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Commentary on *Abolish the Article 9 Filing System* by Professor Peter Alces

Edwin E. Smith*

Professor Peter Alces, in his article *Abolish the Article 9 Filing System*,¹ questions whether the costs of the current filing system outweigh its benefits and then predicts, as he puts it, a "bleak future," with the problems of the current filing system being "exacerbated rather than corrected by developing technologies and law revision initiatives."² Although one might agree that the cost/benefit analysis is key in judging the filing system, some factors on both the cost and the benefit sides are not stressed in Professor Alces's article.

I. THE COSTS

Consider the cost side of the ratio. One may first question whether it is correct or appropriate, as part of the revisions process with which so many of us are involved today, to focus upon the costs of the current system in determining whether the cost/benefit ratio exceeds, or is less than, one to one.³ Of course, I do not challenge directly the accuracy of the statistical data set forth in Professor Alces's article as to the likely current cost of the filing system in relation to overall legal charges.⁴ We must remember, however, that those costs cover various legal tasks.

At the credit origination stage, these tasks consist of obtaining the correct information from the debtor as to where to

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1. Peter A. Alces, *Abolish the Article 9 Filing System*, 79 MINN. L. REV. 679 (1995).

2. *Id.* at 681.

3. *Id.* at 681-93.

4. After all, Professor Alces's figures came from my own law firm and from an attorney who was a member of the practice group that I supervised. See Letter from Meredith S. Jackson, Associate, Bingham, Dana & Gould, to Professor Peter A. Alces, Marshall-Wythe School of Law, College of William and Mary 1-4 (May 28, 1992) (on file with author).

search and where to file, arranging for the appropriate searches to be made, reviewing the search results, completing the various financing statements, arranging for execution of the financing statements, and arranging for the filings to be made in the proper recording offices. To the extent that, after the loan closing, further changes take place (e.g., mergers of existing companies within the corporate group, acquisition of new assets, changes of names, establishing new offices, and the like), lawyers must perform similar tasks.

We must also remember that the transactions for which the data were supplied largely related to national credits involving loans to corporate groups and multistate transactions.⁵ While each of the enumerated tasks may entail a cost, that cost is certainly multiplied to the extent that the process must be repeated for each state in which the debtor or a guaranteeing affiliate has assets or a business location. Although I have not done any empirical analysis of these particular matters, my strong and instinctual guess is that, if these transactions involved a single state, and a single location within that state, where the secured party had to file to perfect its security interest in the debtor's assets, filing costs would be dramatically reduced. If the filing system were reformed to permit such a single filing for *multistate transactions*, one cannot help but believe that this reform would significantly lessen the cost side of Professor Alces's ratio.

Transition costs constitute a second variable in the cost side of the ratio. Although Professor Alces defines his ratio in terms of whether we would invent the same filing system today if we were to start over,⁶ we cannot ignore that we do not have a clean slate today and that there are costs of actually moving to a different system. "Fine tuning" the filing system may have minimal costs. Moving, however, to a state-funded "priority insurance" system, as Professor Alces suggests,⁷ may have substantial costs.

If a state-funded "priority insurance" system were created, for example, states would be likely to view the filing system as an operation with significant contingent liabilities that they must fund, or for which they must establish reserves. Questions would arise as to credit risk to those who use the system and who have claims to collect. Furthermore, insurance coverage

5. Alces, *supra* note 1, at 690; Letter from Meredith S. Jackson to Peter A. Alces, *supra* note 4, at 3-4.

6. Alces, *supra* note 1, at 679-80.

7. *Id.* at 707-13.

and even bond ratings would become major concerns. Adjustments like these would have their own transition costs.

