loans to syndicated credit facilities. Today, the syndicated loan market is one of the

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27 Because of the operation of § 956 of the Internal Revenue Code, foreign subsidiaries do not provide upstream guarantees of the loans because the provision of such guarantees operate as deemed dividends to the United States parent company on which tax must be paid. Instead, two-thirds of the foreign subsidiary's stock is pledged by its owner as security to support repayment of the loan. A pledge of more than two-thirds of the foreign subsidiary's stock would be treated under IRS regulations the same as provision of a direct guarantee by the foreign subsidiary. Treas. Reg. § 1.956-2(c)(2) (2004). The regulations were passed in response to Ludwig v. Comm., 68 T.C. 979 (1977).

28 See generally BLUMBERG, MULTINATIONAL CHALLENGE, supra note 20 (describing group liability under various statutory and regulatory schemes, including tax and pension laws).

29 As will be seen in the discussion and accompanying notes in Part II, infra, the importance of the legal entity boundaries in a borrowing group can be reduced by transaction infrastructure that manages the diversity of legal entities.

30 See generally Steve Miller et al., A Guide to the U.S. Loan Market, STANDARD & POOR'S,
largest capital markets in the world, generating approximately $1 trillion in new loans annually in United States-based transactions alone. In the current market, a paradigmatic syndicated loan has three tranches: a revolving credit facility, an A term loan facility and a B term loan facility.

A lead arranger syndicates the revolving credit facility and the A term loan facility to commercial banks on a pro rata basis, with each lender holding the same percentage of commitments and loans in each of these two facilities. The lead arranger syndicates the B term loan facility to a separate group of lenders, referred to as "institutional investors," who typically do not participate in either the revolving loan or A term loan tranches. The tranche B term loan facility typically has a longer maturity date, a higher interest rate and, often, some form of prepayment protection. When the syndicated credit facility is secured, each of the three tranches share collateral on a pari passu basis.

In the last year, the loan market has seen the expanded use of an additional tranche: a second-lien loan tranche that bears a higher interest rate and often carries an even longer maturity than the tranche B term loan facility. These second-lien term loans appeal to yet an additional class of investor, further expanding the sources of funding for syndicated loans. The syndicated loan market thus displays an evolution towards including ever larger classes of potential lenders under the big tent of a single set of loan documentation.


The institutional investor class traditionally is thought to include insurance companies, prime rate mutual funds and structured investment vehicles, such as, CDOs (collateralized debt obligations) and CLOs (collateralized loan obligations).

Several factors dictate that institutional investors participate in a separate tranche. First, most of these investors are not able to fund revolving credit loans on short notice, see TCW Pro Rata CLO Proving A Hit with Investors, Loan Market Wk., June 23, 2003, at 5, though structures are being developed that overcome this obstacle. See Pierre Paulden, Highland Capital Plans to Join Pro Rata Club with Citi CLO, Loan Market Wk., Dec. 15, 2003, at 1. Second, institutional investors do not have an appetite for prepayments. Participation in the tranche B term loan does not carry ongoing funding obligations and prepayments are structured to apply to the tranche A term loan prior to the tranche B term loan. Sometimes, pre-payment penalties are imposed for early payment of tranche B term loans.

Loan Market's Flexibility Stands Out, Loan Market Wk., Nov. 3, 2003 (describing hedge funds as new investors in the loan market). When commercial banks and other institutional investors were unable to provide needed liquidity to the loan market, non-traditional investors such as hedge funds provided needed liquidity to the market, attracted by alternate structures such as second-lien tranches. In the third quarter of 2003, over seventy-five percent of the investors in the loan market were not commercial banks. Hedge funds made up forty percent of the investors in loans priced at LIBOR plus a spread of four percent or more. See id.

Tranche B term loans for institutional investors almost always appear as part of the
One way to view the increased concern of lenders over obtaining a perfected security interest in all assets of a borrowing group is to focus on demands and expectations created by inclusion of more lenders in a syndicated lending group. As a borrowing group satisfies more of its credit needs through a syndicated loan, more certain and extensive collateral coverage is required. This is particularly true if syndicated loans are to maintain their record for being the asset class with the highest percentage return in a bankruptcy. The way to preserve the high rates of return in default scenarios is to bring a higher percentage of debtor assets under the umbrella of a perfected security interest as a greater percentage of a debtor’s funding needs are supplied by the syndicated credit. In the ideal secured lending world, all assets reflected on a borrowing group’s balance sheet would be included in the collateral package. This allows, to the greatest extent possible, evaluation of the consolidated credit as an asset class unto itself.

In its typical form, such a complicated lending structure is documented on a transaction-by-transaction basis, with all tranches committed (in the case of the revolving facility) and funded (in the case of the tranche A and tranche B term loans) at the same time using a single set of closing documents. To enhance flexibility, however, lead arrangers have worked with borrowers to develop contract provisions that permit the inclusion of delayed draw term loans and the addition or expansion of tranches without the need for additional existing lender consents. Such provisions remove hold-up value from the hands of a few rogue lenders who otherwise might object to expansion. Most recently, a controversial contract provision has surfaced that permits the replacement of lenders who object to amendments to the credit facility that require unanimous lender consent, further promoting flexibility.

documentation for the traditional commercial bank credit facility. Sometimes a second lien loan tranche is included as part of the same documentation and sometime it appears as part of a separately agented facility. Compare West Point Slips, LOAN MARKET WK., Aug. 25, 2003, at 2 (reporting second lien tranche as separately agented) with Merrill Tweaks Colfax Deal, supra note 33 (describing second lien C piece as part of facility). Indeed, the rapid growth of second-lien loans has resulted in a recent call for standardization of terms. See Second-Lien Influx Prompts Call For Standards, LOAN MARKET WK., Jan. 26, 2004, at 1. The emerging pattern of negotiated points include: (i) the collateral entitled to first lien status; (ii) whether the amount of first lien debt is capped; (iii) quiet lien provisions that require the second lien holders to delay exercise of remedies; (iv) whether the first lien holder needs the second lien holder’s consent to approve a debtor-in-possession financing; and (v) whether second lien holders are entitled to request adequate protection payments or challenge those made to first lien holders. Id.

38 See Pulte Builds in L/C Capability, LOAN MARKET WK., Nov. 3, 2003 (describing inclusion of “accordion” feature that allows expansion of facility); Silgan Adds Senior Debt, LOAN MARKET WK., Nov. 17, 2003, at 8 (citing rumor of “accordion” facility add on).
39 See Buyside Frustrated as Contested Allied Waste Amendment Passes, LOAN MARKET
The overall trend is to promote contracting efficiencies by eliminating bilateral contracting in any form. The contracting structures reap the benefits of the contracting efficiencies of shared documentation, without sacrificing flexibility or doling out hold up value, both of which might create increased costs for future contracting. The life span of an existing set of syndicated loan transaction documentation is being extended by pre-agreed parameters for expansion of the facility and nuanced voting procedures.40

Significantly, one contracting technique available for use in unsecured syndicated lending is not available for a secured loan program. To reduce steps in an unsecured loan, a lead arranger might negotiate with a top tier or second tier holding company for negative pledge covenants41 and limitations on debt incurrence by subsidiaries. Such a structure allows the syndicate to contract solely with top tier holding companies and dispense with subsidiary guarantees and security agreements. Such a structure, however, does not protect against willful breaches of covenants by the holding company or against involuntary liens. Such protection comes only with perfected security interests provided by each member of a borrowing group. Though multiple entities might sign a single security agreement to enhance efficiency, separate procedures for perfecting and monitoring the security interest are performed on an entity by entity basis.

Ongoing efforts at reducing contracting costs continue for syndicated lending in the form of projects to develop standard form

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40 The life span of credit agreement documentation is being extended in the form of flexible pricing mechanisms. Typically, the syndicated loan is priced at a floating interest rate, not at a fixed interest rate. Further, the interest spread charged above the floating rate index varies with pricing specified on a grid. The grid pricing fluctuates based either upon credit rating or performance measured by financial covenants. Such a structure protects against junior security holders (i.e., the equity investors in the borrowing group) exporting risk upon senior security holders (i.e., the bank lenders) once a transaction has closed. Grid pricing reduces incentives for opportunistic behavior on the part of junior security holders as the pricing mechanism protects against replacing safe projects with risky projects once a syndicated loan is committed and funded. See Ronald J. Gilson & Reinier H. Kraakman, The Mechanisms of Market Efficiency, 70 VA. L. REV. 549, 613 (1984) (describing opportunistic behavior of junior security holders). The loan market has developed similar contract structures that address other contracting problems predicted by economists. For example, a “competitive advance feature” allows lenders in a syndicate to make non-pro rata advances at lower interest rate spreads than reflected on a pricing grid. This potential intra-syndicate competition removes potential advantages that might accrue to a lending syndicate that sets its loan spreads too high.

contracts for syndicates.\footnote{See The Loan Syndications & Trading Association, Inc., Model Credit Agreement Provisions (dated Jan. 2003), available at \url{http://www.lsta.org/lstamarket_information/Model_Credit_Agreement_Provisions.pdf} (last visited Feb. 26, 2004).} And, to facilitate secondary market trading of syndicated loans, provision has been made recently to assign CUSIP numbers to syndicated loans.\footnote{The CUSIP is a unique identification number assigned to a security to facilitate market trading. See Press Release, The LSTA and Standard & Poor’s Expand CUSIP Numbers to Syndicated Loans, STANDARD & POOR’S, Jan. 6, 2004, available at \url{http://www2.standardandpoors.com/spf/pdf/media/LSTACUSIP16.04.pdf} (last visited Feb. 26, 2004); Cusips Are Coming As Loan Mart UPS Standardization, LOAN MARKET WK., Nov. 3, 2003.} Further, the syndicated loan market is evolving into a market that increasingly expects published credit ratings.\footnote{See Steven M. Bavaria, Syndicated Loans—A Rated Market, at Last!, STANDARD & POOR’S, Feb. 12, 2002.} Standardized terms, credit ratings and tracking mechanisms should enhance liquidity, further expanding the attractiveness of syndicated loans as an asset class for a wide spectrum of lenders. The time needed to execute a syndicated loan is being compressed, reducing yet another species of transaction cost.\footnote{The development of the syndicated lending market has even resulted in the formation of a now public company, Intralinks, Inc., to facilitate the electronic distribution of documents to transaction participants. See IntraLinks, Inc. webpage dedicated to loan syndication, at \url{http://www.intralinks.com/yb/dcmSynd.asp} (last visited Feb. 26, 2004).} However, current procedures needed to secure a syndicated loan impose significant time constraints and other costs inconsistent with the progress made in streamlining the general contracting process. This can be seen most clearly by the continued use of “springing liens” in syndicated credit facilities, in which security interests are created after the closing of the loan.\footnote{A “springing lien” is a security interest that is granted after the closing of a loan to secure antecedent debt. Typically, a borrower agrees to provide collateral to lenders upon some future condition that makes them pessimistic about the prospects of repayment, such as a credit downgrade or the violation of a covenant. If the covenant is never breached or the downgrade never comes, then the cost and expense of providing collateral was saved. If, however, collateral must be granted, then the perfection of the security interest creates serious risk of avoidance as a preference under § 547 of the Bankruptcy Code. 11 U.S.C. § 547 (2000). Further, one must consider the incentives of a borrower to comply with its covenant to provide security once it has the funding, particularly if it is already in default. Nevertheless, use of springing liens remains a common phenomenon. See, e.g., Banks Shop Amphenol Redux, LOAN MARKET WK., Apr. 14, 2003, at 3; Investors Tolerate Disappearing Lien to Stay in Wine Co. Deal, LOAN MARKET WK., Mar. 24, 2003, at 1; Jack In The Box Springs Into New Credit, LOAN MARKET WK., Feb. 24, 2003, at 6.} In this environment, the loan market is primed for additional techniques to enhance certainty, to reduce contracting costs and to speed up the process whereby collateral becomes part of the credit facility package.
C. A Model for Borrowing Groups and Syndicates as Cost Reduction Techniques

We can easily see how the formation of borrowing groups and loan syndicates reduces the direct cost of contracting for financing by considering the outline of a simple model.\(^{47}\) Suppose that (i) a borrowing group contains \(n\) legal entities, (ii) each legal entity has financing requirements for a single project equal to a uniform amount (e.g., $50 million), (iii) each potential lender for the project has a maximum loan amount so that it can supply only a portion of the funding needed to finance a project (e.g., $10 million), such that it takes \(m\) lenders to finance a single project (in this example, five lenders per $50 million project),\(^{48}\) (iv) the total number of potential lenders for projects is at least \(mn\), so all projects in a borrowing group may be financed,\(^{49}\) and (v) the cost to negotiate and document an individual loan agreement is equal to \(K\).\(^{50}\) In such a case, the total direct negotiation and documentation costs paid by the borrowing group\(^{51}\) for its financing needs if each of its members uses bilateral loan contracts with individual lenders is equal to \(mnK\).

If, in contrast to the full bilateral contract approach, a single lead arranging lender (the "lead arranger") acts for all lenders to the borrowing group certain efficiencies can be achieved in the contracting process. However, these efficiency gains are offset to some degree

\(^{47}\) A model developed to explain why financial intermediaries, such as banks, exist to act between depositor/investors and borrowers inspired the model described in this paper for loan syndication. See D. Diamond, Financial intermediation and delegated monitoring, 51 REV. ECON. STUD. 393 (1984); see also XAVIER FREIXAS & JEAN-CHARLES ROCHET, MICROECONOMICS OF BANKING (4th ed. 1999) (describing and summarizing Diamond's results).

\(^{48}\) The size of loans made by individual lenders may be limited for a variety of reasons, including regulatory limits on the permitted size of credit exposure to individual credits and asset diversification preferences dictated by portfolio risk management strategies. See, e.g., Dennis & Mullineaux, supra note 17.

\(^{49}\) If single risk limits and diversification requirements were applied on a legal entity/project basis, rather than on a borrowing group basis, a smaller number of lenders might be needed to finance all projects. In that case we might assume that some lenders make loans to multiple projects. Nevertheless, assuming \(mn\) number of lenders allows us to avoid assumptions relating to the details of these limiting factors.

\(^{50}\) Treating \(K\) as a constant regardless of transaction size or number of lenders and borrowers involved is a simplifying assumption. In reality, certain contracting and administrative costs will be higher for a larger credit facility. My experience, however, suggests that the differences do not create significant distortions that affect the usefulness of the model as an illustration of the cost reduction phenomenon.

\(^{51}\) The convention in loan financing is that borrowers pay their own counsel fees and expenses and also reimburse the lender or lending syndicate for its legal fees, costs and expenses. The borrower pays all filing fees and taxes. An additional significant cost to a borrower or borrowing group is the borrower's management time devoted to negotiating and documenting the loan and, thereafter, to providing ongoing monitoring information to the lender or lead agent with respect to the loan or credit facility.
because the lead arranger charges an amount, designated as $C$, for arranging a group of lenders into a syndicate and acting as an intermediary. A borrower or group of borrowers pays the lead arranger this fee to reduce the direct costs of bilateral contracting with individual lenders.

We assume that the group of lenders allows the lead arranger to negotiate and document transactions on the group's behalf because the lead arranger also is a lender with a significant stake to lose. The lead arranger has the same incentive as the other members of the group to negotiate a favorable transaction and the lead arranger signals this alignment of interest by retaining a portion of the credit facility. Further, the lead arranger will suffer reputational harm if it fails properly to negotiate, document and monitor a transaction. Reputational harm will impair a lead arranger's ability to earn future fees as a loan syndicator. Given this signal, coupled with the cost imposed by potential loss of reputation, the group of lenders does not require additional monitoring of the lead arranger so further costs are not incurred by the lenders.

In the first case, a lead arranger acts for a syndicate of lenders but each member of the borrowing group separately negotiates for funding with the lead arranger. The total direct negotiation and documentation costs paid by the borrowing group for its financing needs in this case is equal to $nK + C$. (Syndicated lending will be more efficient than direct bilateral lending in this scenario if, and only if, $mnK > nK + C$.) Note that, in the absence of a syndicate, the borrowing group is unable to achieve efficiencies by designating a primary borrower to negotiate all loan agreements with individual lenders. Such a structure merely results in the same number of costs being incurred (i.e., $mnK$) as the primary debtor still must negotiate $mn$ number of loan agreements in bilateral negotiations with lenders. The only difference in these loan agreements is that the primary debtor appears as the borrower rather than the individual legal entities that make up the balance of the

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52 The size of the portion of a syndicated loan retained by the agent appears correlated with interest rates charged to borrowers. See Luca Casolaro et al., The Pricing Effect of Certification on Bank Loans: Evidence from the Syndicated Credit Market (Università degli Studi del Molise, Econ. & Stats. Discussion Paper No. 10/03, 2003). A larger retained portion of the loan sends a stronger signal from the agent that the quality of the loan is high. The signal of higher quality explains the lower interest rate.

53 Models developed to explain the existence of financial intermediaries use potential lost reputation, and the attendant loss of future business, to explain why banks honor loan commitments. See Arnoud W. A. Boot et al., Credible Commitments, Contract Enforcement Problems and Banks: Intermediation as Credibility Assurance, 15 J. BANKING & FIN. 605 (1991). Banks have both financial capital and reputational capital in models such as these.

54 Such a structure is possible but, in practice, would be unusual in the syndicated loan market except for loans to very large, diversified companies with subsidiary operations in different lines of business.
borrowing group. Thus, in this model, the formation of syndicates is a logical pre-requisite to achieving efficiencies by creating borrowing groups. Given the existence of a syndicate, we can see in our second case below how a consolidated family of companies may create further efficiencies by forming a borrowing group and designating a primary debtor.\(^5\)

In the second case, the legal entities in the borrowing group designate a primary debtor in the group to negotiate a single loan agreement on behalf of the borrowing group with the lead arranger. In this case, the total direct negotiation and documentation costs paid by the borrowing group to obtain its financing needs is reduced to \(K + C\). (Syndicated lending will be more efficient than direct bilateral lending in this scenario if, and only if, \(mnK > K + C\).) When the primary debtor in such a situation is a holding company that is in an ownership and control position with respect to the other members of the borrowing group, the primary debtor can credibly enter into a single loan agreement for the borrowing group by agreeing that it will cause the other legal entities in the group to comply with the covenants that it has negotiated for the group. If the lending syndicate desires direct claims against subsidiaries, all subsidiaries may sign a single guarantee agreement.

Ongoing costs for monitoring the overall credit extended to the consolidated family of companies similarly are reduced by use of borrowing groups and syndicates rather than individual bilateral contracting. This can be seen by using the formulas above, but letting \(K\) represent ongoing monitoring costs for a particular loan agreement and letting \(C\) represent periodic agency fees charged by the lead bank for the syndicate to compensate the lead for its ongoing administrative role in acting as agent. If the borrowing group prepares consolidated financial reports for other purposes (such as making reports to equity security holders), the syndicate can replace monitoring of individual legal entities with monitoring of the entire borrowing group without imposing a material increased information preparation cost on the borrowing group. In some cases, it might even be more expensive for a borrowing group to provide audited information with respect to individual group members than to provide information on a consolidated group basis.

The foregoing suggests that syndicated lending becomes a preferred funding strategy anytime the lead bank is prepared to charge \(C\)

\(^{55}\) This is because the aggregate amount of funding required by the group remains the same, as does the loan size limit imposed on each lender. There are still \(n\) projects to be financed and each lender may supply funding for only a portion of each project such that \(m\) lenders are required per project. It does not matter whether each legal entity separately contracts, or one legal entity contracts for all: in both cases the cost will be \(mnK\).
in an amount such that \( C < (mn - 1)K \). (Note that \( m > 1 \) and \( n \geq 1 \)). In the case where the lending syndicate funds a single borrower, the syndication strategy becomes a preferred funding strategy whenever \( C < (m - 1)K \). Thus, in every case where \( C < K \), syndicated lending will dominate as a strategy and, in many cases where \( C \geq K \), syndicated lending will dominate. As the number of borrower legal entities and lenders involved in a financing increases, the maximum allowable value that \( C \) may take while preserving syndication as the dominant strategy increases. These relationships in the model suggest that cost savings for both contracting and monitoring at least partially explain the rapid expansion in the syndicated lending market over the last several decades.\(^\text{56}\)

To further enhance the model, assume that all the contracting and monitoring costs \( K \) for an unsecured financing are present in a secured financing.\(^\text{57}\) Further assume that in a bilateral secured financing, the lender takes only a single asset or asset class as collateral for the loan. In a syndicated loan, the lenders share collateral on a pari passu basis. Thus, when syndicated lending dominates as a funding strategy, it will dominate even if the syndication process does not materially reduce the additional contracting and monitoring costs associated with providing collateral security from the costs of providing collateral security for a series of bilateral loan transactions secured by collateral consisting of individual assets or asset classes.

For example, in a bilateral lending situation, one lender might take security in a debtor’s copyrights, another lender might take security in a debtor’s real estate and a third lender might take security in a debtor’s inventory and receivables. Each grant of collateral requires searches and filings in different recording systems. Though use of a single syndicated loan would reduce the contracting costs associated with negotiating the loan agreement (three agreements are replaced with

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\(^\text{56}\) Significantly, syndicated lending allows a debtor to raise significant capital from a large pool of lenders without either filing a registration statement with the SEC or complying with rules and regulations to achieve private placement status exempting a financing from such filing requirements. This is because bank loans are not considered securities under the Securities Act of 1933 or the Securities Exchange Act of 1934. See, e.g., Chem. Bank v. Arthur Andersen & Co., 726 F.2d 930 (2d Cir. 1984), cert. denied, 469 U.S. 884 (1984); C.N.S. Enters. v. G&G Enters., 508 F.2d 1354 (7th Cir. 1975), cert. denied, 423 U.S. 825 (1975); McClure v. First Nat'l Bank of Lubbock Tex., 497 F.2d 490 (5th Cir. 1974), cert. denied, 420 U.S. 930 (1975); Bellah v. First Nat'l Bank of Hereford Tex., 495 F.2d 1109, 1113 (5th Cir. 1974). This position has not changed even though syndicated loans are marketed to non-bank investors, including mutual funds, in which the public invests. Exemption from these regulatory burdens offers an additional cost savings rationale for the growth of syndicated lending.

\(^\text{57}\) This is true, at least, for the large financing transactions considered here. In other contexts, taking collateral might be seen as a strategy for reducing ongoing monitoring costs. In equipment financing, for example, a creditor with a perfected security interest might simply monitor the condition of the equipment and related insurance without undertaking to monitor the financial condition of the debtor generally.
one), the use of syndication does not reduce the procedures that must be taken to perfect a security interest in the total collateral package. Nevertheless, syndicated lending will still dominate bilateral lending based on the costs saved by negotiating a single loan agreement rather than multiple loan agreements.

Syndicated lending may, however, achieve some efficiencies over bilateral lending with respect to procedures to take collateral security when a single filing office is involved. For example, in a bilateral lending situation, one lender might take security in a debtor's inventory, another lender might take security in a debtor's accounts, and a third lender might take security in a debtor's equipment. All three of these filings are made in the same UCC filing office. Each lender would need to conduct its own search and file and monitor its own financing statement. In the syndicated loan, a single search is conducted and a single financing statement is filed and monitored. In this case, syndicated lending reduces the cost of taking collateral security.

Even though syndicated lending will reduce some costs associated with providing collateral to secure a loan, the contracting efficiencies for the loan agreement often exceed the efficiencies related to provision of collateral. To see how contracting practices for unsecured loans have outpaced procedures for providing collateral to secure them, one simply needs to consider an average borrowing group with fifty legal entities that wants to obtain secured financing using inventory, copyrights and real estate as collateral (assume one owned parcel of real estate per legal entity). With syndicated lending, the loan agreement process has been reduced to one contracting step. The collateral process still requires 150 different steps, each with many subparts, even if a single security agreement is signed by all parties. If one assumes a model of bilateral contracting for loans, with each lender taking a single asset or asset class as security, the procedures used to provide collateral for secured loans do not appear particularly inefficient. However, when the loan negotiation process is made more efficient by eliminating bilateral contracting, it becomes apparent that the process of creating security interests remains a source of significant inefficiencies. To further focus on the differences, let us contrast in more detail the dream of the commercial finance attorney with the reality. This exercise should show why transaction infrastructure needs to be developed for security interests if contracting efficiencies in syndicated lending are to evolve.

58 An interesting historical illustration of how syndicated lending has made life easier for management now than in pre-syndication days is illustrated by capital raising activities of robber baron types. See Ron Chernow, Titan: The Life of John D. Rockefeller, Sr. (1998) (describing how Rockefeller travelled from bank to bank to raise sufficient funding for operation of his company).
D. The Dream

The dream of any commercial finance attorney representing lenders is to have the power to orchestrate creation of a first priority perfected secured transaction with the stroke of a pen, while sitting in a conference room far above the hustle and bustle of the street below. The security interest would cover all assets of a debtor, without worry over asset type. In such a fantasy, the secured lender obtains priority over all other creditors, including other secured creditors, unsecured creditors, judgment lien holders and the taxing authorities. The dream is, thus, simply a species of the general fantasy that a variety of transaction costs might be eliminated (save, of course, the attorney's fee).

E. The Reality

The reality of commercial finance practice differs dramatically from the dream. The lender's attorney must worry about a variety of problems on the street below. Asset types matter because different assets types require that different ceremonies be performed to create the secured credit relationship in a form that society will recognize. Information sources matter because the attorney must commission different searches of filing offices and registries to confirm the presence or absence of potentially prior claims to different kinds of collateral. In some cases, possession of collateral by third parties, other than the debtor, or the mere status of a third party, may create priorities not reflected by a search of public records. Further diligence must be done to identify reliably those existing secured claims that do not require some form of public recording to sustain their priority.

59 Examples include: ordinary equipment (for which a UCC filing or possession is used to perfect a security interest), a deposit account (for which "control" is the exclusive method of perfection) and federally registered copyrights (for which a filing with the United States Copyright Office is required for perfection). See supra text accompanying note 58; see also infra notes at 108-11, 122-29 and accompanying text.

60 See supra note 59. Additional examples of separate filing offices include those for aircraft and ships. See infra notes at 139-43 and accompanying text.

61 For example, a security interest in certificated securities may be created by "control," possession or filing a financing statement.

62 For example, a bank has a priority claim to funds on deposit with it and a broker has a priority claim to securities held through a securities account maintained by a customer. In each case, the priority is based upon the status of the bank and the broker.

63 This supplemental diligence relies heavily on representations and warranties made by debtors.
In practice, the process of creating a secured transaction breaks down into three phases. One task of the lender's attorney is to develop a report for the client that identifies other creditors of the debtor and the extent of any priority that those other creditors may have. This often requires that the attorney draw on multiple information sources. Significantly, there is no one-stop shopping source for this information. Further, information available from public sources, even if collected in one place, presents an incomplete picture of the debtor's financial position vis-à-vis other potential secured creditors.

Assuming the attorney's client is prepared to make a loan based on the contents of this report, a second task for the lender's attorney is to draft and negotiate a security agreement that gives the lender the right to take away the debtor's assets, if the debtor does not repay the lender.

The third task is to insert certain information into public records about the lender's new security interest (or to orchestrate other publicly observable steps) to advertise that the lender has a limited property interest in the debtor's assets. The publication of the security interest transforms the rights of the lender in the collateral good against the debtor into rights of the lender in the collateral generally good against

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64 An important additional task remains after creation of the security interest—the task of monitoring the secured transaction to make sure that perfection and priority of the security interest are maintained through the passage of time and changes in debtor circumstances. Significantly, outside law firms religiously avoid responsibility for this monitoring role, taking great care to put responsibility for monitoring transactions with in-house compliance departments at the commercial lender.

65 Literature discussing the efficient capital market thesis contains a taxonomy of information costs. See Gilson & Kraakman, supra note 40, at 594. The debtor is in the best position to efficiently provide information about its prior secured transactions. However, there are reasons to worry about the accuracy of this information source because debtors lie. Id.

66 The due diligence often is facilitated by use of a so-called "Perfection Certificate" that the secured lender asks the debtor to complete. The Perfection Certificate is a compilation of representations and warranties both about the current state of the debtor's affairs and about its past history, such as prior mergers, name changes, reincorporations and chief executive office moves. The general thrust of the inquiry is to determine each and every factor that might affect the priority of the security interest that the secured lender will receive from the particular debtor. Typically, the Perfection Certificate also requests identification of bank accounts and security accounts, a listing of stock certificates representing ownership interests in subsidiaries of the debtor, a listing of instruments held by the debtor and makes further inquiries about other items of Article 9 collateral. The information sought often extends beyond the scope needed to perfect and analyze the priority of security interests under Article 9. The Perfection Certificate may seek information about insurance policies, intellectual property, vehicles, airplanes, boats, railcars, the location of real property, the location of leased property (including identification of the landlord) and so on. Often, a debtor is asked to estimate the value of the collateral not subject to Article 9 perfection procedures so that the secured lender can decide whether or not to require the debtor to perform additional procedures to perfect the lien granted in non-Article 9 collateral. Sometimes, the secured creditor requests appraisals to assist its evaluation.

67 For example, the information required to be included in a financing statement is extremely brief, requiring no details of the secured financing. See U.C.C. §§ 9-502(a), 9-516(b).

the world of third parties.\footnote{69}{Certain exceptions exist that allow third parties to purchase collateral free and clear of the security interest. See, e.g., U.C.C. § 9-320. Publication in some form is required to create property. See, e.g., Organizational Law, supra note 8 (contrasting property law tasks with contract law tasks); JEANNE SCHROEDER, THE VESTAL AND THE FASCES (1997) (describing publicity as an element of a property interest).}

In practice, significant aspects of the searching/information gathering task and the public filing task are delegated to private companies that specialize in searches and filings. Though these companies employ attorneys on their staffs to help them do their jobs, the companies are not technically practicing law. When these private companies are engaged to work on a transaction, the commercial finance attorney’s role in the first and third tasks is limited to identification of the scope of the searches to be conducted, evaluation of the search results, approval of the form that the new filings will take and identification of the offices in which new filings will be made. The searching and filing tasks are passed on to the search company. In complex transactions involving multiple jurisdictions, the primary lender’s attorney is hampered because he or she is likely admitted to practice only in a single jurisdiction.\footnote{70}{Often, this leads to the hiring of “local” counsel to render advice on perfection and priority of security interests. This urge to hire local expertise exists notwithstanding the “uniform” nature of the Uniform Commercial Code.}

Typically, lender’s counsel performs these tasks in parallel with debtor’s counsel. Debtor’s counsel uses the assembled information to prepare a legal opinion to be delivered to the lender confirming (i) the creation of a security interest enforceable against the debtor, (ii) the perfection of the security interest, and, in some cases, (iii) the priority of the security interest.\footnote{71}{Some revisions to Article 9 were made with the express purpose of making it easier for practicing attorneys to render legal opinions. See Steven L. Harris & Charles W. Mooney, Jr., How Successful was the Revision of UCC Article 9?: Reflections of the Reporters, 74 CHI.-KENT L. REV. 1357, 1397 (1999) [hereinafter Harris & Mooney, Revision of UCC Article 9].} Often, these opinions are accompanied by a “no-conflict” opinion stating that the creation, perfection and priority of the new security interest will not violate other existing agreements of the debtor.\footnote{72}{The typical violation would occur if the debtor had an existing agreement with a third party known as a “negative pledge” in which the debtor agreed either not to create security interests in favor of third parties or only to create such security interests on an equal and ratable or subordinated basis.}

The opinion covering the creation of the security interest and the “no-conflicts” opinion both are contract law tasks. Expressing an opinion on perfection and priority are property law tasks, albeit ones that assume the existence of an enforceable security interest.

Preparation of the security interest and no-conflict opinions is viewed as a difficult, risky task, whereas rendering the enforceability opinion is considered routine. The difference relates to the information...
boundaries related to the tasks.

In the case of the enforceability opinion, the attorney is able to render an opinion by examining the contract itself, in isolation from other factors. The attorney either will assume that the debtor has properly authorized the execution and delivery of the security agreement or the attorney also will render an opinion on authorization based upon the attorney's involvement in orchestrating the corporate or other approval for the secured transaction as a whole. In either case, all the information necessary to render the opinion is ready to hand.

In the case of the security interest opinion and, to a lesser extent, the no-conflict opinion, the attorney typically is relying, at least in part, on information received from third party sources, and not on his own knowledge of the facts. The process of monitoring security interests using opinions or their equivalent continues past the closing. The security interest filings often have a limited effective duration. Further, subsequent changes in corporate structure, name or, to a limited extent, office location, require supplemental procedures to maintain perfection. Thus, ongoing monitoring is required to maintain the status achieved at the closing.

Recently, competition for the security interest opinion has surfaced in the form of insurance policies provided by companies expanding their traditional real estate title insurance business. The new insurance policies insure the perfection and priority of security interests in personal property. Though the insurers currently advertise their product as a supplement to the traditional security interest legal opinion, it may well develop into a replacement. Competition for the no-conflict opinion has not developed.

The rise of insurance products for secured transactions in personal property suggests a few things. First, lenders might not feel confident in their own ability properly to evaluate and monitor perfection and priority of secured loans.\textsuperscript{73} Second, lenders might not feel comfortable turning to their outside lawyers to evaluate and monitor this status for them. Third, outside lawyers might not wish to engage in this sort of evaluation and monitoring.\textsuperscript{74} Fourth, even if outside lawyers wished to engage in this sort of evaluation and monitoring, they might not be able

\textsuperscript{73} This may be true even though the agent bank for a secured loan typically charges an annual "collateral management fee" that exceeds its annual agency fee for an unsecured loan. In an unsecured transaction with an annual agent bank fee of $150,000 the comparable fee for agent services on a secured loan might be as high as $500,000.\textsuperscript{74} The typical legal opinion rendered in a secured transaction disclaims any obligation to consider facts and circumstances after the date of the opinion. It may note different steps that ought to be taken in the future but does not undertake to take those steps or to monitor whether they have been taken. This approach differs from what economic theory might predict. See Peter Teece, Towards an Economic Theory of the Multiproduct Firm, 3 J. ECON. BEHAV. & ORG. 39 (1982) (describing economies of scope, as opposed to scale, that result from the production of a number of different products by a single firm).
to provide this service to their lender clients on a cost effective basis. In any case, the market is telling us that there is a demand for more evaluation and monitoring services and insurance companies are promoting the idea that insurance policies, rather than more legal services, are the right product to answer this demand. The problem is aggravated because, when lenders insist on insurance of this type, one can expect the cost to be borne by borrowers.

One conclusion we might draw from this is that lawyers have not been functioning as effective transaction cost engineers in the arena of secured credit. Another conclusion is that, in the area of large-scale commercial finance, we have failed to structure our laws in ways that permit cost effective and certain monitoring by the parties to the transaction and their counsel. On the positive side, we might conclude that the recent amendments to Article 9 were, at least, a partial success because the law became simple and clear enough so that insurance companies now are prepared to offer a product, whereas with the former more complex state of the law, such an insurance business was thought to be too risky.75

To assist in a proper diagnosis of the phenomenon, let us consider how creation of transaction infrastructure might improve the situation.

II. BUILDING THE LOTL INFRASTRUCTURE

Business organizations invest in infrastructure, such as computer networks, telephone systems and assembly lines. The hope is that investment in infrastructure today will make information management, communication and product creation more efficient in the future. Business organizations use the infrastructure assets over and over again. Business organizations also invest in what might be called “transaction infrastructure.” Transaction infrastructure comes in many flavors; these include the development of standard form contracts, filing a shelf registration statement with the Securities and Exchange Commission or entering into master agreements with repeat contracting parties. A business organization creates a highly visible form of transaction infrastructure when it sets up a so-called “master trust” to facilitate securitization transactions. In each case, the hope is that investment in transaction infrastructure today will reduce costs of closing transactions in the future. Transaction infrastructure also is used over and over again

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75 One positive step was the creation of a single, certain location to file a financing statement against “registered organizations,” such as domestic corporations. See U.C.C. § 9-307, following the suggestion of Lynn M. LoPucki; see also Lynn M. LoPucki, Why the Debtor’s State of Incorporation Should Be the Proper Place for Article 9 Filing: A Systems Analysis, 79 MINN. L. REV. 577 (1995) [hereinafter A Systems Analysis].
in lieu of creating new documentation for each transaction.

A. The LOTL Strategy

Our current rules for creating a secured credit transaction start with the background assumptions that debtors lie and steal. Accordingly, the ceremonies society specifies for successful creation of the secured credit relationship promote at least one of two goals. The ceremonies either counteract lying by debtors or prevent stealing by debtors (or both). The law is structured such that, if the secured party does not take steps to counteract at least one of these debtor character flaws, the secured credit relationship typically is not "perfected." The secured creditor may not enforce an unperfected security interest in debtor collateral against third parties. The LOTL strategy is to develop transaction infrastructure primarily using existing legal rules that counteract lying by debtors. Supplemental techniques enhance the credibility of representations made by debtors about their secured credit status. By examining the extent to which the LOTL strategy can be implemented, and identifying impediments, a program for further legal reform might be developed.