Finally, many of the empirical uncertainties that we have today may lead us to question whether the filing system that Professor Alces envisages will, in fact, be cheaper than the current system.⁸ Consider, for example, how a state would determine what "premium" to charge for priority insurance. Normally it would look to the empirical evidence of loss attributable to the current filing system, the very same evidence that Professor Alces recognizes is largely lacking today.⁹ It would use that information, if it could find it, to adjust premiums not only to cover potential losses but also to fund operating costs and, if it could, to make a profit. Where the information is "soft," as is likely here, and given the likelihood that a state would be risk averse, a state might compensate for the uncertain risk by charging a higher premium. Those secured parties relying on their priority secured position would, of course, pay that premium and pass it on to their debtors as part of the price of the credit. One wonders whether the cost of that premium charged would be less than the cost of obtaining priority under the filing system as reformed. Debtors might demand an examination of the filing offices' profits for which the debtors are paying. There might be pressure for states to regulate those profits, as in the case of public utilities. My fear is that by moving from a system where commercial risks are borne by commercial parties, who are risk takers, to a system where these risks are borne by state government, we will not create a cheaper system but instead a more expensive bureaucracy.

II. THE BENEFITS

What about the benefit side of the ratio? Professor Alces argues that the real benefit of the filing system is not to provide general credit information relating to the debtor.¹⁰ It is not to expose "secret liens" to unsecured creditors, and it is not to prevent debtor fraud.¹¹ The benefit of the filing system is merely to ensure a secured party priority against competing secured claimants.¹²

8. *Id.* at 681.

9. *Id.* at 692 & n.41.

10. *Id.* at 694-701.

11. *Id.* at 702-04.

12. *Id.* at 704-07.

I am persuaded that Professor Alces is largely right here. The filing system cannot possibly protect an unsecured creditor from having its claim "primed" by a secured party, because the day after the unsecured creditor's search is made, the debtor could grant a security interest and a filing could be made. Indeed, that the filing system serves to perfect a secured party's security interest against the bankruptcy trustee, as a hypothetical lien creditor, will drive the secured party to file. But such a rule in itself would not necessarily cause the secured party to search those files before extending credit. The secured party searches largely, it appears, to assure the secured party of the priority of its security interest in the collateral against competing secured claimants.

Even so, the filing system does provide other benefits by creating a means of public notice for transactions that the parties might want to publicize. Some debtors appear comfortable with financing statements in favor of their secured lenders, as a recorded means of assuring their suppliers that they have lines of credit to pay for the goods shipped. Some lessors who do not have the benefit of UCC section 2A-308¹³ in their jurisdiction routinely file financing statements in sale and "true" leaseback transactions. These filings minimize the risk that the transaction will be viewed as fraudulent under a "seller in possession" rule in that jurisdiction. Furthermore, filings may provide notice by describing negative pledge clauses and subordination terms. Professor Alces's article mentions my letter to him highlighting these filings.¹⁴ He also states that buyers and investors may look to the filing system to determine the identity of a debtor's lender.¹⁵ Certainly, some persons find all of this information useful; otherwise, Dun & Bradstreet and others would

13. U.C.C. § 2A-308(3) (1990). This provision would insulate a transaction in which the seller sold goods to a buyer, who then leased the goods back to the seller under a true lease governed by Article 2A, from a "fraudulent retention" attack by third-party creditors of a seller. This protection exists as long as the buyer bought in good faith and for value. *Id.* In those jurisdictions that have not passed Article 2A, the public disclosure of the transaction by way of a filing of a UCC financing statement in favor of the buyer under UCC § 9-408 would reduce the possibility that third-party creditors of the seller would be able to claim that they were fraudulently misled by the seller's retention of those goods as lessee.

14. See Alces, *supra* note 1, at 695-96 (discussing and quoting Letter from Edwin E. Smith, Bingham, Dana & Gould, to Professor Peter A. Alces, Marshall-Wythe School of Law, College of William and Mary (July 31, 1991)).

15. *Id.* at 696.

not routinely publish this information in response to credit inquiries.

Hence, one might take issue with Professor Alces's argument that this information only clutters up the filing system.¹⁶ It clutters up the system for those who do not care about this information; for others, the reverse is often true. In any event, as technology advances, we learn to manage more and more information. In fact, today we expect more information to be readily accessible to us, rather than less. Many of us would not discourage the filing system from providing that information, even as an ancillary goal.

I would suggest that, by adjusting Professor Alces's cost/benefit ratio to reflect these cost and benefit factors not stressed in his article, the costs of a "priority insurance" system would outweigh its benefits. Conversely, the benefits of a reformed filing system would outweigh the costs of either the current filing system or the "priority insurance" system that Professor Alces envisages.

16. *Id.* at 701, 706.