Traditionally, creditors have counteracted lying and stealing by debtors on a transaction-by-transaction basis. A particular creditor publishes notice of its security interest in a public record or takes possession of the collateral when it makes a loan to the debtor. In

76 "The world is full of cheaters, liars and thieves. There is no reason to believe that such persons are under-represented in the debtor class." R. SPEIDEL ET AL., COMMERCIAL AND CONSUMER LAW 234 (2d ed. 1974); see also Douglas G. Baird & Thomas H. Jackson, Possession and Ownership: An Examination of the Scope of Article 9, 35 STAN. L. REV. 175, 190 (1983) (referring to the problem as one of debtors "misbehav[ing]"; Thomas H. Jackson & Anthony T. Kronman, Secured Financing and Priorities Among Creditors, 88 YALE L.J. 1143, 1150 (1979) (referring to the problem as the "threat of debtor misbehavior"). Secured lending thus is seen as an area of the law where informal norms of fair dealing do not play a significant role. See Stewart Macaulay, Non-Contractual Relations in Business: A Preliminary Study, 28 AM. SOC. REV. 55 (1963) for a discussion of areas in which norms and customs may play a larger role in governing behavior of economic actors. The secured lending laws theorize creditors to be honest folks that are unable reliably to identify and avoid dishonest debtors. Cf. ROBERT C. ELLICKSON, ORDER WITHOUT LAW: HOW NEIGHBORS SETTLE DISPUTES 152 (1991). The phenomenon of lying by business persons in our society is widespread, as evidenced by recent corporate scandals involving Enron, Tyco, Worldcom and other major corporations. Lying also has been the subject of general scholarly inquiry. See, e.g., SISSELA BOK, LYING, MORAL CHOICE IN PUBLIC AND PRIVATE LIFE (1978).

77 Suggestions for further changes in laws affecting secured credit appear in Part V, infra.

78 There is some debate over the extent to which taking possession of an asset provides a useful form of notice to potential secured parties of prior claims. Compare Baird & Jackson, supra note 76, at 212 (concluding that "[p]ossession of personal property is the best evidence of its ownership"), with James J. White, Reforming Article 9 Priorities in Light of Old Ignorance and New Filing Rules, 79 MINN. L. REV. 529, 545 (1995) (suggesting that possession is no longer
contrast, the LOTL strategy is to replace the transaction-by-transaction approach with a single structural solution. In effect, a system of floating secured parties is created in which particular secured creditors come and go underneath the umbrella of a single nominee secured party. Recent scholarship has underestimated the ability to create floating secured parties and thus missed an opportunity to more fully consider the essential commonality between artificial persons and alternative legal structures, such as security interests.\textsuperscript{79} The LOTL transaction infrastructure satisfies the basic requirement of property law that the secured party publicly identify a reliable party from whom information about secured credit may be obtained as a condition to recognition of the property interest. Thereafter, individual secured parties need only take steps under contract law to obtain the protection afforded secured creditors by entering into a contract with the debtor and the lien lord.

As a logical matter, creating a third party lien lord is nothing more or less than creating what logicians might call a rigid designator. It is the permanent address of the unique someone who will tell the truth about all the related debtor's secured credit situation. To be efficient, a debtor may have but one truth teller. Consolidated companies that form a borrowing group will each use the same truth teller. The records of the lien lord will reflect a debtor's membership in a borrowing group so that a request for information about one member of the group generates a report disclosing the secured credit status of the entire group. Transaction infrastructure will be created around this rigid designator as filings, registrations and other procedures are performed using the lien lord's name and contact information. We want to create transaction infrastructure that will last. At the same time, however, we do not want allow any particular person who is designated as a lien lord to have a practical monopoly over services to a debtor or borrowing group by virtue of having been selected to act as lien lord. Thus, we want a lien lord that is portable. Thus, the first step is to create a portable rigid designator.

B. Creating a Lien Lord

To facilitate portability, an independent special purpose company is formed to act as lien lord for a debtor. If the debtor is a holding
company for subsidiaries, the same lien lord will act for each member of the consolidated group of companies that form a borrowing group. The lien lord has a post-office box, telephone number, web page and e-mail address. An institution (known as a "lien lord operating company") with significant reputation-based and, perhaps, financial capital owns the lien lord. Lien lords and lien lord operating companies are not licensed or regulated by any state. The marketplace will decide the reputation and financial capital needed for a lien lord credibly to vouch for the secured credit status of the debtor.

Candidates for the position of lien lord operating company include insurance companies who issue security interest insurance policies, commercial banks who act as agents on syndicated loans, companies who perform UCC search and filing services, and law firms. The use of the special purpose company to act as lien lord creates flexibility so that a debtor may change lien lord operators by simply directing a transfer of lien lord ownership to a replacement lien lord operator that meets established criteria.

Alternately, a debtor may form its own lien lord and simply transfer the shares of this entity to an independent lien lord operator when it wishes to engage in a significant secured loan transaction. In practice, the possibility of easy transfer of the LOTL

80 Prior suggestions to use private filing offices have been made. See Steven L. Harris & Charles W. Mooney, Negotiability, Electronic Commercial Practices, and a New Structure for the UCC Article 9 Filing System: Tapping the Private Market for Information Technology, 31 IDAHO L. REV. 835 (1995) [hereinafter Private Information Market]. Professors Harris and Mooney served as Reporters for the Drafting Committee to Revise Article 9 and as Reporters for the Permanent Editorial Board UCC Article 9 Study Committee. See Harris & Mooney, Revision of UCC Article 9, supra note 71. A significant motivation for the suggestion in Private Information Market was to work around the inability of state filing offices to timely record filed financing statements. With the advent of electronic filing systems, this initial motivation is less pressing. However, the proposal continues to have merit for other reasons.

In Private Information Market, Harris and Mooney suggest that Article 9 be amended to allow debtors to designate persons to act as private filing offices for particular debtors. Under this proposal, states would license and regulate persons allowed to perform this function. Filings made in the private filing office would have priority over filings made in the public filing office. In contrast, the LOTL structure does not create a licensing mechanism and does not create two competing information sources. Further, LOTL does not require an amendment to Article 9 to implement. Though I prefer the efficiencies created by the LOTL structure for these reasons, the Private Information Market suggestion is a good proposal that would have improved secured financing and would enhance the certainty of the LOTL structure. Accordingly, the LOTL strategy suggests that consideration should be given to an amendment to Article 9 to permit debtors to designate private filing offices, though I would omit the licensing and registration requirements. Also, I would consider making designation of the private filing office an exclusive designation to eliminate the multiple information sources, and would treat any filing designated as a "lien lord" filing, to be perpetual without the need for filing of continuation statements. See Part V, infra.

81 The criteria would be established by the debtor and its financial advisor who design the particular LOTL structure. The criteria might be based on financial measures or recognized standing in an industry. Once secured parties opted to use the lien lord, the identity of the lien lord would not be subject to change, except within the designated criteria, without the consent of the secured parties served by the lien lord.
transaction infrastructure deters entrenched lien lords from price gouging, so limited numbers of transfers might be expected.

C. Financing Statements: Creditor Name

Section 9-502(a) of the UCC provides the elements that must be contained in a financing statement. It states that a financing statement is sufficient only if, among other things, it "provides the name of the secured party or a representative of the secured party." The concept of a "representative of the secured party" is new to Revised Article 9. The definition of "secured party" also has been revised to include within its scope "a trustee, indenture trustee, agent, collateral agent, or other representative in whose favor a security interest or agricultural lien is created or provided for." By way of this definition, we are given examples of types of representatives, including the important clarification that a collateral agent or indenture trustee may be a secured party. Revised Article 9 makes clear that it is not even necessary to indicate in the financing statement that the named secured party is acting as a representative. And, the underlying security interest can be assigned to a new secured party without changing the secured party of record. An unrecorded assignment of this type does not result in loss of perfection. These provisions validate the pre-revision practice of using nominees as secured parties.

D. Financing Statements: Debtor Names

A creditor may file an initial financing statement that names more than one debtor. The UCC includes this feature primarily to allow the filing of a single initial financing statement against a husband and wife. This feature also permits protective filings using debtor trade names to enhance notice. However, the UCC does not limit the number of debtor names that a creditor may index in a single initial financing statement. These provisions clearly contemplate filings against multiple debtors.

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82 See U.C.C. § 9-502(a).
83 Id.
84 U.C.C. § 9-102(72).
85 See U.C.C. § 9-503(d).
86 See U.C.C. § 9-310(c).
87 Id. This clarification is consistent with prior case law, such as Rinn v. First Union Nat'l Bank of Md., 176 B.R. 401 (D. Md. 1995), in which successors to secured parties are treated as themselves secured parties by operation of doctrines such as subrogation, even though the successor failed to follow the proper procedures to perfect a security interest.
88 See U.C.C. § 9-503(e).
and not merely filings against a marital unit or a single debtor that uses multiple names. Official comments explain how a filing office may properly reject a single initial financing statement with respect to one named debtor while simultaneously accepting the same initial financing statement with respect to another named debtor.\(^8\) Thus, a creditor may file an initial financing statement that names all members of a borrowing group.

The practice of making initial financing statement filings that contain multiple debtor names confronts two fact patterns. In the first fact pattern, all members of the borrowing group consist of "[r]egistered organizations"\(^9\) formed under the laws of a single jurisdiction.\(^9\) In this instance, the single filing provides a one-stop procedure for both perfection and notice. In the second fact pattern, the borrowing group contains members that either are registered organizations formed under the laws of several jurisdictions or are not registered organizations at all. In this second case, creditors must make initial financing statement filings in every jurisdiction (i) where a member is organized, if the member is a registered organization, (ii) where a member maintains its chief executive office, if it is a U.S. entity but not a registered organization, or (iii) in the District of Columbia, if the member is organized under the laws of a non-U.S. jurisdiction that itself does not have a central filing system for security interests in personal property.\(^9\)

A filing in any given jurisdiction need only mention the debtor names for the entities deemed located in that jurisdiction. However, a creditor might index additional names for borrowing group members located elsewhere to enhance notice.

In current practice, the primary debtor makes representations and warranties to the creditor as to the accuracy and completeness of a schedule that purports to list all legal entities that comprise the borrowing group (typically, corporate subsidiaries). The creditor then uses this list to order searches and to prepare initial financing statements. The creditor typically makes individual initial financing statement filings separately against each individual legal entity in a borrowing group rather than utilizing the ability to index multiple debtor names in a single filing. If this practice changed, the most efficient borrowing group structure would be one consisting entirely of registered organizations formed under the laws of a single jurisdiction. A borrowing group would enhance its ability to facilitate group wide

\(^8\) See U.C.C. § 9-520(d) cmt. 5.

\(^9\) "Registered organization" is defined at U.C.C. § 9-102(70). It includes domestic corporations, but not foreign corporations.

\(^9\) Under section 9-307(e) of the UCC, all of these entities would be deemed located in the jurisdiction of organization.

security interest filings by forming or reincorporating all its domestic entities as registered organizations under the laws of a single jurisdiction. Nevertheless, filings including multiple debtor names would reduce the total number of filings creditors make against borrowing groups even if multiple jurisdictions remained relevant within a borrowing group.

The LOTL strategy uses multiple indexing of debtor names in a single initial financing statement wherever appropriate. To enhance notice, these filings may index names of debtors located in other jurisdictions. This procedure serves not only up-front efficiency but also streamlines ongoing monitoring as creditors must file fewer continuation statements. This reduces the occasion for error in reproducing filing numbers in the continuation statements or overlooking the filing of a financing statement altogether for a particular debtor in the group.

A creditor may add debtor names to the initial financing statement as the borrowing group acquires or forms new legal entities. A creditor may delete debtor names from the financing statement as the borrowing group liquidates or sells legal entities. In current secured financing practice, the creditor relies on covenants of the primary debtor or the borrowing group to promote receipt of notice of the correct legal name and other particulars for legal entities added to the borrowing group so that the creditor may make additional filings when appropriate to add the new entity to the borrowing group.

A creditor might enhance the integrity of this system by requiring the primary debtor or the borrowing group to deliver to the creditor a certification from the borrowing group's accountants. The certification would state that the accountants had compared the list of debtor names in particular UCC filings supplied to the accountants by the lien lord with the names of the legal entities whose consolidating financial statements are included in the consolidated financial statements of the borrowing group examined by the accountants. Further, the certification would either state that the accountants found the two lists in agreement or note any discrepancies discovered. Under the LOTL structure, intra-group transfers (other than to foreign subsidiaries) pose no danger to the

93 One reason this practice has not developed may be the perception that it is better to file separate financing statements for debtors who join a borrowing group rather than adding the new names to an existing financing statement because adding a name to an existing financing statement does not create any timing advantages for measuring the date of perfection. However, adding a name by amendment to an existing financing statement does shorten the amount of time that the financing statement is effective against the new debtor. See U.C.C. § 9-512 cmt. 4. Though this observation is true, it fails to take account of the fact that the secured party will be filing a continuation statement for the existing filings in any event and the practice of filing separate financing statements merely multiplies the number of continuation statement filings and the dates that must be monitored.
creditors because no new perfection requirement will exist unless new entities are identified through this procedure.

This LOTL strategy with respect to completeness of the debtor name list supplements the traditional representation, warranty and covenant procedure with third party validation of the list by auditors.

Deletions of debtor names from the UCC filings do not present a monitoring problem because the debtor or borrowing group must approach the creditor to request a deletion. Unilateral deletion by a debtor would not be effective.\(^4\) When confronted with a borrowing group request for a deletion, the creditor or lead agent bank can investigate the circumstances before consenting to the filing of the amendment that deletes the name.

E. Financing Statements: Collateral Indication and Other Content

The UCC distinguishes between indication of collateral and description of collateral.\(^5\) A financing statement must indicate the collateral whereas a security agreement must describe the collateral. A description of collateral may serve as an indication of collateral but not always the reverse. The key difference lies in the possibility of a creditor using a supergeneric description as an indication of collateral but not as a formal description of collateral. Following the Article 9 revisions, a financing statement sufficiently indicates the collateral if it simply states: “All assets of the debtor.”\(^6\)

Use of such a super-generic description eliminates any real chance of error in the financing statement. Even if the creditor intends to take a security interest only in debtor equipment, for example, the

\(^4\) Though filing an unauthorized termination statement is not effective, see U.C.C. §§ 9-509, 9-510, such a filing nevertheless might result in the deletion of the financing statement from the UCC filing office records because the filing office does not know that the filing of the termination statement was unauthorized. One can imagine a UCC “terrorist” funded to file unauthorized termination statements against filings made against the Russell 2000 companies or to facilitate securitization transactions. It appears that the UCC filing office would only need to maintain a record of the original filing against the debtor name for one year after the filing of the termination statement. See U.C.C. § 9-513 cmt. 5. Such an “attack” against filed financing statements would render a search of UCC filing offices even more meaningless as a source of notice than it is today. See discussion infra Part III.G & accompanying notes. Potential secured parties would not even know from whom they should seek information about the secured credit status of a debtor if the public records were corrupted in such a fashion. In the LOTL strategy, with the name of the lien lord otherwise publicized in a debtor’s or borrowing group’s financial statements, the ineffective termination statement does not create undo harm to the notice function. The potential secured party will obtain information from the lien lord regardless of whether the interest of the lien lord is indexed properly in the filing system.

\(^5\) Compare U.C.C. § 9-108 (providing a description of collateral for security agreement), with U.C.C. § 9-504 (providing an indication of collateral for financing statement).

\(^6\) See U.C.C. § 9-504(2).
supergeneric description works in the financing statement. The limitation of collateral to equipment occurs in the security agreement where the granting clause is limited to equipment, either specifically described or described generically by class. The debtor need not worry that the generic description in the financing statement creates additional rights in the creditor so long as the granting clause in the security agreement is limited.\(^\text{97}\)

The LOTL strategy with respect to collateral indication entails use of a super-generic collateral description in the initial financing statement.

The financing statement contains room for information in addition to the indication of collateral. Including a statement to the following effect in the financing statement will help preserve the integrity of the structure.

Each debtor listed in this financing statement has granted \(X\) the exclusive power and authority to file financing statements against it. Further, each such debtor has covenanted and agreed with \(X\) not to authorize or permit any other person to file a financing statement against it. Any filing of a financing statement against any such debtor that the debtor authorized or purports to have authorized without the prior written consent of \(X\) constitutes an event of default in agreements between each of the debtors and one or more creditors for whom \(X\) is acting as secured party of record. Unauthorized filing of a financing statement constitutes tortious interference with these contracts.

Whatever one thinks about the debtor's ability to grant exclusive authority to \(X\) to file financing statements, a filing including a legend such as this should have the practical effect of limiting, if not eliminating, the filing of additional financing statements against the named debtors in voluntary secured credit transactions.

The debtor would covenant not to authorize or permit filing of further financing statements. The subsequent public filing of a financing statement against the debtor would be evidence that the debtor violated its contractual commitment not to authorize or permit the filing of further financing statements. The possibility of highly visible defaults on existing debt agreements for this covenant breach would help to police the arrangement.\(^\text{98}\)

\(^{97}\) See U.C.C. § 9-510 cmt. 2, ex. 1.

\(^{98}\) Doubt has been expressed over the ability of a debtor to contract away its right to obtain purchase money financing on a priority secured basis. See Jackson & Kronman, supra note 76, at 1173 n.97 (noting that “the priority afforded purchase money lenders does not appear to be subject to private contractual modification—at least in a way that would bind third parties”).
F. Security Agreement

The LOTL structure would rely on a core short form security agreement pursuant to which each member of the borrowing group creates a security interest in the defined "collateral" in favor of the lien lord to secure repayment of the defined "secured obligations." The security agreement would contain a comprehensive definition of collateral covering all personal property of the debtor. To be effective, the collateral description would individually list all asset types covered by the UCC, as well as excluded asset types. "Collateral" would expressly include after-acquired property and proceeds. The definition of secured obligation would include an initial $1,000 advance made by the lien lord, together with all other obligations described in supplemental financing agreements of lenders for whom the lien lord has agreed to act as secured party representative. In all cases, secured obligations would be defined to include costs and expenses of collection, as well as attorney fees. The focus of the core short form security agreement is to contain the essential terms needed to create the secured credit relationship in a format that needs little review and covers items that, though essential, might inadvertently be dropped in the preparation and negotiation of a much longer document.

99 The UCC defines a security agreement simply as any "agreement that creates or provides for a security interest." U.C.C. § 9-102(73).
101 The UCC allows a security interest to extend to after-acquired collateral. See U.C.C. § 9-204. Generally, specific mention of after-acquired collateral must be made in the security agreement for this coverage. For certain assets types, however, such as inventory and accounts, case law has not required specific mention. A security interest continues in proceeds whether or not the security agreement mentions that proceeds are covered. See U.C.C. § 9-315(a)(2). Use of a standard and comprehensive granting clause would reduce risks of ambiguity or mistake. See, e.g., Shelby County State Bank v. Van Diest Supply Co., 303 F.3d 832 (7th Cir. 2002) (finding a failure of a granting clause to cover after-acquired property). A failure of contract scope would not likely be covered by an insurance policy because the scope of collateral coverage is a matter of intent, not a failed procedure.
102 Such inclusion takes advantage of the UCC provisions that provide for the application of proceeds of collateral to pay reasonable attorney’s fees and legal expenses incurred by the secured party to the extent provided by agreement and not prohibited by law. See, e.g., U.C.C. § 9-615(a)(1).
103 In practice, I encountered many drafting horribles, such as “secured” trust indentures that omitted such essentials as granting clauses, though containing wonderful procedures for conducting meetings of bondholders. The LOTL strategy would reduce the frequency of such exciting events by providing basic structure in easy to perceive relief and then omitting the errors caused by word processing and similar mistakes as procedures are replicated on a transaction by transaction basis.
A particular LOTL structure might require that all secured parties share a single core security agreement. Alternately, multiple security agreements might be used, each incorporating the core short form, with different creditor groups supplementing the core in different ways. Use of multiple security agreements might be preferred if a debtor and its financial advisors desired to provide creditors who had different priority levels with different individual liens.\textsuperscript{104} Particular creditors or creditor groups might attach riders to the core short form expressly disclaiming security in certain assets, or limiting their security interest only to specified assets or asset classes. In cases where multiple creditors share a single security interest but different priority levels are desired, the public priority would be created for the lien lord generally against the world, with the desired priorities among the individual creditors created internally by intercreditor arrangements or specified rules (such as first to record with the lien lord has priority over later recorded interests). Such internal rules are part of every securitization transaction.

The tremendous flexibility afforded to the treatment of security agreements comes from the lack of linkage under the UCC between a financing statement and a security agreement. One financing statement can be used to perfect security interests created pursuant to multiple security agreements, including security agreements that were not even contemplated at the time of the original financing statement filing. There is no requirement that a financing statement service only a single transaction or series of transactions that are related in some way.

G. Bank Accounts and Security Accounts

The recent amendments to Article 9 included deposit accounts as a type of collateral subject to perfection under Article 9.\textsuperscript{105} Previously, perfection of a security interest in deposit accounts as original collateral had been excluded from the scope of most state's versions of the UCC\textsuperscript{106} and, accordingly, secured parties had to rely on less certain procedures gleaned from case law.\textsuperscript{107} Though the amendments provided

\textsuperscript{104} Such a desire to use separate security agreements might arise as a means to provide for post-petition interest to a senior lender. See In re Ionosphere Clubs, 134 B.R. 528 (Bankr. S.D.N.Y. 1991). Such matters similarly can be addressed with contract provisions.

\textsuperscript{105} A secured party may obtain control over deposit account. See U.C.C. § 9-104. Obtaining control over a deposit account is the exclusive method of perfecting a security interest in this asset type as original collateral and not proceeds. See U.C.C. § 9-312(b)(1).

\textsuperscript{106} See, e.g., U.C.C. § 9-104(l) (1972) (New York) (excluding deposit accounts from the scope of Article 9). California and Illinois were two states that included deposit accounts in coverage under the UCC. See Jason M. Ban, Deposit Accounts: An Article 9 Security Interest, 17 ANN. REV. BANKING L. 493, 497 (1998) (listing states that included deposit accounts as Article 9 collateral prior to the revisions).

\textsuperscript{107} See, e.g., Gerald T. McLaughlin, Security Interests in Deposit Accounts: Unresolved
welcome certainty, the specified method of perfection was limited to the secured party obtaining "control" over the deposit account.\textsuperscript{108} Filing a financing statement was not made an option. This choice differs from the choice made with respect to security accounts, a similar type of collateral, for which both control and filing a financing statement are options.\textsuperscript{109} Thus, to implement the LOTL structure with respect to bank accounts, the lien lord must appear as a party to a three-party control agreement among the debtor/account owner, the bank at which the account is maintained and the lien lord. The debtor might simply arrange for the signing of a control agreement naming the lien lord each time it opens a new account. When the debtor obtains secured financing backed by a blanket lien on all assets, the control agreements obtained for existing accounts may continue in effect beyond the particular financing and be used in future financings. In practice, often it is difficult to obtain control agreements from all of a debtor's or borrowing group's banks in a timely fashion, though such agreements usually are forthcoming in the fullness of time. The lien lord's pre-existing perfected interest in bank accounts would significantly reduce the time needed to complete a secured financing using all assets of a debtor as collateral.

Though not required for perfection, the debtor could provide similar comfort for secured parties by following a similar procedure with respect to security accounts.

Registering bank accounts and security accounts with the lien lord has an added monitoring benefit. In the recently uncovered Parmalat fraud,\textsuperscript{110} the debtor apparently created false records for a non-existent bank account and security account. The accountants did not uncover the fraud and non-existent assets were reported on the debtor's balance sheet. If a debtor had a policy of subjecting all its bank accounts and security accounts to the control of a lien lord, the accountants could check the list of covered accounts at the lien lord against the list of accounts included as assets in the balance sheets subject to audit. The

\textsuperscript{108} See supra note 105. This limitation for bank accounts has been criticized. See ROBERT L. JORDAN ET AL., COMMERCIAL LAW 213-14 (5th ed. 2001). The LOTL strategy would similarly criticize this limitation as it adds a procedure to the perfection process that would not be required by many secured creditors if filing were an option, as it is in the case of security accounts. For a description of the new procedures to perfect a security interest in a deposit account, see Ben Carpenter, Security Interests in Deposit Accounts and Certificates of Deposit Under Revised UCC Article 9, 55 CONSUMER FIN. L.Q. REP. 133 (2001).

\textsuperscript{109} A security account is a form of investment property. A security interest may be perfected against investment property by filing a financing statement. See U.C.C. § 9-312(a). Also, a security interest in a security account may be perfected by control. See U.C.C. § 9-314.

extent to which a debtor honors its promise to the lien lord to subject all accounts to the collateral package would provide a signal as the extent to which the debtor had procedures in place to manage and monitor its own assets.

H. Other Filing Systems

The lien lord's role would not be limited, however, to mere appearance on a UCC financing statement and in a security agreement, and maintenance of a record of secured lenders. In principle, the lien lord name could be inserted into the various registry and title systems for real estate, vehicles, intellectual property, railcars, insurance policies, aircraft, and so forth, as a matter of course, so that the required forms of public notice are pre-positioned for any possible secured financing. Such a strategy would work best in legal structures that, like the Uniform Commercial Code, permit lien inflation\(^\text{111}\) (i.e., future advances) and subject newly acquired debtor assets to after-acquired property clauses.

Debtors would reap fewer benefits from using the LOTL structure in recording systems designed to raise revenue through fees based on the amount of a secured financing, such as those found in the real estate laws of many states.\(^\text{112}\) The non-exhaustive outline below indicates some of the other procedures that need to be followed to implement the LOTL structure for non-UCC covered asset types. The costs and benefits of implementing the LOTL structure vary by asset type and jurisdiction. The summary does, however, indicate those types of structures that facilitate financing in contrast to those that make creation of transaction infrastructure problematic.

I. Property Subject to Certificate of Title Statutes

The UCC excludes from its scope perfection of security interests in


\(\text{112}\) For example, some states have flat fees for recording mortgages on real property. See, e.g., N.J. STAT. ANN. § 4-4.1 (West 2003); TEX. LOC. GOV'T CODE ANN. § 118.011 (Vernon 2003). Other states' fees vary in proportion to the value of the indebtedness secured by the mortgage. See, e.g., N.Y. TAX LAW § 253 (McKinney 2003); MINN. STAT. § 287.035 (2003). Unfortunately, a few states use the UCC filing system to raise revenue in a similar fashion, creating practical problems for financing by businesses with entities organized under the laws of those states. See, e.g., TENN. CODE ANN. § 67.409(b) (2003).
vehicles and other assets subject to certificate of title laws. The LOTL strategy should work well for vehicles and other property subject to certificate of title statutes. Recent case law confirms that the notation of secured party names on title certificates merely serves to put third parties who would examine the title certificates on inquiry notice that a secured party claims an interest in the vehicle. It is not important that the name of the actual secured party appear on the certificate so long as a name appears from whom third parties might ascertain the status of secured claims against the vehicle. Thus, notation of the lien lord on certificates of title should suffice to create perfected security interests, even though the lien lord is acting as a nominee for others.

Certain securitization transactions provide an example of a concrete benefit that the LOTL strategy might provide.

Parties such as automobile manufacturers and leasing companies have developed transaction infrastructure known as "titling trusts" to facilitate securitization financing for fleets of leased vehicles. Such transactions involve the re-titling of ownership of leased vehicles into special purpose trusts to isolate the assets from the bankruptcy estate of the transaction originator. However, no security interest is noted on the vehicles' titles. The weakness of the structure lies in the fact that certain liabilities, most notably pension liabilities, do not stop at the discrete legal entity level but instead extend to all entities in a controlled group.

Thus, it is possible that, if the securitization transaction sponsors have unfunded pension liabilities and then file for bankruptcy, the Pension Benefit Guaranty Corporation might seek a priority claim against the assets held in the titling trust, including both the vehicles and the leases. The use of the LOTL structure might be used by such enterprises, as well as by enterprises that do not have such concentrations of asset value in vehicles, if, as a matter of course, all newly acquired vehicles contained a title certificate notation listing the lien lord as a secured party at the time the original title certificate was

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113 See U.C.C. § 9-311. This would typically include ships that are not registered with the federal authorities or under the laws of another country. See infra notes at 140-43 and accompanying text.


115 A variety of such entity piercing laws are discussed in BLUMBERG, MULTINATIONAL CHALLENGE, supra note 20. This phenomenon of entity piercing laws illustrates one type of circumstance in which security interests act as a more protective method of asset partitioning than legal entities.

In the case of a lease securitization in which the investors hold senior equity interests in the trust rather than debt investments, the security interest might secure an indemnity obligation holding investors in the lease securitization harmless against loss from specified liabilities, such as those relating to pensions. Over time, use of the LOTL strategy would result in all of a firm’s vehicles becoming easily available as collateral for secured financings.

J. Insurance Policies

Article 9 of the UCC excludes perfection of security interests in insurance policies from its scope. Use of the LOTL structure would make creation of security interests in insurance policies easier. Typically, a secured party has three choices for insurance policies. In the first option, the secured party obtains status as a “certificate holder” of the policy. This status entitles the secured party to receive prior notice of any cancellation of the policy so that it may protect itself by paying a policy premium if the debtor fails to do so. It does not give the secured party a priority status in the policy or payments thereunder. In the second option, the secured party obtains the status of either an “additional insured” or a “loss payee.” This status entitles the secured party to a priority interest in payments made under the policy, as well as giving the secured party an enhanced element of control over the use of insurance proceeds. This is the most common form of protection taken by secured parties. In the third option, the secured party obtains a “lender loss payable” clause on its policy. This clause entitles the secured party to receive payment under the policy even if some act by

117 The current version of the UCC takes a modest step in the direction of efficiency by providing that a security interest in vehicles subject to certificate of title statutes generally will, in the case of motor vehicles held as inventory by a person in the business of selling goods of this kind, be perfected by filing financing statements rather than notification on a certificate of title. See U.C.C. § 9-311(d). This provision does not, however, cover companies that are in the business of leasing, but not selling. See U.C.C. § 9-311 cmt. 4. Thus, the convenience of financing statement filing is not available for a typical lease securitization in which the leasing activities have been isolated in a special purpose subsidiary to separate those assets from the bankruptcy estate of the manufacturer of the vehicles. The LOTL strategy would suggest that a security interest in all vehicles should be capable of perfection by filing a financing statement, with the simple proviso that a bona fide purchaser would take free of the interest unless it were noted on the certificate of title.

118 See U.C.C. § 9-109(d)(8). This exclusion generally applies to security interests in insurance policies as original collateral. Payments received by debtors under insurance policies for loss suffered to collateral constitute proceeds of the collateral and are covered under the UCC. See U.C.C. § 9-102(64). But see CAL. COM. CODE § 9109 cmt. 13 (2004) (including insurance as original collateral under California UCC). Even in cases where UCC coverage is provided, however, secured lenders prefer following additional procedures so that they might monitor the policy to prevent unexpected cancellation for failure to pay premiums and to control the use of the proceeds should a payment be made.
the debtor would provide a defense to payment of the debtor for the insurance company. In effect, the lender loss payable clause gives the secured party a direct contract claim against the insurance company for loss up to the amount of the loan; with the clause, the secured party does not merely stand in the shoes of the debtor.

In most cases of inventory and equipment insurance, insurance companies do not impose an additional charge for these endorsements. In the case of large cost items, such as aircraft and marine insurance, an additional charge may be imposed for the equivalent of a lender loss payable clause (often known as a "breach of warranty" rider in this context).

In transaction practice, it often takes several weeks and some limited negotiation with insurance company counsel to insert the name of a secured party or collateral agent into a debtor's insurance policies. The use of the LOTL structure reduces costs in this procedure if the name of the lien lord simply is inserted when the policy is obtained or when the next secured financing is completed. Further, secured parties may benefit from the original delegation without the need to repeat steps on a transaction by transaction basis to obtain a security interest in the insurance policy for future secured loans.

K. Intellectual Property

Obtaining and perfecting security interests in intellectual property is famously convoluted. Under current case law, UCC filings appear sufficient to perfect security interests in patents and trademarks owned by a debtor. However, a secured party must make a federal filing to perfect a security interest in a federally registered copyright. Recent case law has found that a UCC filing is sufficient to perfect a security interest in an unregistered copyright. Thus, the LOTL structure might be used to insert the name of the lien lord into federal copyright records to notice security interests in those assets. The real financing problem presented by copyrights, however, is caused by the antiquated Federal copyright registration system which does not provide an easy mechanism for recording interests in after-acquired copyrights on a


120 In re Peregrine Entm’t Ltd., 116 B.R. 194 (Bankr. C.D. Cal. 1990). Filing fees for the federal registry are eighty dollars per title and twenty dollars per additional group of ten titles. See 37 C.F.R. § 201.03(c) (2003).

121 In re World Auxiliary Power Co., 303 F.3d 1120 (9th Cir. 2002); cf In re Chattanooga Choo-Choo Co., 98 B.R. 792, 796 (Bankr. E.D. Tenn. 1989) (analyzing service marks).
blanket basis. Each registration of a security interest must be done on a copyright by copyright basis.\(^{122}\) If a debtor noted the lien lord’s interest as a matter of course each time it registered a federal copyright, it would have qualified all of its federally registered copyrights for use as collateral in secured financings. A debtor might notice the lien lord’s interest against its existing federally registered copyrights at the time of a significant secured financing and would not, thereafter, need to make similar filings for future financings.

As a matter of secured financing practice, lenders often require filings with the Patent and Trademark Office to reflect security interests in patents and trademarks\(^ {123}\) even though case law suggests that such filings are not necessary to provide protection against a bankruptcy trustee.\(^ {124}\) Though such an approach raises certain other issues for protection of the debtor’s rights in these items of intellectual property,\(^ {125}\) if desired by the parties, the name of the lien lord might be pre-positioned in these records as well.

In many cases, debtors do not own the intellectual property that they use. Instead, debtors license the use of intellectual property from third party owners/licensors. Often, the license prohibits assignment of the licensee’s rights to use the intellectual property. Further, existing law often creates a presumption in favor of the licensor that the licensee may not assign the rights to its licensee position.\(^ {126}\) The LOTL structure

\(^{122}\) Collateral must be specifically described by title or registration number, 17 U.S.C.A. § 205(c) (2003), inhibiting financing of after-acquired property. Various proposals, including legislation, have been advanced to correct these well known problems. It is rumored that major film studios lobbied to block legislation that would improve the system for recording security interests against registered copyrights. The motivation was to deprive independent film makers of a source of financing. Fewer independent films means less competition for the established studios who are able to obtain financing under the current less than ideal recording system.

\(^{123}\) See JORDAN ET AL., supra note 108, at 459-61.

\(^{124}\) See supra note 119.

\(^{125}\) The belts and suspenders approach of making both UCC filings and federal filings against intellectual property may not always be wise. An example of a risk that may be caused by simply recording an assignment of intellectual property with the PTO as part of a secured transaction is contained in *The Clorox Co. v. Chem. Bank*, 40 U.S.P.Q.2d 1098 (TTAB 1996). In that case a security interest was created in an “intent-to-use” application for which no Statement of Use had been filed. In form, the security agreement purported to assign and transfer to Chemical Bank all of a debtor’s rights in specified trademarks, including an “intent-to-use” application to register the mark “SUPER SCRUB.” The Trademark Trial and Appeal Board determined that, even though the debtor and bank intended to create a security interest in the “intent-to-use” application, the assignment was an “outright, rather than conditional, assignment of all right, title and interest in and to the specific trademarks which USA Detergents Inc. warranted to own . . . .” Because section 10 of the Trademark Act, 15 U.S.C. § 1060, prohibits an assignment of an intent-to-use application prior to the filing of a Statement of Use, the assignment voided not only the application but the registration of the trademark.

\(^{126}\) Everex Sys, Inc. v. Cadtrak Corp., 89 F.3d 673, 679-80 (9th Cir. 1996) (sustaining licensor objection to licensee assignment of non-exclusive patent license); Harris v. Emus Records Corp., 734 F.2d 1329 (9th Cir. 1994) (sustaining objection to assignment of copyright license); see also *In re Access Beyond Techs., Inc.*, 237 B.R. 32 (Bankr. D. Del. 1999). In *Institute Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489 (1st Cir. 1997), cert. denied, 117 S. Ct. 2511 (1997), the
suggests a way forward for debtors who would like the option of offering licensee rights to secured parties as collateral, but it imposes certain upfront contracting costs. The problem is not raised by the recording system, as such. Rather, the problem is the potential value of the collateral.

Following the LOTL strategy of pre-positioning assets for secured financing, a debtor might negotiate an assignment of its licensee rights with the licensor to the lien lord at the time the license is obtained. If this assignment expressly stated that its purpose was to create priority in the proceeds realized from the transfer of the licensee rights but at the same time reserved to the licensor all rights that it may have under other law to determine the identity and suitability of the transferee (but without the right to forbid transfers altogether), the licensor should have little reason to object to the provision. If use of the LOTL structure became commonplace, the costs of explaining and negotiating for such a provision could be expect to decline. A similar approach to security interests is taken in the case of certain regulated licenses.

L. Regulated Licenses

Perfection of security interests in regulated licenses involves a patchwork of approaches and procedures that may be illustrated by a few examples, such as FCC licenses, liquor licenses and commercial fishing licenses. Unfortunately, treatment of any individual license will be sui generis to its particular regulatory scheme and must be investigated on a case by case basis. In certain cases, UCC filings are used (with more or less effect), in others filing must be made with a regulatory agency and, in some cases, no form of security interest is possible.

FCC licenses are a particularly valuable asset type in which a secured party may not perfect a security interest. After much confusion in situations in which secured parties attempted to perfect security interests in FCC licenses by filing UCC financing statements, the FCC and case law arrived at a compromise. Though no security interest may be taken in the license itself, a financing statement may be filed to perfect a security interest in any proceeds realized from the sale or

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127 The practical problem is not that the filing of a UCC financing statement fails to perfect a security interest in the licensee rights, including any proceeds from the transfer of the licensee position. Rather, the problem is that there never will be any proceeds from such a transfer because the licensor has the right to prohibit transfers.
transfer of the license.128

The compromise gives the regulatory authority the assurance that it wants: the creation of the security interest in the license will not result in loss of control by the regulator over the identity and suitability of transferees of the license who might acquire the license pursuant to exercise of remedies by the secured party. Also, the compromise appears to give the secured party what it wants most: the ability to apply value realized from the sale of the asset to repayment of debt. Though it would be better for the secured party to be able to transfer the license without the need for regulatory approval, given the nature of the property there is not much alternative but to accept regulatory approval as a condition to transfer. Similar need for regulatory approval often exists under antitrust laws anytime a sufficiently valuable asset is sold, so the need for regulatory approval is not as unusual as it might seem at first blush.129

The favorable aspect of the compromise is that the filing of a UCC financing statement suffices to perfect the security interest in the FCC broadcast license proceeds. The unfavorable aspect of the compromise is that it creates a preference risk or worse for the secured lender. One structural truth is that the proceeds of the license do not exist as debtor property until the license is sold. A security interest in these proceeds thus cannot attach until the sale.130 A sale that occurs shortly before a bankruptcy filing will result in delayed attachment of the security interest, a classic transfer in respect of antecedent debt.131 A sale after a bankruptcy filing will not generate assets to which a security interest


129 See 16 C.F.R. § 802.63 (2000) (providing that acquisition of collateral by a bona fide creditor in a foreclosure is exempt from reporting requirements of Hart-Scott-Rodino, but sale of same collateral to a third party may not be exempt).

130 U.C.C. § 9-203. Currently, courts seem to be ignoring the structural problem posed by granting a current security interest in assets, such as proceeds, that do not exist; however, there is no assurance that courts will ignore the problem for all types of regulatory collateral on a prospective basis. Compare Thomas E. Plank, The Limited Security Interest In Non-Assignble Collateral Under Revised Article 9, 9 AM. BANKR. INST. L. REV. 323, 347-48 (2001) (collecting cases in which courts find proceeds of licenses to not constitute after-acquired property), with Edwin E. Smith, Article 9 in Revision: A Proposal for Permitting Security Interests in Nonassignable Contracts and Permits, 28 LOY. L.A. L. REV. 335, 344 (1994) (noting problems with creating a present security interest in proceeds that do not exist).

may attach. This is because a security interest may not attach to property acquired by a debtor post-petition unless the post-petition property represents proceeds of pre-petition property in which the debtor had granted the secured party a perfected security interest. This favorable situation for post-petition proceeds does not exist in the case of the FCC broadcast license because the law does not permit a secured party to have a security interest in the FCC license itself.

Though the regulatory regime does not prevent creation of a security interest in the name of a lien lord in the proceeds of the license using a UCC filing, regulatory confusion has created a serious risk. Where a regulatory authority confuses permission to grant a security interest with loss of control over the ability of the regulatory authority to approve transferees of the regulated property, either preference risk or the risk of no security is created. Properly analyzed, the permission to grant a security interest need not result in loss of approval rights by the regulator over the party who acquires the asset in any foreclosure proceeding. This regulatory problem, however, is not caused by the LOTL structure. The lien lord has the same advantages and disadvantages as other creditors.

In the case of liquor licenses, different jurisdictions have different rules. At one extreme, California provides an example in which it is not possible to perfect a security interest in a liquor license. Florida provides an example in which it is possible to perfect a security interest in a liquor license by filing with the regulatory authority rather than filing a financing statement. The name of a lien lord may be inserted into the records of the Florida Division of Alcoholic Beverages and Tobacco in the same manner as the name of the lien lord is inserted into the UCC records. Pre-positioning of security interests in liquor

132 See id. § 552.

133 An ideal structure to implement the LOTL strategy would be for every regulatory agency to permit a simple UCC filing to perfect a security interest in regulatory property of any type of license or concession subject to its jurisdiction. However, where a regulator desires control and approval rights over potential transferees of the license or concession, the regulator would retain the right to approve any person who would acquire the asset by exercise of remedies by the secured party or in a transfer following an insolvency of the debtor. The only cases in which such a structure becomes complicated are cases in which the regulator wishes to approve the substantive terms of secured financing obtained by its licensees. Such regulatory oversight would be better accomplished by direct operating restrictions on the regulated businesses, rather than by indirectly managing the process by creating alternate property procedures for creation of security interests.

134 The California Business and Professions Code, section 24074, contains the exclusive remedy for creditors seeking proceeds of the transfer of a liquor license. See Grover Escrow Corp. v. Cole, 453 P.2d 461 (Cal. 1969). Section 24074 requires that creditors be paid pro rata from proceeds of a liquor license. Thus, an attempt to obtain a priority in these proceeds by means of a security interest likely would be ineffective.

135 See Fla. Stat., § 561.65(4); see also Dery v. Occhiuzzo & Occhiuzzo Enter., Inc. 771 So. 2d 1276 (Fla. App. 2000).
licenses, where permitted, might be a valuable tool for restaurant chains to facilitate various financings.

Commercial fishing licenses illustrate a potential trap for the unwary. A commercial fishing license would appear to constitute intangible personal property that would be subject to the UCC perfection procedures in the absence of an alternate regulatory filing system. There is no federal law expressly providing for the registration of security interests against federal commercial fishing permits. Case law has held, however, that a federal commercial fishing permit, even though intangible, is property appurtenant to the commercial fishing vessel. Thus, the federal fishing permit is subject to maritime liens asserted against the vessel. This logic, if followed to its conclusion, would suggest that a preferred ship mortgage should be used to perfect a security interest in a commercial fishing permit.

M. Aircraft, Railroad Equipment & Ships

Perfection of security interests in aircraft, railroad equipment and ships generally requires federal filings because federal law contains registration systems that provide for recordation of security interests. These federal laws preempt the UCC filing system. In principle, these recordation systems do not present material obstacles to

136 See Gowen Inc. v. F/V Quality One, 244 F.3d 64 (1st Cir. 2001) (asserting maritime lien to recover for wharfage and repairs under the Federal Maritime Lien Act imposing a maritime lien for debts owed to pay necessaries furnished to a vessel).
138 A secured lender perfects a security interest in locomotives, railcars and other railroad equipment by recording a lien at the Surface Transportation Board. See 49 U.S.C. § 11301 (2002). Security interest filings against tow boats, barges and other watercraft subject to Surface Transportation Board authority also are made at the Surface Transportation Board. Filings may cover after-acquired property and are subject to a thirty dollar per document filing fee.
139 The controlling provisions are a codification of the Ship Mortgage Act at 46 U.S.C. §§ 31321-30. Liens on ships operate from the perspective that the ship itself is a legal entity obligated on the debt or other liability, creating added complexity to this area of the law. In general, maritime liens arise from maritime transactions and torts without recordation. The recording of a preferred ship mortgage with the United States Coast Guard is an exception in which filing is required. Generally, if a ship is under twenty-five feet in length, a security interest in the vessel is perfected under state certificate of title statutes similar to the procedures followed for an automobile. If the ship is five net tons (generally a ship of more than twenty-five feet in length), federal recordation is available. See 46 U.S.C.A. § 12102 (expressing eligibility for federal registration in terms of five net ton minimum).
140 U.C.C. § 9-109(c)(1). If a ship is not registered with the United States Coast Guard or under the flag of another nation, perfection of a security interest in the ship would be governed by a state certificate of title statute.
implementation of the LOTL structure.\textsuperscript{141} In practice, however, the LOTL structure should not be expected to add as much value for these asset types as for others. This is because often the financings for expensive assets such as these are accomplished in leverage lease and similar transactions\textsuperscript{142} in which a complicated ownership structure is developed so that third party investors, other than the debtor/operator of the assets, is the owner of the assets for tax purposes. This allows the investor/owner of the assets to take advantage of current depreciation on the assets that the debtor/operator may be unable to use. In general outline, the rules governing ship mortgages can result in priority on a last-in-time / first-in-right basis so that certainty of priority is compromised.\textsuperscript{143}

Overall, debtors may avail themselves of pre-positioning opportunities for assets of these types subject to federal regulation, but the LOTL structure is not primarily directed at them.

\textbf{N. Real Estate Assets}

Debtors either own real estate or lease it from third parties. In the case of owned real estate, the LOTL structure is easily implemented by filing a deed of trust or mortgage in the name of the lien lord. The value of this procedure is greatest in states that do not raise revenue by charging a mortgage recording tax.\textsuperscript{144} In those states, a debtor may pre-position the lien lord to facilitate future extensions of secured credit without worry over subsequent procedures. In states that do charge a mortgage recording tax based on the amount of the debt secured, pre-

\textsuperscript{141} Some adjustments might be required. For example, the Ship Mortgage Act allows a secured party to secure a contingent obligation, though it requires listing of a specific dollar amount. The fee, however, is a mere four dollars per filed page. 46 C.F.R. §§ 67.529, 67.550 (2003). In the LOTL structure, the value of the vessel might be listed. In any event, future advances may be secured by a ship mortgage which facilitates the LOTL structure. Often, vessels are registered under the laws of foreign jurisdictions, such as Liberia, the Cayman Islands or the Marshall Islands. In the case of the Marshall Islands, the laws are patterned on the corporation laws of Delaware and the United States Ship Mortgage Act. The similarity to known legal regimes facilitates financing. The managers of the Marshall Islands ship registration system came from Liberia where they conducted similar operations.

\textsuperscript{142} For example, the operator of a ship might either lease or charter the ship, rather than own it. The high value of these assets already supports financing through large syndicates of lenders so that the efficiency gains largely may be realized without the LOTL structure.

\textsuperscript{143} See Bank One Louisiana N.A. v. M/V Mr. Dean, 293 F.3d 830 (5th Cir. 2002) (holding that a later perfected claim for breach of a charter contract had priority over an earlier filed and perfected preferred ship mortgage because the charter contract existed prior to the mortgage and, thus, the claim under the charter contract was deemed to arise at that time).

\textsuperscript{144} Compare N.Y. TAX LAW § 253 (McKinney 2003) (specifying that New York state mortgage recording tax is computed based on amount of mortgage debt), \emph{with} N.J. STAT. ANN. § 4-4.1 (West 2003) (specifying that New Jersey mortgage recording tax is set at a flat fee unrelated to amount of debt secured).
positioning may have some advantages but the value of the procedure is significantly reduced as further taxes and subsequent filings in the real estate records will be required at the time material credit is extended or refinanced.

In the case of leased real estate, the world divides between short-term space leases that typically have little value and often are not recorded in the real estate records in the first place and long-term leases with potentially significant value that are recorded in the real estate records to protect the lessee's position. In the later case, it is typical for the debtor/lessee to worry about its ability to use its leasehold estate as collateral. With this possibility in mind, the lessee typical negotiates notice and cure rights with the lessor pursuant to which the lessor agrees to give any leasehold mortgagee notice of defaults under the lease and the ability to cure those defaults. Such a provision typically is negotiated even if no current financing of the leasehold estate is contemplated. The provision affords the leasehold mortgagee the ability to protect the value of its collateral in case of defaults by the lessee. In the context of such a negotiation, it adds zero cost to designate the name of the lien lord as the secured party. Whether such a designation offers material savings will again depend on whether the applicable state law charges a tax based on the amount of the debt secured by the leasehold mortgage.

O. Knitting the Secured Guarantee Web

To start the process of constructing the guarantee web, the lien lord loans the debtor $1,000, the debtor signs a security agreement naming the lien lord as representative of secured parties and the lien lord files a financing statement indicating that the collateral consists of "all assets of the debtor." The description of collateral contained in the security agreement is made by type reference to asset classes and includes all assets in which a security interest may be created under Revised Article 9. Additionally, the security agreement collateral description may include references to asset types excluded from the scope of Article 9. The collateral description in the security agreement expressly covers after-acquired property. The description of secured obligations in the security agreement includes both the $1,000 loan and all future

145 The debtor is required to authenticate the security agreement, though the secured party is not. U.C.C. § 9-203(b)(3)(a).
146 The super generic description of collateral is permitted in the financing statement. U.C.C. § 9-504.
147 Description of collateral by asset type is permitted in the security agreement. U.C.C. § 9-108(b) cmt. 2.
148 Examples of such collateral include copyrights.
advances of any party for whom the lien lord acts as representative. A post-filing search of the UCC filing office is made. This search reflects the filing made in the name of the lien lord and, ideally, the absence of other UCC filings. A legal opinion is rendered confirming the perfection and priority of the security interest. In the case of a borrowing group, all members of the group guarantee the $1,000 loan and all future advances. They grant security interests to secure their guarantees.\textsuperscript{149}

A debtor may take these steps prior to any specific plans to obtain significant secured financing from lenders. The token $1,000 advance preserves the integrity of the initial filing of the financing statement. Without such an advance, the debtor could require that the secured party file a termination statement.\textsuperscript{150} For good measure, the $1,000 advance is expressly not pre-payable and has a maturity date far in the future. Creditors that make advances relying on the presence of this "golden" financing statement want to be confident that, once the lien lord has agreed to act for them, the financing statement on which they are relying has not been terminated at a time when no advances or commitments are in place. With the token advance outstanding, the debtor cannot cause the filing of a termination statement.

A loan document evidencing the $1,000 advance is styled the "master advance agreement." The definition of "secured obligations" in the security agreement includes "all present and future advances, including principal, interest and fees made pursuant to the master advance agreement, as it may be amended, modified and supplemented from time to time." Provision also is made to secure various costs and expenses, including legal fees. The master advance agreement provides that various lenders, trustees and other financiers may become parties to the master advance agreement and incorporate by reference into that master agreement their various individual financing agreements separately negotiated with the debtor.


\textsuperscript{150} The debtor can compel the filing of a termination statement, or file one itself if the secured party of record does not, if no secured debt is outstanding and there is no commitment to lend. U.C.C. §§ 9-509(d)(2), 9-513.
P. Privacy/Publicity of LOTL Information

A borrowing group might choose to direct the lien lord to maintain its list of secured creditors in confidence. In such a case, the lien lord only would disclose information to existing creditors appearing on the list and to potential creditors identified by the debtor or borrowing group. Such an information management structure mirrors the existing rules under Article 9 pursuant to which a secured party appearing as a matter of record in a financing statement is not required to provide information to anyone who asks for it. Instead, the debtor must direct the creditor to provide the information either to it for distribution to others or to persons that the debtor identifies.

Alternately, a borrowing group might choose to direct the lien lord to maintain its list of secured creditors in a publicly available manner. One option for public companies might be to publish the list with its quarterly or annual reports, with updates (if material) on Form 8-K. Another option might be to maintain the list of secured creditors on a website available to all. Such a web-based list would be updated in real time as the list itself is updated; indeed, the original list might be maintained in the hypertext markup language or html format used to create web pages.

Recent economic research indicates that the level of disclosure offered by a firm is positively correlated with lower interest rates charged by the private debt markets—that is to say, more disclosure translates into a lower interest rate spread.\textsuperscript{151} This is true even for firms that have outstanding public issues of debt for which a certain level of disclosure already is mandated. This research supports earlier theories to the effect that, in the absence of costs associated with providing information, all firms would provide complete disclosure. To date, because information about a debtor or borrowing group’s secured credit status is contained in a variety of places the information is expensive to produce and to accurately update. Using a LOTL structure, however, a one stop shopping source for accurate information is available. Accordingly, a debtor or borrowing group might find it financially beneficial to take advantage of the LOTL structure to provide more

complete information about its secured credit status because such disclosure might lead to lower interest charges on its debt instruments. Indeed, a view that disclosure about details of financing arrangements may benefit a firm might be behind a recent decision by a public company to provide enhanced disclosure about compliance with covenants in a bank credit facility.152

Q. A Simple Priority Structure

In simplest form, the lien lord agrees to act as representative for a secured party upon the direction of the debtor following agreement with the secured party that the new loan will be secured and will have priority based on the date and time that the lien lord agrees to act for the secured party. The agreement to act for the lender is evidenced by entering the name of the lender and identification of the loan into a ledger maintained by the lien lord. Section 9-322 of the UCC states that security interests will have priority based on the earlier of the time of filing or perfection.153 There is no rule stated for the case in which multiple secured parties rely on a single financing statement and security agreement. It would seem that all the secured parties would have equal priority in such a case. Nevertheless, section 9-339 contains the remedy for this situation.154 It states that “[t]his article does not preclude subordination by agreement by a person entitled to priority.”155 It is this section that is relied upon. When the lien lord agrees to act for a lender, it obtains the agreement of the lender that the lender will have priority based on the time that the lien lord agrees to act for it as evidenced by entry of the lender and loan into the ledger. The simple form of the LOTL structure is a pure first-in-time, first-in-right system.

R. Altering Traditional Priority Schemes

The direct transaction cost saving provides sufficient reason to pursue the LOTL strategy. However, potentially more significant benefits emerge from this approach. When multiple secured parties simultaneously rely on the same documentation to perfect security interests, opportunities exist to share cash flow and proceeds from asset

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152 See Gretchen Morgenson, Why the Secrecy About Financial Covenants?, N.Y. TIMES, Oct. 12, 2003, at C1 (describing one company’s disclosure of financial covenants in its periodic SEC reporting and predicting other companies will follow).

153 See U.C.C. § 9-322.

154 See id. § 9-339.

155 Id.
dispositions in proportions and priorities that differ from the results required under the default rules provided by law for separately documented transactions. Further, because the sharing of documentation reduces the cost of obtaining preferred security status, creditor classes that traditionally are unsecured may be given security, so long as the debtor and its financial advisor determine that providing such security would result in a preferred capital structure or business model. Consider the following examples.

In addition to confronting documentation and information production burdens, under our existing rules for secured credit priorities, a second secured creditor faces several kinds of uncertainty. First, the first secured creditor might inflate its lien by making additional future advances. Piling more secured credit upon the priority given to the first filed financing statement erodes the cushion provided to the second secured creditor. Second, in a bankruptcy of the debtor, the first secured creditor will be entitled to receive post-petition interest to the extent of collateral value. This accumulation of post-petition interest will erode the position of the second secured creditor in an uncertain amount because the length of any future bankruptcy proceeding of the debtor is unknown. The problem of post-petition interest is a special case of lien inflation in action.\(^\text{156}\)

Using the LOTL structure, a borrowing group and its financial advisor might determine that these default rules are not the most efficient for its circumstances. The borrowing group can alter these priorities within the intercreditor structure while at the same time avoiding direct creditor-by-creditor bilateral negotiations by simply implementing the structure that is deemed most desireable. This approach is used all the time in securitization transactions in which different priorities are assigned to different classes of principal and interest. The financial engineers model for efficiency and then present the structure to the marketplace. The difference is that, to date, this approach is used for discrete pools of assets rather than for a debtor or a borrowing group as a whole.

I have no particular private ordering of security interests to recommend. Under the LOTL structure, the debtor, its financial advisor and the marketplace will determine the preferred ordering system.\(^\text{157}\)

\(^{156}\) See In re Ionosphere Clubs, Inc., 134 B.R. 528 (Bankr. S.D.N.Y. 1991) (discussing operation of post-petition interest in the context of shared security interest); see also In re Southeast Banking Corp., 710 N.E.2d 1083 (N.Y. 1999) (stating rule of "explicitness" under New York law for a senior creditor to obtain post-petition interest from a junior creditor). Any intercreditor and subordination language must be explicit. See id.

\(^{157}\) See generally Jackson & Kronman, supra note 76, at 1180 (noting circumstances in which the old transaction based system of priorities might be more efficient than the notice filing system provided by Article 9 and how one might achieve a similar result by notation on particular financing statements). The notion of flexibility advanced by Jackson and Kronman is expanded
However, a few possibilities suggest themselves.

For example, to facilitate obtaining secured credit from second and third priority creditors, the amount that a first creditor might advance on a priority secured basis could be limited. Further, provision for post-petition interest might be made out of a "fourth priority" pool after payment of principal to first, second and third priority creditors. Though similar results might be achieved on an ad hoc basis by bilateral negotiation or covenant, the LOTL structure eliminates the bilateral negotiation and the risk of breach. The modification of the current treatment of post-petition interest reduces the risk that a second or third creditor seeks relief from the automatic stay for erosion of its position in a bankruptcy of the debtor.

Traditionally unsecured creditors might be granted collateral in a vertical carve-out, pari passu with other secured creditors, or in a horizontal carve-out, subordinated to senior creditor classes but nevertheless senior to unsecured creditors. A debtor might offer this benefit to trade creditors to induce the extension of more credit, with longer terms and lower interest charges, or to employees if current cash flow will not support higher current wage payments. A horizontal carve-out might be offered to supplement unsecured priorities found in § 507 of the Bankruptcy Code. Perhaps customers, such as those of a grain elevator operator, would prefer to use a debtor that offered a $10,000 secured priority to supplement the unsecured approximate $4,650 priority created under current law.

On a more speculative level, debtors or borrowing groups might create horizontal or vertical priority for larger groups of unsecured creditors without their consent. Receipt of a distribution from this priority in bankruptcy, however, would be conditioned on a vote supporting a bankruptcy reorganization plan approved by the debtor or,

by the LOTL strategy. The bilateral negotiations envisioned by Jackson and Kronman to contract out of the Article 9 priority scheme, however, can be eliminated if a debtor and its financial advisor develop an alternate scheme of priorities within which creditors must lend.

158 This suggestion amounts to a private implementation of the so-called "carve-out proposal" pursuant to which a specified percentage of assets (e.g., twenty percent) would be exempt from the secured creditor's security interest. The exempted assets would be available to satisfy the claims of non-adjusting unsecured creditors. The carve-out proposal, initially advanced by Elizabeth Warren, fueled a large, continuing academic debate over whether the institution of secured credit itself is efficient. See generally Lucian Arye Bebchuk & Jesse M. Fried, The Uneasy Case for the Priority of Secured Claims in Bankruptcy: Further Thoughts and a Reply to Critics, 82 CORNELL L. REV. 1279 (1997); see also Claire A. Hill, Is Secured Debt Efficient?, 80 TEX. L. REV. 1117 (2002).


161 See id. § 507(a)(5).
perhaps, a senior class of creditor. Though facially coercive, such a structure would give these creditors a real stake in the enterprise, rather than mere hold-up value. The prospect of losing this stake might result in more rapid resolution of reorganization plans. This is particularly true if the allocation provisionally granted to traditionally unsecured creditors matched, as an empirical matter, distribution percentages negotiated by similarly situated creditors in other bankruptcy proceedings. In some sense, this type of priority structure might function as the ultimate pre-packaged bankruptcy. Even senior classes of creditors might support such carve-outs if they were convinced that this structure reduced the risk of a long and drawn out bankruptcy proceeding.

Use of privately created vertical carve-outs might blunt certain criticisms of the current operation of our secured credit system, discussed in Part IV below.

Lastly, as an innovative matter, a debtor might require the recording of negative pledges and similar restrictions with the LOTL as a condition to their effectiveness. Such a requirement would be enforced by an amendment to the debtor's organizational documents specifying that no such contractual restriction shall be effective unless recorded in the LOTL ledger. Of course, such a restriction only would be effective on a prospective basis. Over time, however, information burdens associated with due diligence review of a debtor's contractual restrictions would be reduced.

S. Enhancing Credibility with Investors

A borrowing group with an LOTL structure in place might elect to grant all creditors of the borrowing group a security interest in all of its assets. In general, such a security interest would benefit no creditors because it benefits all creditors. However, the general rule is that a

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162 Cases such as In re SPM Mfg. Corp., 984 F.2d 1305 (1st Cir. 1993) provide reason to believe that the post-filing adjustments to secured claims needed to implement such a structure would be upheld. Use of the LOTL structure also might provide valuation benefits for secured creditors. Secured claims generally are determined using either liquidation value or going concern value. Typically, courts use liquidation value in bankruptcy cases under Chapter 7, and going concern value in reorganizations filed under Chapter 11. See David Gray Carlson, Secured Creditors and the Eady Character of Bankruptcy Valuations, 41 AM. U. L. REV. 63, 76 (1991). Using the going concern value can be problematic when trying to assign part of the value of the business to a particular asset class and, therefore, may yield undesirable results. At least one case suggests that a secured creditor should receive going concern value when its collateral consists of all of the debtor's assets. In re Pullman Constr. Indus., 107 B.R. 909, 938 (Bankr. N.D. Ill. 1990). From this perspective, the blanket lien of the LOTL structure may provide greater recovery for secured creditors by enhancing arguments that going concern value should be used to calculate the amount of secured claims.
security interest continues in property transferred by the debtor notwithstanding the transfer.\textsuperscript{163} A debtor might use this feature to enhance its credibility in the marketplace.

A debtor might establish a structure such that any transfer of property (or related series of transfers) above a specified dollar amount to or for the benefit of an officer or director of the company would not be transferred free of the lien unless the transfer and its dollar amount had been specifically approved by a disinterested committee of the board. Any transfer received in violation of the specified approval procedures would trigger a prepayment event of outstanding indebtedness, enforceable against the improperly transferred assets or their proceeds. This repayment obligation might apply to indebtedness that otherwise is unsecured.

Such a structure might offer several benefits. Officers and directors should take a particular interest in seeing that any transfer of company property either to them, or for their benefit, received full disclosure and consideration by the proper committee of the board. The incentive for full disclosure is the risk of transfer subject to the lien. Second, in case of an improper transfer, creditors would have an extra tool to make recoveries against officers and directors. Seeking a recovery based upon a security interest may have advantages over seeking a recovery based upon theories such as constructive trust or fraudulent conveyance. All that is required for recovery is a tracing rule; existing law already has developed rules, such as the lowest intermediate balance test, that might be used for this purpose. Ambiguity of the scope of application of the rule does not detract from its \textit{in terrorem} effect. Any buyer or other transferree of assets from a debtor making such use of the LOTL structure similarly would have an added incentive to make sure that any indirect benefits received by an officer or director of the debtor were properly disclosed and approved.

The overarching benefit of this use of the LOTL structure would be the signaling effect to the financial markets. A company that adopts such a policy signals to the market that it is serious about following procedures for managing conflicts of interest within the company. It is hard to object to implementation of such a policy if the only price for making significant property transfers free and clear of the security interest simply is that a proper committee approve the transfer and the amount. By covering transfers “to or for the benefit” of an officer or director, transactions transferring assets to shell companies or companies in which an officer or director held an interest would be captured.

Investors understand the risk that managers may improperly

\textsuperscript{163} See U.C.C. § 9-315(a)(1).
appropriate value from the firm, resulting in losses. Particularly in today’s market, saturated as it is with almost daily news reports of managers running amok,\textsuperscript{164} responsible managers should seek to develop methods to assuage investors that they will not improperly appropriate value. Even in light of legal reform, such as the Sarbanes-Oxley Act,\textsuperscript{165} comparative advantages should accrue to firms that can provide credible assurance that their managers will not misuse firm assets. Preferably, this assurance will not take the form of increased direct monitoring costs by investors. Though not a perfect net, the continuing lien does provide a mechanism by which investors might recover improper transfers discovered after the fact, without resort to ongoing monitoring.

\section*{III. Obstacles and Objections to the LOTL Structure}

The LOTL structure’s utility and feasibility can be further explored by considering various obstacles and objections to it use. A variety of these issues are discussed below.

\subsection*{A. The Major Meltdown}

\textit{Objection:} The creation of a single set of filings for all secured creditors creates the risk of a massive failure of secured credit at a firm if one or a small number of filings are improperly made or continued.

\textit{Response:} Reliance on a single filing or a small number of filings to perfect security interests in very large financings occurs all the time. A common example is filings made in respect of accounts sold in securitization transactions to special purpose vehicles. These transactions may total in the tens of billions of dollars and rely on a single UCC-1 financing statement. Similarly, a large syndicated loan transaction may rely on a small number of filings. The risk of a mistake is reduced in the LOTL structure in several ways, and the risk of mistake can be reduced by a few additional procedures, if desired. First, the LOTL structure can be used to regularize the timing for filing continuation statements such that filings are confirmed or continued each year during the three-month period prior to preparation of a firm’s annual audited financial statements. If a problem is found, the firm will


have another three-month period to correct the problem. If, despite this regularization, further protection is desired, a second set of staggered financing statements might be filed that offset the initial filings by a two or three-year period. The maintenance of the backstop filings should reduce to near zero the risk of a continuation failure. If a report on the secured credit status of the LOTL structure were made part of the regular financial reporting of a company, the company would publicly signal its compliance with its private covenants to maintain and protect the perfected status of its secured creditors. In theory, the company should be performing this monitoring by virtue of its existing contractual commitments. If the company takes monitoring these covenants seriously, the LOTL structure actually would reduce costs.

B. Cost of Implementing the Structure

Objection: One might acknowledge the benefits of the LOTL transaction infrastructure if it could be put in place with the snap of a chief financial officer’s fingers. At the same time, one might argue that such a structure has not been implemented because corporate officers have calculated that the cost of building the LOTL transaction infrastructure exceeds the cost of building a secured guarantee web on a transaction-by-transaction basis.

Response: I believe the reasons lie elsewhere. First, one needs to understand how the LOTL structure might be created at minimal cost.

I see the LOTL system as being implemented over time in several different ways. First, as any company acquires an asset, such as a vehicle, that requires a special registration in order to perfect a security interest, I would expect the company to plan ahead and, create the policy that, upon acquisition of any asset requiring special notation or registration of a security interest, note the lien lord on the title or in the other registry. Also, as a matter of policy, whenever a company opens a bank account or brokerage account, the lien lord would as a matter of course be given “control” over the account in the original documentation. Second, as any company closes a secured financing, whether advertised as secured by “all its assets” or otherwise, I would expect the company to require that the UCC-1 and other security filings for that transaction be made in the name of the lien lord so that these filings can be used both by the present transaction and in future transactions. Third, even for companies that are not presently contemplating a secured financing, I would expect them to consider filing financing statements today in the name of the lien lord that will be on record, and thus available to prime, other filings, for future secured financings. Lastly, changes in law might be passed to make the
implementation of an LOTL structure easier and more complete, particularly by promoting the possibility of lien inflation and provision for after-acquired property clauses.166

Particularly in the case of creeping implementation of the LOTL structure, the added cost of creating the transaction infrastructure should be modest. When the LOTL structure is implemented as part of a secured transaction that is being documented anyway, the cost of using the name of the lien lord on filings, rather than the name of the agent for a loan syndicate, is truly minimal. The only real additional cost, other than an educational one, is the creation of the special purpose entity to act as lien lord. This should prove modest in relation to the potential savings as the secured guarantee web can be used over and over again.167

The educational cost of the structure lies in the time and effort spent by debtors to sell creditors on the idea of the lien lord. This cost is more difficult to quantify. However, if the structure merely promotes a “first in time, first in right” priority structure, there is nothing particularly complex to explain to lenders that varies from the general rule under existing law. If the agents for the syndicated loan can market loan sales based on the comfort that the transaction is at least as fully secured as a loan using a conventionally constructed secured guarantee web, then I would expect little resistance based on increased cost. I distinguish the educational costs associated with the basic LOTL structure from the greater educational costs associated with creation of alternate priority structures discussed in Part II above.

The question of why the structure has not been implemented already is discussed below under “Why Now?” in Part III.

C. The Problem of Purchase Money Security Interests

Objection: Although the lien lord’s financing statement will create priority over most subsequent filings even if further financing statements are filed, the UCC contains a significant exception to the “first to file, first in right” principle. This exception applies to purchase money financing transactions. A later filed financing statement used to perfect a purchase money security interest, creates a prior security

166 An example of such a needed change is the case of federally registered copyrights. Current law does not permit creditors to file generally against copyrights. Instead, a filing must be made on a copyright-by-copyright basis. Recent proposed amendments to correct this problem did not pass, allegedly due to lobbying efforts by large film studios who wanted to make it more difficult for small, independent film companies to obtain financing. See supra notes 122-27 and accompanying text.

167 See LoPucki, A Systems Analysis, supra note 75 (describing how technology makes use of corporate forms increasingly inexpensive).
interest in the acquired property. There is no way to police purchase money secured creditors who wish to file in the UCC filing office rather than with the lien lord. Thus, absent continuing multiple searches, the ledger maintained by the lien lord will be incomplete.

Response: There are two responses to this concern. The first response is that reasons have been advanced for why earlier secured creditors should be unconcerned with the priority given to later secured purchase money financiers. The assets of the debtor are not depleted from the standpoint of the prior secured creditor because, in the absence of the purchase money financing, the debtor would not have acquired the asset. As the purchase money security interest is limited to the acquired asset, the position of the prior secured creditor is never eroded by purchase money financing or the priority given to it.

The second response is that the LOTL structure guards against purchase money filing made with the UCC filing office rather than in the lien lord ledger. As further protection for the structure, the lien lord requires that the debtor give it the exclusive authority to file financing statements. Although Revised Article 9 provides that the mere signing of a security agreement constitutes authorization for the secured party to file a financing statement, there is no express prohibition on the parties modifying this statutory authorization by contract. The exclusive grant of this right to the lien lord would be coupled with an interest based on the advance of $1,000 by the lien lord to the debtor. A financing statement filed by a person without authority is not effective. The fact of this exclusive delegation of authority is stated in the lien lord's financing statement itself to put subsequent creditors on notice. As a practical matter, this notice may inhibit most creditors from trying to opt out of the single financing statement regime imposed by LOTL even if other parties make argument's that the exclusive delegation is ineffective. If a debtor and its financial advisors believed purchase money priority was an effective option to maintain, this possibility might be included as part of its basic priority ordering as a supplement to the simple first-in-time priority. In such a case, there would be no incentive for the purchase money financier to file with the UCC filing office rather than with the lien lord. In any case, subsequent filings with the UCC filing office would result in a very public form of default, which further polices the arrangement.168

168 The criminal law may have a role to play here. For example, Iowa law makes it a crime to transfer property in a manner that defeats a perfected security interest. See State v. Friedley, 2003 WL 1523343 (Iowa App. 2003).

The elements of theft of property with a security interest are: (1) defendant gave the victim an instrument resulting in the victim having a security interest in property held by the defendant; (2) the defendant owed the victim a balance under the terms of the instrument; (3) the defendant destroyed, hid, took, or disposed of the property subject to the security interest; and (4) the defendant did so with the specific intent to defraud
D. The Problem of Judgment and Tax Liens

**Objection:** Many of the creditors using the LOTL structure will come to the structure without funding commitments. In the absence of a funding commitment, judgment liens may prime the security interest for a new secured creditor advance notwithstanding an earlier UCC filing by the lien lord.\footnote{169} Federal tax liens raise similar priority problems.\footnote{170} Thus, the potential new secured creditor will want to perform new UCC searches in every case. Thus, one claimed efficiency for the structure is illusory.

**Response:** The structural problem presented by possible judgment and tax liens is a real problem that theoretically might increase the number of UCC searches potential secured creditors want to perform. However, a few factors mitigate the problem. Many lenders believe that they will be made aware of significant judgment or tax liens through other avenues, such as the financial press, a debtor’s accountants or a debtor’s outside counsel. Further, the debtor itself typically has reporting obligations for events such as the imposition of tax or judgment liens, the debtor typically represents and warrants the absence of such claims prior to funding a loan and the imposition of such claims results in events of default under existing indebtedness. The imposition of a judgment lien or a tax lien is an unusual and significant event for a company with which the members of management making the representations and warranties should be aware. Further, in current practice creditors often rely on such alternate sources rather than searches in any event. This is because such liens may not be revealed by traditional UCC searches.\footnote{171} Judgment liens often appear docketed

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\footnote{169}See U.C.C. § 9-323(b).

\footnote{170}See 26 U.S.C. §§ 6323(c), (d) (2000).

\footnote{171}Where a tax lien is filed is a matter of state law. See id. § 6323(f). Many states have adopted The Uniform Federal Lien Registration Act, published in 1978, to bring some order to filings. 7A UNIF. L. ANN., BUS. & FIN. L. 449 (1999). Even if a federal tax lien is required to be filed in the UCC filing office, some concern over the form of the filing exists. In *In the Matter of Spearing Tool and Manufacturing Co.*, 302 B.R. 351 (E.D. Mich. 2003), the district court overturned a bankruptcy court ruling that held a federal tax lien filing did not need to comply as to form with the UCC filing rules even though it was required to be indexed in the UCC filing office. The specific question was whether the tax lien filing had to use the debtor’s exact legal name as required by the UCC or instead might use another formulation if permitted by federal...
in court records, rather than UCC filing offices, and there is some concern over whether tax liens must strictly comply with UCC filing requirements so that they would be uncovered by a conventional UCC search. Secured creditors do not, as a matter of practice, make all the searches needed to uncover the extent of these claims. The LOTL structure does not aggravate this problem.

E. The Additional Involvement of Accountants

Objection: Debtors and borrowing groups will object to the additional oversight of accountants and increased reporting that is sprinkled throughout the description of the LOTL structure.

Response: Corporate executives may not like the additional reporting and scrutiny. However, such additional monitoring may make good business sense. Historically, companies did not publicly report on the status of their compliance with covenants in loan agreements. Recently, however, we have seen that tradition being broken.\textsuperscript{172} Companies should recognize that the credibility of their executives is at a low point. Even absent outright fraud, investors will tire of executive claims of ignorance about details of financial arrangements.\textsuperscript{173} A borrower's accountants are in the best position to report on the integrity of the borrowing group by virtue of their preparation of consolidating financial statements. Also, accountants are in the best situation to confirm the status of bank accounts and security accounts. When balance sheets are prepared, the accountants similarly are in the best position to determine which advances purport to be purchase money financings. A borrower can signal to the loan market that it is serious about procedures to perfect and maintain security interests if it adopts a strategy, such as the LOTL strategy, that enhances credibility of representations, warranties and covenants made by debtors.

F. Overreaching by Creditors

Objection: The LOTL structure will make it easier for creditors to demand more collateral than they need. Debtors will not have the excuse of transaction costs to avoid overbroad creation of security

\textsuperscript{172} See Morgenson, \textit{supra} note 152 (describing one company's disclosure of financial covenants in its periodic SEC reporting and predicting other companies will follow).

\textsuperscript{173} See Jeffrey L. Seglin, \textit{When Executives Say They Don't Have a Clue}, N.Y. TIMES, Nov. 16, 2003, C4.
interests at the insistence of predatory creditors.

Response: This concern is misplaced for the large and sophisticated debtors and borrowing groups who would implement the LOTL structure. There is evidence that these borrowers can take care of themselves in negotiations. In an analogous situation, concern was expressed that banks would pressure borrowers to commit to use investment banking services as a condition to obtaining credit extensions—an illegal tying of credit to other services. The Department of Justice recently stated that there was little reason to worry about such pressures.

Syndicated lending is a national market with a substantial number of bank and non-bank competitors. Further, borrowers in this market are large corporations with well-trained and sophisticated staff fully capable of negotiating favorable terms. The syndicated loan market is the largest capital market in the world, with over $1 trillion of annual volume. We see no evidence that large borrowers such as syndicated loan borrowers need additional assistance beyond the antitrust laws to protect themselves from anti-competitive tying. Such firms are much less likely to be victims of anti-competitive ties than small business customers or individual consumers, and were not the customers that were intended to be protected by section 106. Consequently, if the Board determines that section 106 must remain broader than the antitrust laws, the section’s reach should be limited to those small businesses and consumers that were the original focus of the legislation.\textsuperscript{174}

G. Creating a System of Secret Liens

Objection: The LOTL structure turns the concept of notice filing on its head by, in effect, making the nature and extent of secured credit at any debtor or borrowing group secret. The LOTL structure makes further inquiry beyond a search of the UCC records by potential secured creditors a virtual certainty whereas, with the existing system, in which each creditor files its own financing statement, many potential inquiries are avoided because the public records disclose the only information needed by a potential secured creditor to make a lending decision.

Response: The type of notice envisioned by the current UCC filing system is one of inquiry notice. The publicity envisioned is not publication of information useful to the capital markets generally or needed by individual secured lenders to make credit decisions. Rather, the notice merely indicates that a possible priority claim to debtor assets

exists and identifies a reliable third party (other than the debtor or its affiliates) from whom a potential creditor might inquire for further information. Such a notice system inhibits lying by a debtor about the status of priority claims to its assets. What the LOTL structure does is merely separate the identification of the reliable third party information source who will speak the truth about secured credit transactions from the implementation of particular transactions. Though, in current practice, the truth teller often is designated on a transaction by transaction basis, there is no need for this connection and, indeed, often the connection proves inefficient. Let us compare and contrast some efficient and inefficient situations.

The situation in which the information received from the UCC search results proves most efficient is one in which the searcher does not feel the need to make further inquiries from additional secured parties disclosed by the search. No further inquiry is needed either if the search results disclose no extent financing statements or if the search results disclose only financing statements with collateral descriptions limited to collateral in which the secured party has no great interest. The latter situation often exists if the potential new secured party represents a loan syndicate that requires a lien on all assets of the debtor and the extent financing statements all contain limited, specific collateral descriptions that suggest ordinary course isolated purchase money financing transactions for office equipment and similar smaller cost items. In all cases with broad collateral descriptions further inquiry may be prudent.

The current amendments to Article 9 make the situation of the narrowly crafted financing statement that eliminates the need for further inquiry merely fortuitous. A prudent secured lender will reduce its ex ante cost of preparing financing statements by using a broad “all assets” description to reduce the risk of transcription error created by reproducing a narrow granting clause description in the financing statement. The debtor does not have a structural way to police use of an overbroad description because its signature no longer is required to appear on the financing statement. The debtor might negotiate with the secured party for its agreement to use only a narrow description but, other than concern over client relationships, it is difficult to see how such a covenant might be practically enforced. The mere signing of the security agreement gives the secured party authority to file initial financing statements with whatever collateral descriptions it choses.

The amendments to Article 9 confirm that the point of financing statement disclosure is to identify a reliable third party to tell the truth about the status of the debtor’s secured financings and not to reveal useful information about individual secured financings. The UCC does not require the financing statement to disclose such important matters
as: (i) whether the secured party’s security agreement contains a future advance clause or covers after-acquired property, (ii) the maturity of the secured debt, (ii) the interest rate and other payment terms of the secured debt, (iii) whether the secured debt contains provision for revolving credit advances, and (iv) the stated maturity date of the secured debt.

Particularly in the case of a borrowing group, the LOTL structure may prove more efficient for a potential secured party because the secured party must make one inquiry from the lien lord, rather than commissioning multiple searches against various debtor names in multiple jurisdictions. If the debtor or borrowing group is serious about maintaining a record that is useful to future secured parties, it can structure the ledger maintained by the lien lord to contain additional information that potential secured parties may find useful. The debtor has control over the structure of the lien lord’s ledger to a greater degree than it can control the public filing system. It might even use the lien lord as a record depository to compensate for its own inadequate recordkeeping practices. It is a common experience to perform a UCC search and, on the basis of the search, to request further documentary information from the debtor. Often, the debtor is unable to produce underlying financing documents or to link particular financing statements with particular transactions. Such information management problems at a debtor would be eliminated if the lien lord maintained an electronic copy of the underlying security agreement and related financing documents for the secured parties that it indexed in its ledger.

H. Why Now?

Objection: If the LOTL structure truly provided the benefits suggested, the market would have recognized its virtues and developed it already. The absence of the structure indicates possible inefficiencies not noted in the development of the proposal outlined above.

Response: There are three responses to this objection. The first is that, to a limited extent, aspects of the structure have been with us for a long time. As developments in the lending markets evolve to further reduce bilateral contracting in lending arrangements, the mature LOTL structure should develop. The second is that, until recent amendments to the UCC became effective, the legal certainty for the structure that make its full implementation possible did not exist. In the absence of this certainty, the market did not want to try something new. The third is that, at a theoretical level, the legal academy has failed to appreciate the flexibility that security interests provide as an asset partitioning device in contrast to the benefits of using legal entities to partition
assets. Let us consider the third response in more detail.

Professors Hansmann and Kraakman have suggested that one way to understand the existence of firms is by focusing on the ability of firms to facilitate “asset partitioning” (the “H&K thesis”). The H&K thesis identifies firms as superior asset partitioning devices over other legal forms, including security interests. They label security interests as inferior asset partitioning devices for a variety of reasons, including the inability of security interests to accommodate floating secured parties and the need to reflect the names and addresses of secured parties in financing agreements. Unfortunately, as a technical legal matter, the H&K thesis is wrong in its characterization of the limited flexibility of security interests. This mischaracterization has two bad side effects. First, it may blind transaction cost engineers to the full potential of security interests as a structuring tool. Second, it prevents the H&K thesis from pursuing a little more deeply the implications of an extremely valuable way of looking at the problem that Professors Hansmann and Kraakman have developed. The possibility of the LOTL structure hopefully will cause a reexamination and further development of the H&K thesis.

The H&K thesis is led astray by a misuse of the Fretz case, in which the judge carelessly stated the problem presented as one of “floating secured parties.” The Fretz court claims that floating secured parties are not possible. This type of observation also may have led practitioners astray. The facts of Fretz are far different from the court’s rhetoric.

In Fretz, a secured party held an oversecured claim against a bankrupt debtor. The security agreement that created the security interest contained a “dragnet” clause stating that the security interest secured not only all existing debt held by the secured party but also all other debts of the bankrupt, whenever acquired by the secured party. After the filing of the bankruptcy petition, the secured party purchased unsecured claims from other creditors of the bankrupt. The secured party argued that these unsecured claims were transformed into secured claims by virtue of the purchase and operation of the dragnet clause. The court’s ruling was correct, but for reasons not stated in the opinion. The court’s holding prevented the post-filing conversion of unsecured claims into secured claims. The character of a claim is determined as of the date of the filing of the bankruptcy petition. The secured creditor in

\[175\] See Organizational Law, supra note 8.

\[176\] Id. at 417-19.

\[177\] In the Matter of Fretz, 565 F.2d 366 (5th Cir. 1978). See generally Flechtner, Inflatable Liens, supra note 111, at 714-15 (discussing Fretz). Inflatable Liens fails to note that the key problem in Fretz was the post-petition change in the status of unsecured claims into secured claims; see also Steven Walt, The Case For Laundered Security Interests, 63 TENN. L. REV. 369 (1996).
Fretz attempted an end run around this timing principle.

As a contract law matter, if the secured creditor had purchased the unsecured claims prior to the filing of the bankruptcy petition, the claims would have become secured claims in the bankruptcy. In fact, floating secured parties would have existed. The pre-petition protection against such behavior is provided by another source. If the purchase of the unsecured claims had occurred within ninety days of the filing of the bankruptcy petition, the creation of the security interest to secure previously unsecured antecedent debt would have been avoidable as a preference under § 547 of the Bankruptcy Code.\textsuperscript{178} Post-petition protection against such a conversion is provided by the fact that the status of claims is determined as of the filing date.

Beyond Fretz's unfortunate language, floating secured parties exist all the time in commercial finance transactions. In any secured bond financing, the trustee typically acts as collateral agent for the bondholders who come and go as bonds are traded. A secured party today will not be a secured party tomorrow if the investor sells the bonds. Similarly, an agent bank for a secured syndicated loan typically acts as collateral agent for the syndicate. The identities of the secured lenders change as the members of the syndicate buy and sell loans. Again, floating secured parties are simply part of the secured lending landscape.

An additional possible reason accounting for why the H&K thesis misses this point is the date of the article advancing the thesis. Though the practice had been to use floating secured parties in the distant past of secured financing, for example by railroads using nominees such as trustees and collateral agents to act for the bondholders and other lenders, the practice only recently was expressly sanctioned by Article 9, with its express adoption of the concept of a "representative" of secured parties, conforming express positive law to existing practice.\textsuperscript{179}

Once one sees that these alleged differences between firms and security interests do not exist, then one is free to examine some other possible explanations for the use of firms and to develop security interest practices towards more efficient structures.

I. Transaction Costs as Friends?

The LOTL approach might receive opposition from three different sources, each of which views transaction costs as friends. First, the supporters of grand proposals (discussed in Part IV below) who see


\textsuperscript{179} See text accompanying notes 83-87 supra.
secured credit as globally inefficient will oppose implementation of such a program. More secured credit, and more comprehensive secured credit, leaves fewer assets and asset classes for the unsecured creditors to feed upon when bankruptcy strikes. Second, some theories argue that inefficiencies created by perfection hierarchies actually might be efficient because they force creditors only to take as collateral those assets on which they really intend to rely. That is to say, the added costs of complying with certain procedures prevents creditors from being greedy when it comes to the scope of collateral coverage. Third, some debtors may find it convenient to use transaction costs as an excuse to provide a loan syndicate with a smaller collateral package than is ideal from the perspective of the syndicate.

None of these objections should prevail over the LOTL structure. As discussed below in Part IV, implementation of the LOTL structure presents the opportunity for debtors and creditors to create alternate priority structures that at least partially address the concerns of grand proposal supporters. As the grand proposals were completely defeated (or, perhaps, ignored) in the last round of amendments to Article 9, the supporters of the grand proposals might be prepared to advocate a different approach to solving the problems they have identified. Though I believe creditors often are greedy and borrowers often are spineless, I do not believe that transaction costs are the cure. As discussed above, debtors should be able to protect themselves, notwithstanding the convience of transaction costs as an excuse to reject a greedy creditor’s demand. Rather, the possibility of creating alternate priority structures will create the financial incentive for debtors to resist overreaching and also may create incentives for creditors. Indeed, creditors who also act as financial advisors to borrowers may be in the vanguard of promoting alternate priority structures just as they have, in the past, promoted securitization programs for their debtor and borrowing group clients. Alternate priority structures typically involve giving special carve-outs and priorities in designated asset classes to targeted investor groups. To work, the alternate priority structure cannot operate with a pure first in time, first in right philosophy and will not work if debtors needlessly have granted excess collateral to the first lender to provide financing. As a common example, a securitization program is nothing but a large scale carve-out of whole asset classes for the benefit of the securitization lenders at the expense of general lenders.

180 Opponents can be expected to include Professors Elizabeth M. Warren, Lucien Ayre Bebchuk and Jesse M. Fried. See supra note 158; infra note 183; see also G. Ray Warner, The Anti-Bankruptcy Act: Revised Article 9 and Bankruptcy, 9 AM. BANKR. INST. L. REV. 3 (2001) (criticizing recent amendments to Article 9 as giving too much away to secured creditors).  
181 Preferring one method of perfection over another method of perfection creates a "perfection hierarchy." See Picker, supra note 11, at 1158 (suggesting that perfection hierarchies may be efficient in matching creditors to collateral on which they are relying).
to the borrowing group that generates the assets subject to the securitization. Lending groups routinely either permit securitization transactions as a carve-out to their own security interests or later grant consent for debtors to implement them. Agent banks find it to their advantage to work with debtors and borrowing groups to maximize financing opportunities.

IV. GRAND PROPOSALS AND TECHNICAL PROPOSALS

Suggestions to amend Article 9 fall into two camps. In the first camp are proposals to change the substantive law of priorities or make other sweeping changes ("grand proposals"). By and large, these suggestions have been unsuccessful. In the second camp are proposals that have, as their general aim, the reduction of very specific transaction costs ("technical proposals"). These suggestions have been far more successful. The former, unsuccessful suggestions tend to be motivated by a big picture insight into some large systemic inefficiency in the secured credit system. The latter, successful suggestions are less grand, and take aim at making some single step in the secured credit process easier to accomplish.

The grand proposals further subdivide into two types. The first type of grand proposal starts with the insight that individual contracting among parties often can be a significant transaction cost. To reduce these types of transaction costs, the strategy is, through logical argument and empirical observation, to identify the priority structure that would appeal to most creditors and debtors. If the law then enacts this priority structure, the aggregate amount of contracting activity will be reduced as most parties accept the priority structure that the law has drafted for them. In the minority of cases where the default priority structure will not suffice, the parties incur transaction costs to alter the priorities.

The second type of grand proposal starts with the idea that the contracting process itself, in the milieu of secured credit transactions, produces an inefficient result. This inefficient result obtains even if

183 See, e.g., Lucian Arye Bebchuk & Jesse M. Fried, The Uneasy Case for the Priority of Secured Claims in Bankruptcy, 105 YALE L.J. 857 (1996) (providing a model in which secured credit functions to permit transactions that transfer costs to non-adjusting creditors, resulting in net negative utility); Alan Schwartz, Security Interests and Bankruptcy Priorities: A Review of Current Theories, 10 J. LEGAL STUD. 1 (1981) (arguing that secured credit is inefficient); Alan Schwartz, Taking the Analysis of Security Seriously, 80 VA. L. REV. 2073 (1994) (explaining how subsequent secured financing reduces the value of pre-existing unsecured claims more than subsequent unsecured financing); Paul M. Shupack, Solving the Puzle of Secured Transactions, 41 RUTGERS L. REV. 1067 (1989) (explaining how secured credit harms non-adjusting creditors,
(and, perhaps, particularly if) the direct transaction costs of creating secured credit can be reduced or eliminated. On this view, big picture inefficiencies are created by secured credit transactions because contracting parties ("insiders") export costs on those who are unable to make contracts within the secured credit system ("outsiders"). Outsiders may be unable to make contracts within the secured credit system because: (i) they are involuntary creditors, (ii) they lack bargaining power, or (iii) transaction costs for those creditors are too high to make bargaining for protection a viable option. Though the direct transaction costs incurred to implement a secured loan may be reduced by implementing technical proposals, thus creating apparent local efficiencies, the very institution of secured credit operates to create system wide global inefficiency. The theory that the institution of secured credit creates global inefficiency has been hotly debated, with numerous arguments made by academics defending the institution of secured credit as efficient.\footnote{See, e.g., David Gray Carlson, On the Efficiency of Secured Lending, 80 VA. L. REV. 2179 (1994); Steven L. Harris & Charles W. Mooney, Jr., A Property-Based Theory of Security Interests: Taking Debtors' Choices Seriously, 80 VA. L. REV. 2021 (1994) (noting that many debtors who incur secured debt do not have the option of incurring unsecured debt); Claire A. Hill, Is Secured Debt Efficient?, 80 TEX. L. REV. 1117 (2002) (providing empirical research suggesting that secured creditors do not intentionally transfer undue risks to non-adjusting creditors); Jackson & Kronman, supra note 76 (suggesting that unsecured creditors compensate for increase risk posed by security interests by charging higher interest rates); Steven L. Schwarz, The Easy Case for the Priority of Secured Claims in Bankruptcy, 47 DUKE L.J. 425 (1997) (providing a model in which secured credit is efficient).}

The technical proposals interact with the grand proposals in the following ways. First, as the technical proposals make steps in the secured credit process less costly to implement, the difference between effecting a secured transaction using the default rules and creating a custom tailored contract solution diminish. In the limiting case, where the cost of constructing an alternative to the default rule approaches zero, the choice of the default rule does not matter. In the real world in which transaction costs cannot be eliminated entirely, the urgency of drafting the "correct" default rule is diminished, though the value of the project is not eliminated. The LOTL structure adds an additional insight. It is important to draft rules in a manner that facilitates modification of the default rules at lowest cost. This allows the market to adjust most easily if the legislators and their advisors either get the default rule wrong or if technology evolves such that what once was an efficient default rule no longer holds that exalted status. Allowing the use of nominee secured parties such as a lien lord greatly facilitates drafting around laws that may prove inefficient.

Second, the implementation of the technical proposals apparently conflicts with grand proposals that see secured credit as inefficient.
This is so because the technical proposals, by reducing the cost of implementing secured credit, make secured credit more prevalent and more comprehensive as it becomes easier to encumber more asset classes owned by debtors. This enhanced coverage for secured insiders reduces assets available to repay the unsecured outsiders, further encouraging the exporting of costs onto the outsiders.

This conflict, however, may be only partial. It all depends on why the unsecured creditors are outsiders. As suggested in Part II above, the LOTL structure might be used to bring certain traditionally outside creditors under the secured creditor umbrella in a locally cost effective manner. If debtors and their financial advisors elected to do so, aggregate efficiency might be enhanced, rather than reduced, by technical proposals. This is true, even from a big picture perspective, if the technical proposals led to a broader class of creditor being able to take advantage of the protections offered by secured credit.

One reason why technical proposals have been implemented may be that consensus can be reached on whether a specific rule change that targets a step in the secured credit process promotes efficiency in a narrow sense. If steps are eliminated, and the process simplified, local transactional efficiency has been enhanced. One reason why the grand proposals have not been implemented may be that often there is no consensus on whether altering a priority scheme will create a more or less efficient secured credit system. The lack of consensus prevents the formation of a majority block needed to enact a sweeping grand proposal.

The technical proposals and the creation of transaction infrastructure have a common denominator: promotion of efficiency by the reduction in steps. The recent amendments to Article 9 took three giant steps forward in this direction with (i) the specification of a single location for filing a financing statement against most debtors, (ii) the creation of a single office for filing a financing statement against most debtors, and (iii) the creation of a single filing office for filing a financing statement against most debtors.

See supra notes at 158-62 and accompanying text.

An example of such a proposal is the reduction in the number of applicable filing offices. See supra note 75.

One significant reason for the lack of consensus may be the lack of empirical data on the distribution of transaction opportunities that are globally efficient and the distribution of transaction opportunities that are globally inefficient. Models may be constructed in which secured credit promotes completion of inefficient transactions and models may be constructed in which the lack of secured credit results in efficient transactions not being pursued. In the absence of information on the distribution of good and bad transactions in the marketplace, it is difficult to draw system wide conclusions.

The benefits of a single filing office is not a phenomenon unique to the UCC or to secured lending practice. For example, on November 2, 2002, President Bush signed legislation to implement the Madrid Protocol for trademarks. The Madrid Protocol will permit United States trademark owners with an international trademark portfolio to facilitate multiple country registration of trademarks in a single application as opposed to using individual filings in foreign jurisdictions. See World Intellectual Property Website, at www.wipo.int/madrid (last visited Feb. 27, 2004). A single application is filed in a single office with filing fees paid in a single currency.
elimination of the signature requirement for UCC-1 financing statements, and (iii) the ability to use a generic description of collateral on a financing statement. It is easy to underestimate the importance implementation of these paradigmatic technical proposals will have on the secured transaction process. Indeed, if debtors were organized as single legal entities (i.e., if borrowing groups did not exist), it is reasonable to believe that we would see increased satisfaction with the secured credit system rather than the rise of insurance products for secured transactions.

Certain of the procedures followed in the creation of a secured credit transaction can be represented by branching tree diagrams in which each node represents an information source that must be consulted. The evolution of Article 9 can be seen, in part, as an attempt to collapse multiple branches into single branches, thus eliminating information sources (i.e., nodes in the diagrams) that must be consulted by creditors making secured loans. On the definition of "efficiency" used in this article, the elimination of steps creates a more efficient secured credit structure and, thus, should be promoted.

The technique of collapsing multiple information branches into a single branch is best illustrated by the recent amendments to Article 9 that specified a single debtor location for filing a financing statement, replacing a system in which filings against a single debtor might be required in multiple jurisdictions. Examining the diagrams reveals a structural similarity between the steps that formerly needed to be taken with respect to a single debtor before the Article 9 revision and the steps that currently need to be taken with respect to a single borrowing group composed of multiple individual debtors. Though the UCC has reduced multiple information sources to a single source in the case of the solo debtor, multiple information sources still must be consulted (i) in the case of borrowing groups and (ii) to evaluate the status of collateral in certain asset classes. Part of the LOTL strategy is to isolate multiple branch structures in the tree diagrams (for both individual debtors and borrowing groups) and consider how they too may be collapsed (preferably with minimal amendments to the UCC). The use of the lien lord as a nominee is the primary mechanism through which multiple information sources are collected into a single source, thus eliminating transaction steps.

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189 The deletion of the signature requirement was intended primarily to facilitate electronic filing of financing statements. Nevertheless, the elimination of this requirement dramatically eased the process of closing secured transactions for borrowing groups.

190 See supra text accompanying notes 95-97.

191 See Appendix infra text accompanying notes 203-05.

192 The process is not unlike construction of connected graphs in graph theory in which the
V. ASSET PARTITIONING REVISITED

The foregoing analysis will have been successful if it results in a re-examination of the usefulness of security interests as asset partitioning devices and how that usefulness might be enhanced through development of business practices and changes in law. The legal structures used to create artificial legal entities, such as corporations, do not differ in form as dramatically from the legal structures used to create security interests as might first appear. However, these similarities of structural form have been obscured because legal actors have tended to use legal entities to create relatively permanent transaction infrastructure for business organizations whereas legal actors have tended to use security interests to create custom structures on a transaction by transaction basis for particular financings.

Debtors and borrowing groups can use both legal entities and security interests to organize the property interests of a group of investors under a single nominee name in a relatively permanent manner that facilitates trading of asset positions without further need to comply with property law procedures that require additional notice to third parties. The use of a legal entity, rather than a security interest, has some advantages in that it can provide protection against application of the automatic stay in bankruptcy. However, use of a security interest, rather than a legal entity, can provide protection against veil piercing laws that impose liability regardless of the insertion of a legal entity between the actor generating the liability and the assets in the separate legal entity. Within a business organization consisting of multiple legal entities, the most secure asset partition often requires use of both a separate legal entity and a security interest so that the impact of both the automatic stay and veil piercing laws may be avoided.

The case study of the evolution of syndicated lending reveals a connected graph with the fewest edges uses a single point to link all other points in the structure. See, e.g., GARY CHARTRAND, INTRODUCTION TO GRAPH THEORY (1977). See 11 U.S.C. § 362. Even this partition will not be effective for this purpose if used to partition assets within a borrowing group without further procedures. The parent company in the borrowing group has the power to file, or to direct the filing of, voluntary bankruptcy petitions on behalf of its subsidiaries. The automatic stay may thus apply to subsidiary assets even though partitioned by use of a legal entity. To avoid this risk, secured creditors need to supplement the use of the legal entity with special bankruptcy remote governance procedures in which the subsidiary's ability to file a voluntary petition in bankruptcy is neutered. Generally, this takes the form of appointing independent directors sympathetic to the secured parties who will not vote to file a bankruptcy petition and amending the charter of the subsidiary to require the vote of all directors as a pre-condition to a bankruptcy filing. Generally, such an arrangement is thought to be workable because it does not constitute a mere contractual prohibition on filing for bankruptcy, which would be void as against public policy.

See BLUMBERG, MULTINATIONAL CHALLENGE, supra note 20.
trend towards reduction of transaction costs in capital raising activities by shifting away from bilateral contracting to raise funds towards inclusion of multiple financiers in a single contract structure. Increasingly, this structure is designed to accommodate various changes in business needs, thus prolonging the life of the contract structure. Prolonging the life of the contract structure further minimizes contracting costs. The creative use of contracting techniques in the syndicated lending arena reveals how transaction cost engineers may reduce many inefficiencies inherent in raising capital from multiple financing sources. However, we also have seen how the continued development of these cost-reducing practices confront obstacles when security interests form part of the financing package. The obstacles to cost reduction result when asset partitioning within a debtor or borrowing group form part of the capital raising strategy.

The obstacles arise because, as a practical matter, asset partitioning that allocates collateral for priority claims to a subset of firm creditors requires compliance with property law procedures in addition to use of contracting procedures. The development of syndicated lending to date reflects problem solving that focuses on problems which have solutions achievable by contracting alone. The LOTL structure expands the universe of cost reduction techniques by working with property based rules.

The contrast between the streamlined process of raising capital in an unsecured syndicated loan with the much more complex process of raising secured financing reflects a comparative complexity for secured financing that lawyers, acting as transaction cost engineers, have not addressed sufficiently to suit current business requirements. The time compression achieved for unsecured financing can only be matched in the secured financing arena by compressing the time frame in which the necessary property law tasks must be completed. Such hurried procedures, performed on a transaction-by-transaction basis, increase the chance of error and create dissatisfaction with the process in both lawyers and businesspeople. This is why we see the market trend of participants turning to alternate sources, such as insurance companies, for confirmation that assets have been partitioned successfully, or we find market participants simply throwing up their hands.

The asset partitioning obstacles may be addressed for a variety of asset types with varying degrees of success, but only by supplementing

195 The use of multiple bilateral contracting among existing creditors to create subordination agreements, though a theoretical option using pure contract, does not offer efficiencies. Such procedures introduce a new set of bilateral negotiations into contracting practices that have made strides to eliminate bilateral contracting. Further, they are not binding on future voluntary creditors or on involuntary creditors, resulting in both the need for ongoing bilateral contracting and reduced certainty for the asset partition. See U.C.C. § 9-339 (noting that parties must agree to subordination).
contract law techniques with property law procedures. Effecting transaction cost reduction in the area of secured credit requires a shift in thinking that treats the creation of property law partitions involved in taking collateral on a systemic or programmatic basis, rather than on a transaction by transaction basis. In effect, it requires that transaction cost engineers think about security interests as they currently think about legal entities.

The separation of a necessary property law task from execution of an individual contract transaction is not a revolutionary step. This is precisely the move made in the securities trading business as the direct transfer of ownership of paper security certificates between brokerage firms was replaced by the indirect holding system for securities, in which security transfers are reflected on the books and records of a reliable securities intermediary. The inefficient ceremony of property transfer that required the physical delivery of paper certificates by brokers to settle transactions at each day’s end was replaced with a nominee system in which a reliable third party, such as The Depository Trust Company, holds jumbo certificates that represent large positions in stocks and bonds. The truth of ownership of these securities are simply reflected on the nominee’s books and records in simple book entries. The analogy to the indirect holding system for financial assets and its possible application to Article 9 of the UCC was made in 1994 by the Reporters to Revised Article 9 when they suggested implementation of a private filing system option for security interests.196 Unfortunately, this suggestion was not pursued.

What the foregoing analysis demonstrates is that the private filing system option continues to have merit, even if the public filing office difficulties that prompted its initial suggestion by the Reporters have largely been addressed. The LOTL strategy does not merely perform an end run around state filing offices to solve problems of administrative backlog but actually contributes to transaction cost reduction in other meaningful ways. One benefit will be to promote greater certainty for the status of secured financings, particularly in circumstances of time pressure to complete a financing. This greater certainty might assist insurance companies in writing coverage for secured transactions and lawyers in rendering legal opinions. To the extent that ascertaining the secured status of a particular debtor’s or borrowing group’s obligations can be reduced to essentially an accounting function, the need for insurance policies and legal opinions might be reduced or eliminated.197

196 See Private Information Market, supra note 80.
197 Indeed, the foregoing analysis suggests that the most efficient system might allow perfection of security interests merely by notation in a debtor’s or borrowing group’s financial statements. This was a path considered, but not taken, early in the Article 9 drafting process. 1 GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY, § 15.1, at 463-64 (1965)
What we find is a conflict of sorts between the existing ceremonies required to create generally enforceable security interests in property and the most efficient contracting techniques employed to raise capital. What emerges from an examination of the conflict are the parameters of the types of property based rules that minimize the conflict, permitting the maximum contracting flexibility to partition assets among various financing sources. Generally, these preferred property rule parameters are: (i) the express ability to indicate security interests in public records and other financing documents by use of a nominee name or designation of a representative of secured parties, (ii) the absence of a limitation requiring a specified amount of obligations to be registered as a condition to recording a security interest, coupled with express protection for future advances dating back to the date of the original security interest filing, (iii) the ability to describe the property subject to the security interest in a generic manner in the property records, with express coverage for after-acquired property, rather than rules that require object specific identification of particular assets, and (iv) the absence of rules that impose payment of taxes on the amount of financing secured as a condition to creating a security interest. An additional beneficial law change would be the elimination of the requirement to periodically continue financing statements that expressly provide that the secured party is a representative or nominee. Currently, financing statements expire after five years if not continued with a new filing.

The best solution to promote asset partitioning by contract would be for legal rules to be amended to provide a single filing source for recordation of all security interests, regardless of asset type. Indeed, such a simplifying move motivated the replacement of multiple filing systems for security interests in personal property with the unified system reflected in current Article 9. Though this simplifying move was made, much to the benefit of secured financing, the UCC system never was comprehensive. As the economy has evolved, assets

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198 I am not arguing against raising revenue from such transactions. I am arguing against linking the raising of revenue to the compliance with the property law rules needed to create effective security interests and mortgages. A more efficient rule would raise revenue through documentary stamp taxes on secured notes. Failure to pay the tax on the secured note would render the obligation unenforceable.

199 See U.C.C. § 9-515.

200 See generally 1 GILMORE, supra note 197, § 9.1 (discussing simplification of legal regimes as a motivating factor behind Article 9 of the UCC).
excluded from UCC coverage, such as certain items of intellectual property and regulatory property, have become increasing significant as items of collateral. The significance of our current system of multiple recording systems for property interests, and its inefficiencies, are placed in stark relief by the financing trends away from bilateral contracting towards syndicated financing in which financiers must work with multiple systems to create blanket liens for syndicated credits. The weakness of the system was not exposed when financiers extended credit in smaller, bilateral facilities in which less collateral coverage was required so that the financier needed only to work with a single property recording system to perfect an interest in collateral for a particular transaction.

Being realistic, however, the secured financing nirvana created by a single filing system for all assets of a debtor or borrowing group is an aspirational goal to be realized, if at all, in the distant future. However, to the extent existing property recording regimes reflect the parameters identified above, private parties can create transaction infrastructure that will mimick the benefits promised by the aspirational target of a single recording system. The parameters also provide guidance for incremental law reform. Those systems that currently do not conform to the identified parameters might be amended to accomodate the LOTL strategy.201 The guiding principle is to structure our property rules in a

201 The proposals made in this article have broad applicability. For example, The Organization of American States (OAS) formulated principles to be followed in formulating laws governing secured transactions. See Committee on Juridical and Political Affairs, Permanent Council of the Organization of American States, Comparison of the Two Working Documents on Secured Transactions Based on the Legal Principle of a Secured Financing System (Nov. 8, 2000). These stated principles do not mention the importance of allowing nominees to act for secured creditors. Id. Following these stated principles, the OAS subsequently promulgated a model act providing for secured transactions. See Model Inter-American Law on Secured Transactions, CIPID-VI/Res. 5/02 (approved Feb. 8, 2002), available at http://www.oas.org/dil/CIDIP-VI-securedtransactions_Eng.htm (last visited Feb. 24, 2004). Though not specifically enunciated as a principle, the model act does appear to provide for the use of nominees by secured parties. See id. at Tit. I, Art. 3, III. It is expected that the OAS and the International Institute for the Unification of Private Law (UNIDROIT) will coordinate the future development of recommendations on the private law relating to secured transactions. See Committee on Juridical and Political Affairs, Permanent Council of the Organization of American States Resolution, Follow-up Activities on the Model Inter-American Law on Secured Transactions and the Uniform Bills of Lading for the International Carriage of Goods by Road (May 8, 2003), available at http://www.oas.org/dil/CIDIP-VII_res.1922.htm (last visited Feb. 24, 2004). The ongoing joint efforts would do well to make explicit the importance of allowing nominees to act for secured creditors. Similarly, mention should be made of how passage of misguided taxes and filing fees can defeat efforts to enhance efficient credit structures. Consideration might be given both in the United States and abroad to extending the effectiveness of financing statements indefinitely (i.e. not requiring filing of continuation statements), particularly in the case of secured parties who are identified as acting in a nominee capacity. For a description of the UNIDROIT efforts on recent private law reform, see Sandeep Gopalan, Securing Mobile Assets: The Cape Town Convention and its Aircraft Protocol, 29 N.C. J. INT'L & COM. REG. 59 (2003); Charles W. Mooney, The Cape Town Convention: A New Era For Aircraft Financing, 18 AIR & SPACE L. 4 (2003).
manner calculated to promote, to the greatest extent possible, the freedom of contract to partition assets while at the same time preserving the promotion of goals which have structured our property rules in the first instance.\textsuperscript{202}

\textsuperscript{202} These goals traditionally have been inhibiting lying and stealing by debtors. See supra note 76. Promotion of only one of these property based goals typically is sufficient to confer property status on the claims of a secured creditor to the collateral posted by a debtor.
Diagram 1, Pre-revision Article 9 structure:

Diagram 2, Revised Article 9 structure:

203 Enhances efficiency by replacing multiple filing locations with a single location so that searches are made in a single location.
Diagram 3, LOTL structure: 204

Diagram 4, Consolidated Group Borrower: 205

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204 Enhances efficiency further by replacing inquiries of multiple creditors with inquiries made to a single source.

205 Each subsidiary corresponds to a unique location given revisions to Article 9. An expansion of the diagram might insert a “location” node between “Subsidiary” and “Filing Office” in a one-to-one relationship.
Diagram 5, Group Borrower using LOTL: