

SECURED TRANSACTIONS INSIDE OUT: NEGATIVE PLEDGE COVENANTS, PROPERTY AND PERFECTION

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INTRODUCTION

Lowly tools, when put to a new use, can accomplish great things. When Archimedes mounted an ordinary wooden bar on a fulcrum, he created a new device called a lever, with which we can move masses.¹

The potential for similarly surprising results inheres in one lowly tool of unsecured lenders: the negative pledge covenant, by which a borrower promises its lender that it will not grant security interests to other lenders. These covenants are common in unsecured loan agreements because they address one of the most fundamental concerns of the unsecured lender: that the borrower's assets will become unavailable to repay the loan, because the borrower will have both granted a security interest in those assets to a second lender and dissipated the proceeds of the second loan. Unfortunately, negative pledge covenants' prohibition of such conduct may be of little practical comfort, because as a general matter they are enforceable only

¹ His boast, "Give me where to stand, and I will move the earth," dramatizes the surprising power that such a simple device can have. 8 PAPPUS OF ALEXANDRIA, prop. 10, § 11, quoted in BARTLETT'S DICTIONARY OF QUOTATIONS 83 (16th ed. 1992).

against the borrower, and not against third parties who take security interests in violation of the covenant. Hence, when a borrower breaches a negative pledge covenant, the negative pledgee² generally has only a cause of action against a party whose assets are, by hypothesis, already encumbered.³

This Article explores the possibility of alleviating this problem. It proposes making negative pledge covenants enforceable against subsequently perfecting secured parties, provided that the negative pledgee satisfies certain third-party notice concerns in the manner currently required for security interests by Article 9 of the Uniform Commercial Code. In short, it proposes making negative pledge covenants perfectible, without altering negative pledgees' characteristic vulnerability to other unsecured creditors. This fairly simple change in the law would generate a number of extraordinary results, both practical and theoretical.

On a practical level, this change would bring new vitality to a very common device, making negative pledge covenants much more effective, and reducing uncertainty on the part of both secured and unsecured lenders. It would integrate protection for negative pledgees into the statutory pattern of Article 9, thereby obviating the need for much of the costly, judge-made doctrine relied upon today. It would enrich the range of possible outcomes of bargaining between borrowers and lenders, which in turn would have several salutary effects: (1) increasing party autonomy, (2) furthering borrowers' ability to alienate their property, and (3) increasing transactional efficiency by enabling some borrowers to save interest costs without harm to third parties. In sum, the proposal may encourage the market to recognize negative pledge debt as a new and distinct mezzanine, located midway between current law's poles of secured and unsecured debt.

The proposal also offers theoretical insights that are at least as important as the practical effects. In effect, it turns Article 9 inside

² "Negative pledgee" is the standard term used to refer to the promisee of a negative pledge covenant.

³ Why, then, do lenders use negative pledge covenants at all? This and related natural questions are addressed *infra* in Part I.E. As a preliminary matter, it is important to note that most debtors do not breach their negative pledge covenants, and that presumably only a minority of the debtors who do breach dissipate, on a problematically quick basis, the proceeds of the resulting secured loan. See *infra* text accompanying note 16 (noting that breach of a negative pledge covenant typically triggers acceleration of the original debt); *infra* notes 281-82 and accompanying text (noting a variety of other forces that bolster the effectiveness of negative pledge covenants). For these reasons, negative pledge lending is widespread under current law and, for the most part, functions well.

This Article's purpose is not to urge any legislative reform, but rather to explore what a certain complex of ideas can reveal about current law and about commercial law in general. For that reason, though I refer throughout this piece to a "proposal," I use that word in its relatively neutral sense, as a simple means of referring to the principal subject of discussion.

out, using a statute that is often considered the nemesis of unsecured creditors as a tool to help them. In the process, the proposal invites us to look deeply into Article 9's structure and into the nature of unsecured debt itself. It also invites us to explore the nature of property rights, revealing the concept as a relatively flexible linguistic construct that should not automatically exclude lenders without security interests. It offers a fresh view of the longstanding scholarly debate over whether secured credit is a desirable institution, recasting that question as one that each borrower can effectively answer for itself, rather than one with only a single answer on an aggregate social level. Current law forces onto borrowers the power to defeat unsecured lenders by issuing secured debt, even when borrowers would prefer to give up that power in order to protect their unsecured lenders from the corresponding threat. Under the proposal, by contrast, borrowers could, in effect, opt out of the regime that creates that threat, thus choosing their own answer to the debate over secured credit.

After briefly explaining why negative pledge covenants are important, Part I of this Article critiques the present doctrine governing them. Part II develops the details of this Article's proposal and considers how the concept of property rights would apply to negative pledge lenders that use the proposal. Part III examines three structural alternatives to the proposal. Part IV explores some of the proposal's larger theoretical ramifications. The Article then concludes with some thoughts on the general question of enabling rules in commercial law.

I

A CRITIQUE OF CURRENT NEGATIVE PLEDGE COVENANT DOCTRINE

The negative pledge covenant has heretofore been only as primitively useful as a wooden bar without a fulcrum. The covenant does not prevent third parties from acquiring a security interest, but merely confers on the negative pledgee a cause of action against the borrower for contract damages in the event of breach. Often, even this cause of action is but a hollow promise, for in the very act of breaching the covenant, the borrower places its assets out of reach of the negative pledgee and into the hands of the very third party against which the negative pledgee seeks protection.

A. Some Basics and a Challenge

One respected lawyer remarks, "Lenders to the same borrower are fated to coexist in a Hobbesian state of nature."⁴ Each lender

⁴ LEE C. BUCHHEIT, *HOW TO NEGOTIATE EUROCURRENCY LOANS* 80 (1995).

poses a risk to all other lenders having claims against the common borrower, because the greater the aggregate claims, the greater the possibility that the borrower's assets will be insufficient to satisfy them all. Part I.A examines these risks and shows that negative pledge covenants, as currently enforced, do not adequately address them. Part I.A also attributes this inadequacy to the nature of secured and unsecured debt, and concludes with a challenge to the assumption that these two poles necessarily exhaust the range of varieties of debt.

1. *Secured and Unsecured Debt*

Just as combatants in a state of nature have varying strengths, so do creditors competing under the portion of the social contract that we call commercial law. One of the most important distinctions in creditors' relative strengths is whether they are secured or unsecured; many of the most fundamental principles of commercial law turn on this distinction.

The first of these principles, which I call the "pari passu principle," provides that unsecured creditors rank equally with each other in right to payment, regardless of the temporal order in which they extend credit, and that (outside of bankruptcy⁵) the first among them to execute on a judgment will have priority over the others.⁶ Thus, one unsecured creditor can harm another such creditor's chances of repayment by diminishing the latter's pro rata share of the debtor's available assets or by executing a judgment first. An equally fundamental principle, which I call the "perfection principle," provides that unsecured creditors rank behind a secured creditor in their right to payment from the assets serving as collateral, regardless of whether they extend credit before or after the secured creditor.⁷ Thus, a se-

⁵ See *infra* Part II.D.

⁶ See, e.g., 735 ILL. COMP. STAT. 5/12-136 (West 1992); N.Y. C.P.L.R. 5234 (McKinney 1998). It is interesting to note that the term "pari passu" is adopted from the Latin for "with equal step," or "side by side." One of the core ideas of the cognitive linguistic approach discussed in Part II.A.2 is that abstract concepts are founded metaphorically on physical experience.

⁷ See, e.g., U.C.C. § 9-201 (1995) (providing that security agreements are effective against creditors except as otherwise provided). Perfection also entails rights against purchasers of the collateral, see *id.*, but that idea is not central to this Article except as applied to purchasers that are secured parties, principally because negative pledge covenants have never been used as protection against such other purchasers. See *infra* note 160.

The perfection principle is subject to a number of provisos, the most important being that the secured creditor must take appropriate steps to perfect the security interest. These steps are generally designed to provide notice to third parties. See *infra* Part I.D.

In the Bankruptcy Code, this general principle also applies, although the Code nowhere directly states it. See DAVID G. EPSTEIN ET AL., BANKRUPTCY §§ 7.9-10, at 461 (1993) (explaining that "secured claims are always given top priority as to the assets subject to the security," despite not being listed in Code sections that define the hierarchy of claims); cf. 11 U.S.C. § 725 (1994) (requiring trustee to dispose of property subject to lien before making distributions to administrative expense claimants and unsecured creditors); *id.*

cured creditor can severely harm an unsecured creditor's chances of repayment, particularly if the secured creditor perfects after the unsecured creditor has extended its loan.⁸

As a result, an unsecured creditor faces potential harm from all possible later lenders,⁹ whether unsecured or secured, and of the two threats, that posed by a secured creditor is greater than that posed by an unsecured creditor. This Article's proposal provides a means for unsecured creditors to virtually eliminate this greater threat.¹⁰

§ 724(b)(1) (providing that the holder of a tax lien has priority in the distribution of property subject to the lien).

In addition to the perfection principle, secured credit entails two other powerful features. I call the first the "self-help power": if the debtor defaults on the loan, the secured creditor has the right to seize and sell the collateral (or exercise other self-help remedies with respect to the collateral) without the time, expense and uncertainty involved in bringing suit. See U.C.C. §§ 9-503 to 9-507. The self-help power is conceptually independent from the perfection principle. See Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857, 860 (1996) (distinguishing between a secured creditor's "priority right" and "repossessory right"). One effect of this Article's proposal is to clarify how, even more readily than under existing law, one of these rights can exist without the other. See *infra* Part II.A.1. The self-help power is also relevant to Parts I.E and II.A.3.

The last principal feature of secured credit, the "priority principle," is introduced below. See *infra* note 30 and accompanying text.

⁸ By contrast, if the secured creditor perfects its interest before the unsecured creditor extends its loan, the unsecured creditor may often be able to adjust for its presence in negotiations with the debtor, by means, for example, of a higher interest rate or an inter-creditor agreement with the secured creditor. See, e.g., Alan Schwartz, *Security Interests and Bankruptcy Priorities: A Review of Current Theories*, 10 J. LEGAL STUD. 1, 7 (1981). Not all unsecured creditors, however, have this capacity. See *infra* note 176 and accompanying text.

⁹ The text's statement is somewhat oversimplified in the interest of clarity. As Lynn LoPucki describes at a greater level of detail, not all unsecured creditors face these vulnerabilities. See Lynn M. LoPucki, *The Unsecured Creditor's Bargain*, 80 VA. L. REV. 1887, 1924-47 (1994) (discussing "asset-based unsecured lending" and "cash-flow surfers").

On the other side of the coin, secured creditors, too, may be concerned over later borrowings. They may wish to avoid the expense and delay of an insolvency proceeding caused by unwise borrowings (secured or unsecured), even though they are at a relative advantage in such proceedings. They may also prefer to keep their collateral free of subordinate liens in order to minimize the complications posed by a junior's foreclosure, or by a junior having claims in the event of flaws in the senior's foreclosure. Negative pledge covenants can accordingly be useful tools to secured lenders. This Article, however, focuses only on their use by unsecured lenders, who stand to be more severely harmed in the event of a breach.

¹⁰ The proposal does not provide a means to alleviate the threat posed by other unsecured creditors, not because this threat is unimportant, but because one purpose of this Article is to explore the underpinnings of Article 9, and one cannot meaningfully address this threat within the framework of Article 9. See *infra* note 259. One proposal for protecting certain unsecured lenders against, among other things, the threat posed by other unsecured lenders is advanced by Alan Schwartz, who proposes quite marked departures from Article 9's principles. See Alan Schwartz, *A Theory of Loan Priorities*, 18 J. LEGAL STUD. 209 (1989). See *infra* Part III.C for a discussion of Professor Schwartz's argument.

The threat posed by later lenders does not, to be sure, inevitably ripen into actual harm. As several commentators have noted,¹¹ any later lending transaction will be a two-way proposition: the later lender will acquire a claim against the debtor and a security interest in its property, but will, at the same time, infuse cash or other assets into the debtor.¹² This infusion has the potential to help not only the debtor but also those with claims against the debtor, including the prior unsecured lender. The potential problem, however, is that the infused assets do not sit safely and indefinitely in the debtor's coffers. If the debtor uses those new assets in unprofitable projects, or otherwise dissipates or misappropriates them, then the assets will fail to benefit the prior unsecured lender and, in addition, the new claims of the later lender will have a net negative effect on the prior lender. Whatever the frequency with which such problems actually arise,¹³ prior lenders tend to be less than sanguine about the net positive effect of later lending. The protective measures that they take, addressed next, demonstrate this attitude.

2. *Function and Dysfunction of the Negative Pledge Covenant*

To protect themselves against the threats posed by other lenders, prudent lenders extract covenants from their borrowers. The covenant most germane to this Article is, of course, the negative pledge covenant, which is intended as protection against later secured borrowings.¹⁴ The lender's hope is that such a covenant will preserve a

¹¹ See, e.g., Steven L. Harris & Charles W. Mooney, Jr., *A Property-Based Theory of Security Interests: Taking Debtors' Choices Seriously*, 80 VA. L. REV. 2021, 2023 (1994) (rejecting the "popular misconception" that later secured debt "necessarily harms a debtor's unsecured creditors").

¹² This discussion excludes cases in which the debtor grants a security interest in order to secure a previously incurred debt. Such grants of security interests are relatively unusual, and are avoidable in bankruptcy as preferences under certain circumstances. See 11 U.S.C. § 547.

¹³ See *supra* note 3.

¹⁴ Though negative pledge covenants may bar all security interests, it is far more usual for them to set forth certain exceptions (known as "permitted liens" or, informally, as "carve-outs") designed to leave the debtor with necessary business flexibility. Typical among these carve-outs are purchase money security interests ("PMSIs"), that is, security interests on specific property securing debt that finances the acquisition of that property, and liens that arise by operation of law and are not yet payable. See BUCHHEIT, *supra* note 4, at 86-90; SANDRA SCHNITZER STERN, *STRUCTURING COMMERCIAL LOAN AGREEMENTS* ¶ 5.03[2] (2d ed. 1990); 2 PHILIP WOOD, *LAW AND PRACTICE OF INTERNATIONAL FINANCE* § 6.02[5]-[6] (1981); Ronald J. Mann, *Explaining the Pattern of Secured Credit*, 110 HARV. L. REV. 625, 645 n.71 (1997).

Covenants protecting against later unsecured borrowings are beyond the scope of this Article but, briefly, may include covenants limiting the overall indebtedness of the borrower to specified financial ratios, such as the ratio of (1) cash flow and net earnings to debt service or interest coverage, (2) debt to capitalization or cash flow, or (3) current earnings to fixed charges. See, e.g., STERN, *supra*, ¶ 5.04 (Supp. 1998); George G. Triantis, *Secured Debt Under Conditions of Imperfect Information*, 21 J. LEGAL STUD. 225, 235-36 (1992).

cushion of assets, keeping it free from encumbrance by a later perfecting secured party and thus available to the negative pledgee (and, due to the *pari passu* principle, other unsecured creditors).

However, negative pledge covenants in fact provide little protection to unsecured lenders when the breach is accompanied by dissipation of assets.¹⁵ The covenants usually confer on the negative pledgee nothing more than the rights to sue for damages and, assuming the loan agreement is correctly drafted, to accelerate the original debt.¹⁶ Moreover, the only damages from breach of the covenant will be the increased difficulty in collecting the underlying debt.¹⁷ In effect, then, the right to sue for breach of the covenant amounts to little more than a second reason that the lender is entitled to collect the original debt.

This result is particularly troubling because every breach of a negative pledge covenant implicates the perfection principle: the secured party whose presence violates the covenant is entitled to repayment from the collateral before the injured negative pledgee. Every dollar of collateral in which the later lender perfects is, *ipso facto*, unavailable to the negative pledgee who sues for breach.¹⁸ Thus, to the extent that the debtor has dissipated the assets infused by the secured lender by the time that the negative pledgee asserts its rights, the value of the negative pledgee's remedy for the breach varies inversely with the se-

See generally Robert E. Scott, *A Relational Theory of Secured Financing*, 86 COLUM. L. REV. 901, 919-20 (1986) (describing conflicts of interest between borrower and lender that may arise after the loan agreement is in place).

The negative pledge covenant is also thought to afford protection against indebtedness (whether secured or unsecured) in excess of ratios that the market deems healthy. According to this view, borrowers unable to obtain further unsecured credit will resort to granting security and the negative pledge covenant prevents such a strategy. *See* 2 WOOD, *supra*, § 6.02[1], at 6-6. But even assuming that borrowers resort to secured borrowings only when they have no choice (a questionable assumption, *see infra* Part I.E), current negative pledge covenant law provides only limited protection. *See infra* Parts I.B, D; *cf.* Mann, *supra*, at 641-45 (discussing relative effectiveness of security interests and negative pledge covenants for this purpose).

¹⁵ This point has been widely noted. *See, e.g.*, Bebchuk & Fried, *supra* note 7, at 888-89.

¹⁶ In certain cases, state law gives the negative pledgee greater rights, but these rights are problematic in themselves. *See infra* Part I.C. Bankruptcy law may also be helpful under some circumstances. *See infra* Part III.A.

¹⁷ Punitive damages are not generally available in breach of contract actions. *See, e.g.*, *White v. Benkowski*, 155 N.W.2d 74, 76 (Wis. 1967); RESTATEMENT (SECOND) OF CONTRACTS § 355 (1981). *But see generally* Timothy J. Sullivan, *Punitive Damages in the Law of Contract: The Reality and the Illusion of Legal Change*, 61 MINN. L. REV. 207 (1977) (examining contract decisions allowing punitive damages).

¹⁸ One can (but need not) think of the grant of the security interest as a conveyance of property by the debtor to the secured party. It places the assets into the hands of the secured party, out of the hands of the debtor and, by extension, out of the hands of its unsecured creditor the negative pledgee. *See infra* note 32 and accompanying text; *infra* note 178 and accompanying text; *infra* Part II.A.2.

verity of that same breach. In the worst case, when the security interest covers all of the borrower's assets and the assets infused by the secured lender have been entirely dissipated, the negative pledgee's remedy is utterly valueless. It is surprising that rules so basic as the perfection principle and the measure of contract damages can lead to such an unsatisfactory result.¹⁹

3. *The Needless Excluded Middle*

The law of the excluded middle is associated with the axiom that propositions are either true or not true: there is no middle possibility such as semi-truth.²⁰ This so-called law is controversial even in the realm of logic,²¹ and should be at least suspect in law, where the raw material of human conduct rarely lends itself to such rigorous characterization.

Yet, curiously, no middle ground is generally recognized between secured and unsecured debt; all debt is referred to as belonging to one pole or the other.²² To be sure, observers do notice variations, but they nonetheless pigeonhole any given instance of debt into one of the two extremes. Thus, a lender with an unperfected or junior security interest is nonetheless said to hold secured debt, and similarly, a lender with a negative pledge covenant is said to hold unsecured debt.²³ Moreover, an undersecured creditor in bankruptcy is treated as being both secured and unsecured, rather than as being at some intermediate point.²⁴

¹⁹ On the other hand, one should not overstate the magnitude of the resulting practical problems. See *supra* note 3.

²⁰ Aristotle formulated the axiom as follows: "There is nothing between asserting and denying." THE OXFORD COMPANION TO PHILOSOPHY 256-57 (Ted Honderich ed., 1995). In modern terms of symbolic logic, the axiom can be formulated as "P or not-P" is valid, i.e., true of all interpretations of 'P.'" *Id.*

The law of the excluded middle is characteristic of a view of language that presumes categories to be accurately delineable in terms of lists of necessary and sufficient features. See Steven L. Winter, *Bull Durham and the Uses of Theory*, 42 STAN. L. REV. 639, 652-53 (1990); see also *infra* Part II.A.2 (examining an important alternative approach to categorization).

²¹ See SIMON BLACKBURN, THE OXFORD DICTIONARY OF PHILOSOPHY 45 (1994).

²² The new edition of Lynn LoPucki's and Elizabeth Warren's casebook opens by observing: "In the movie *Wall Street*, the neophyte stock broker is concerned that what Gordon Geko proposes is insider trading. Geko responds, 'either you're *inside*, or you're *outside*.' That is the way it is with credit. Either you're *secured*, or you're *unsecured*." LYNN M. LOPUCKI & ELIZABETH WARREN, SECURED CREDIT: A SYSTEMS APPROACH xxxiii (2d ed. 1998) (quoting WALL STREET (20th Century Fox 1987)).

²³ See, e.g., *Knott v. Shepherdstown Mfg. Co.*, 5 S.E. 266, 269 (W. Va. 1888) ("Of course this [negative pledge covenant] creates no lien on or pledge of any property."); BARKLEY CLARK, THE LAW OF SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE ¶ 1.03[4][b], at 1-27 (1993 & Supp. 1998).

²⁴ See 11 U.S.C. § 506(a) (1994) (providing secured creditors with a secured claim to the extent of the value of collateral and unsecured claim to the extent of the remainder).

This world view is Procrustean²⁵ and deserves skeptical scrutiny. Since the Legal Realists, the law has become increasingly willing to resist the simplistic attractions of polar absolutes,²⁶ and this willingness should be particularly strong in that great Realist project, the Uniform Commercial Code.²⁷ In that spirit, this Article's proposal should help to confer on negative pledge debt a distinct, intermediate status of its own. Negative pledge debt will more clearly be viewed as neither secured nor unsecured and, instead, will occupy a new mezzanine staked out between the two poles. As a result, the bargaining possibilities available to borrowers and lenders will be enriched.²⁸

The following two sections examine and critique the traditional reasoning used to support treating negative pledge debt as little different from any other unsecured debt.

²⁵ Procrustes, the Attican robber, preyed upon travelers and tied them to an iron bed. If a victim was shorter than the bed, he stretched his or her limbs to make the victim fit. If taller, he cut off the bottom of the victim's legs. See THOMAS BULFINCH, *BULFINCH'S MYTHOLOGY* 137 (Richard P. Martin ed., 1991).

Under current law as opposed to this Article's proposal, the classification of negative pledge debt with all unsecured debt is perhaps understandable: the limited value of negative pledge covenants makes negative pledge debt different from other unsecured debt only in a feeble, shadowy way.

²⁶ See generally GRANT GILMORE, *THE AGES OF AMERICAN LAW* 81, 83 (1977) (associating Karl Llewellyn with "disintegration of unitary theory" and "atomization of sales law"); MORTON J. HORWITZ, *THE TRANSFORMATION OF AMERICAN LAW, 1870-1960*, at 3-31, 193-212 (1992) (discussing the foundations for and legacy of Legal Realism); Felix S. Cohen, *Transcendental Nonsense and the Functional Approach*, 35 *COLUM. L. REV.* 809, 809-821 (1935) (decriing the then-traditional legal theory's presumption of access to a "heaven of legal concepts" divorced from empirical and ethical questions).

Duncan Kennedy describes a similar phenomenon in a different context: "The history of legal thought since the turn of the century is the history of the decline of a particular set of distinctions—those that, taken together, constitute the liberal way of thinking about the social world." Duncan Kennedy, *The Stages of the Decline of the Public/Private Distinction*, 130 *U. PA. L. REV.* 1349, 1349 (1982). One of the six stages of decline that he identifies is "the development of intermediate terms," in which it is formally recognized that "some situations are neither one thing nor another—neither public nor private—but rather share some characteristics of each pole." *Id.* at 1351. This Article's proposal produces much the same effect on secured lending.

²⁷ "Despite the numbers of persons involved in the drafting of the Code, the extent to which it reflects Llewellyn's philosophy of law and his sense of commercial wisdom and need is startling." SOIA MENTSCHIKOFF, *COMMERCIAL TRANSACTIONS* 4 n.3 (1970). See generally WILLIAM TWINING, *KARL LLEWELLYN AND THE REALIST MOVEMENT* 270-340 (1973) (discussing the origins and early development of the Uniform Commercial Code). Article 9 was generally less influenced by Llewellyn's ideas than was Article 2. See GILMORE, *supra* note 26, at 140 n.38; John A. Sebert, Jr., *Rejection, Revocation, and Cure Under Article 2 of the Uniform Commercial Code: Some Modest Proposals*, 84 *NW. U. L. REV.* 375, 382 & n.45 (1990); cf. Richard Danzig, *A Comment on the Jurisprudence of the Uniform Commercial Code*, 27 *STAN. L. REV.* 621 (1975) (discussing Llewellyn's influence on the drafting of the UCC, particularly on Article 2). However, if one can move Article 9 further in that direction without sacrificing the certainty so important to lending, all the better.

²⁸ See *infra* Part I.E.

B. The Negative Pledge Covenant as Mere Contract

Commentators have never suggested that negative pledge covenants and security interests have anything structurally in common.²⁹ Strong reasons, going to the essence of each of the two devices, presumably account for this distinction. Negative pledge covenants do not prevent a subsequent third party from acquiring rights in the property superior to those of the negative pledgee, while security interests do. I shall refer to this attribute of security as the “priority principle.” It provides, in essence, that just as a perfected security interest has priority over unsecured creditors under the perfection principle, a perfected security interest has priority over certain subsequently granted or perfected property interests.³⁰ Furthermore, a negative pledge covenant does not give the negative pledgee a security interest³¹ or, in general, any other right in the debtor’s property. In a nutshell, security interests have generally been viewed as conveyances of an interest in the debtor’s property,³² and negative pledge covenants have not. Instead, the latter have been viewed as mere contract rights.³³

A seminal case developing the contract versus conveyance view is *Knott v. Shepherdstown Manufacturing Co.*,³⁴ in which Knott held a note from Shepherdstown that included a covenant not to give “any volun-

²⁹ The two devices have, however, been understood to have similar effects: negative pledge covenants, in combination with other covenants, are sometimes said to replicate many of the effects of a security interest. See, e.g., Bebluk & Fried, *supra* note 7, at 878-79.

³⁰ The complex particular rules implementing the priority principle need not be explored here, but the vital baseline pattern is “first in time, first in right”: an earlier-in-time security interest will have priority over one that is later in time.

This leads to the question, “first at what?” As adopted by Article 9, the first-in-time security interest is the one that is first perfected or first filed. See U.C.C. § 9-312(5)(a) (1995). Thus if SP-1 files but is not yet perfected, SP-2 then files and perfects, and SP-1 subsequently perfects, SP-1 will have priority over SP-2 even though SP-2 was the first to perfect.

Some of Article 9’s other priority rules are inconsistent with the first-in-time principle. See *infra* note 173.

³¹ See *infra* text accompanying notes 38-43. Since the advent of Article 9, this point has become too basic to litigate. Among commentators who have thought about the point, “[t]his seems to be the only sensible answer.” CLARK, *supra* note 23, ¶ 1.03[4][b], at 1-27; see also 1 GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 11.1, at 336-37 (1965) (explaining that a variety of hybrid assurances to lenders are not necessarily security interests).

³² See Steve Knippenberg, *The Unsecured Creditor’s Bargain: An Essay in Reply, Reprisal, or Support?*, 80 VA. L. REV. 1967, 1972 n.22 (1994) (“The notion that the creation of a security interest is a transfer of property is deeply rooted in doctrine and is clearly the dominant conceptualization of security.”); see also *infra* Part II.A.1, particularly note 178 (discussing whether a security interest is property).

³³ Parts II.A.1 and 2 below argue that this view reflects too simplistic a notion of property, and that negative pledge covenants (at least if perfected) can indeed be considered a form of property.

³⁴ 5 S.E. 266 (W. Va. 1888). One court writes that *Knott* is apparently the oldest case on this subject. See *Equitable Trust Co. v. Imbesi*, 412 A.2d 96, 102 (Md. 1980).

tary lien of any character whatever on any of [the borrower's] buildings, machinery, or grounds so long as this debt remains unpaid."³⁵ After Shepherdstown had assigned its property for the benefit of creditors and after some of those creditors had obtained judgments, Knott brought an action in equity for the purpose of having his rights "in some manner' declared to be 'a preferred claim or first lien upon the company's property.'"³⁶ The court construed Knott's claim as seeking to impose an "equitable mortgage"—also known today as an equitable lien—and explained that doctrine as follows:

"The doctrine may be stated in its most general form, that every express executory agreement in writing, whereby the contracting party sufficiently indicates an intention to make some particular property, real or personal, or fund therein described or identified, a security for a debt or other obligation, or whereby the party promises to convey or assign or transfer the property as security, creates an equitable lien on the property so indicated, which is enforceable against the property in the hands, not only of the original contractor, but of his heirs, administrators, executors, voluntary assignees, and purchasers or incumbrancers with notice."³⁷

However, the court proceeded forcefully to reject Knott's equitable lien claim as applied to the facts before it:

Of course [the agreement's negative pledge covenant] creates no lien on or pledge of any property. It is simply negative; an agreement not to do a particular thing. The creation of a lien is an affirmative act, and the intention to do such act cannot be implied from an express negative. It seems to me that both of these clauses of the obligation [that is, the negative pledge covenant and a covenant to keep the property insured] are simply personal covenants, for the breach of which the remedy must be sought in a court of law. . . . They simply impose a personal obligation upon the covenantor.³⁸

³⁵ *Knott*, 5 S.E. at 269.

³⁶ *Id.* at 268.

³⁷ *Knott*, 5 S.E. at 268 (quoting 3 JOHN NORTON POMEROY, A TREATISE ON EQUITY JURISPRUDENCE § 1235, at 2469-70 (3d ed. 1905)). Equitable lien theory (which, as discussed in Part I.C.1 below, is also important to current negative pledge covenant doctrine) is further glossed in an important modern case:

Thus, a promise to give a mortgage or a trust deed on particular property as security for a debt will be specifically enforced by granting an equitable mortgage. An agreement that particular property is security for a debt also gives rise to an equitable mortgage even though it does not constitute a legal mortgage. If a mortgage or trust deed is defectively executed, for example, an equitable mortgage will be recognized. Specific mention of a security interest is unnecessary if it otherwise appears that the parties intended to create such an interest.

Coast Bank v. Minderhout, 392 P.2d 265, 266-67 (Cal. 1964) (Traynor, J.) (citations omitted). For a discussion of *Minderhout* and equitable liens, see *infra* Part I.C.1.

³⁸ *Knott*, 5 S.E. at 269.

The court also held that the defendant's insolvency did not make Knott's remedy at law inadequate, remarking that "courts do not provide the means to pay debts, but only the means of enforcing their payment."³⁹

Knott starkly illustrates the principle that a negative pledgee's remedies are purely contractual; the covenant confers no rights in the property. The negative pledgee's vindication, if any, comes only from a damages remedy against the breaching borrower. But when the borrower is insolvent (as in *Knott* and in most other cases in which lenders are not being paid), the law of cause and effect applies in a particularly bitter fashion: the suit will be ineffective for the very reason that the suit has been brought. By encumbering its assets, the borrower has placed them out of reach of the negative pledgee who seeks to recover for the violation represented by the encumbrance.

During the century since *Knott*, courts⁴⁰ and commentators⁴¹ have routinely drawn similar conclusions about the rights of a nega-

³⁹ *Id.*

⁴⁰ See, e.g., *Chase Manhattan Bank, N.A. v. Gems-By-Gordon, Inc.*, 649 F.2d 710, 713 (9th Cir. 1981); *Browne v. San Luis Obispo Nat'l Bank (In re Browne)*, 462 F.2d 129, 133 (9th Cir. 1972); *In re Friese*, 28 B.R. 953, 955 (Bankr. D. Conn. 1983); *Weaver v. Tri City Credit Bureau*, 557 P.2d 1072, 1075-76 (Ariz. Ct. App. 1976); *Tahoe Nat'l Bank v. Phillips*, 480 P.2d 320, 325-26 (Cal. 1971); *Fisher v. Safe Harbor Realty Co.*, 150 A.2d 617, 620 (Del. 1959); *Equitable Trust Co. v. Imbesi*, 412 A.2d 96, 98, 107 (Md. 1980) ("[T]his instrument by no stretch of the imagination can legitimately be called a mortgage We have nothing but an agreement *not* to do a particular thing."); *Western States Fin. Co. v. Ruff*, 215 P. 501, 504 (Or. 1923), *reh'g denied, opinion modified*, 216 P. 1020 (Or. 1923).

⁴¹ Gilmore comments as follows on the rights of a negative pledgee:

Negative pledges should not, it is submitted, be allowed to operate as informal or inchoate security arrangements, even against third parties with notice. If a creditor wants security, let him take a security interest in some recognized form: mortgage, pledge, an Article 9 security interest or whatnot. If he wants protection against third parties, let him take possession of the collateral or file. Nothing is to be gained by giving a shadowy effectiveness to informal arrangements which conform to no recognized pattern. The debtor's covenant not to encumber property . . . should be treated, as on the whole the case law has done, as a covenant 'merely personal'—good enough to give rights against the covenantor for breach, to bring an acceleration clause into play, to constitute an 'event of default' under a loan agreement, but not good enough to give rights, whether they be called legal or equitable, in property.

2 GILMORE, *supra* note 31, § 38.3, at 1017; see also 1 GARRARD GLENN, *MORTGAGES* § 17.2, at 103 (1943) ("If . . . people wish to secure a debt by mortgage, they must at least make a stab at drawing up a mortgage, and they cannot say, 'Well, let's play as though there were a lien.'"); GEORGE E. OSBORNE, *HANDBOOK ON THE LAW OF MORTGAGES* § 44, at 88-89 (2d ed. 1970) (distinguishing *Minderhout* from other negative pledge covenant case law and arguing that the decision does not mean that negative pledge covenants are generally equivalent to security interests); Peter F. Coogan et al., *The Outer Fringes of Article 9: Subordination Agreements, Security Interests in Money and Deposits, Negative Pledge Clauses, and Participation Agreements*, 79 HARV. L. REV. 229, 264 (1965) (expressing the same idea as Gilmore); George E. Osborne, *Mortgages*, in 4 AMERICAN LAW OF PROPERTY § 16.38, at 77-78 (A. James Casner ed., 1952) ("The purely negative covenant not to mortgage certain property while

tive pledgee. Indeed, with one important exception,⁴² no court appears ever to have sustained a contention that a purely⁴³ negative pledge covenant creates rights in property. Accordingly, *Knott* represents the greatly predominant rule of negative pledge law.

The *Knott* rule does have the virtue of being clear, which fosters predictability and, within limits, efficient commercial behavior. However, when combined with the perfection principle and the debtor's dissipation of assets, it frustrates the negative pledgee's manifest goal of protecting itself against later security interests.⁴⁴ Part I.C will show how courts have sometimes vindicated this goal at the expense of the *Knott* rule's predictability. Part I.D will then suggest a heretofore neglected structural kinship between negative pledge law and Article 9. Part II, which exploits this structural kinship, will show that adapting Article 9 to accommodate negative pledgees can protect them while also reducing current law's uncertainty.

C. Unpredictable Exceptions to the Mere Contract View

Knott reveals only half of the story of current negative pledge covenant doctrine. The rest of the story, addressed in this section, is one of the courts trying rather clumsily to protect negative pledgees in cases where the subsequent secured party has knowledge or notice of the negative pledge covenant. Because Article 9 does not currently apply to these cases, judges have resorted to three other doctrines in order to protect negative pledgees: equitable lien, injunction, and liability of the secured party for tortious interference with contract.

All of these doctrines impose substantial costs on commercial actors, in part simply because they are judge made.⁴⁵ As often in common-law adjudication, case-by-case findings are a fine basis for post hoc individualized justice,⁴⁶ but the unpredictability of their applica-

the obligation of the owner remains unpaid seems, on the authorities, pretty clearly not to create any security interest in the promisee.").

⁴² See *Minderhout*, 392 P.2d at 265. For further discussion of this case see *infra* Part I.C.1.

⁴³ A "purely" negative pledge covenant (or "absolute" negative pledge covenant), such as those considered heretofore in this Article, simply bars some or all security interests, without additional (and often ambiguous) affirmative elements that more frequently support imposing an equitable lien. See *infra* notes 56-61 and accompanying text.

⁴⁴ Informed lenders are not, of course, surprised by the limited effectiveness of their covenants. Their real-world goals may often be satisfied, if only because the law's less than complete effectiveness has caused the lenders correspondingly to reduce their expectations.

⁴⁵ The remainder of Part I.C describes additional particular costs in connection with each doctrine.

⁴⁶ In the hoary words of Chief Justice Shaw:

It is one of the great merits and advantages of the common law, that, instead of a series of detailed practical rules, established by positive provisions, and adapted to the precise circumstances of particular cases . . . the common law consists of a few broad and comprehensive principles . . .

tion to future cases causes substantial cost and difficulty in business planning. Indeed, the cases in this area often constitute little more than dress-up, irreducible assertions that given conduct is "right" or "wrong."⁴⁷ As Grant Gilmore remarked of the theories of certain older cases, "These were no doubt so many ways of saying that the [negative pledgees] ought to recover because they ought to recover; the opinions in the series of cases make little progress toward an articulated theory."⁴⁸ Specifically, "right" conduct has been enforced through equity—that heartland of irreducible moral judgments—by means of equitable lien and, potentially, injunction. "Wrong" conduct has been redressed through tort, and specifically by means of the doctrine of tortious interference with contract. I discuss each of these three doctrines separately in the remainder of this section.

1. *Equitable Lien*

As the *Knott* court explained, the equitable lien is a creature of intent. A court imposes (or, in the *Knott* court's formalistic worldview, "recognizes"⁴⁹) an equitable lien when the parties, though intending to create a security interest, have failed to comply with the statutory formalities necessary to do so.⁵⁰ If a prior lender has an equitable lien and a later secured lender has notice or knowledge of it, then the later lender takes subject to it. The effect is to award the

[which] are rendered precise, specific, and adapted to practical use . . .
[particularly] by judicial exposition

Norway Plains Co. v. Boston & Maine R.R., 67 Mass. 263, 267 (1854).

⁴⁷ The term "dressed-up" is not entirely pejorative. As the text indicates, the courts have resorted to two basic notions. The first is equity, a word that derives from the Latin *aequitas*, meaning "equality" or "fairness." The second is tort, a word that, in Middle English, meant simply "wrong" or "inquiry." 18 OXFORD ENGLISH DICTIONARY 275 (2d ed. 1989). Thus the words carry, beneath the drapery of later refinements, the simple, frank, and powerful meanings right and wrong. "Language disguises the thought; so that from the external form of the clothes one cannot infer the form of the thought they clothe, because the external form of the clothes is constructed with quite another object than to let the form of the body be recognized." LUDWIG WITTGENSTEIN, TRACTATUS LOGICO-PHILOSOPHICUS ¶ 4.002 (C.K. Ogden ed., 1922).

⁴⁸ 2 GILMORE, *supra* note 31, § 38.3, at 1007; *see also* CLARK, *supra* note 23, ¶ 3.14[7], at 3-160 (remarking that in *First Wyoming Bank v. Mudge*, 748 P.2d 713 (Wyo. 1988), a tortious interferences with contract case, "the priority rules of Article 9 are mangled in the name of 'equity' and 'fairness'"). For a discussion of the *Mudge* decision, *see infra* Part I.C.3.

⁴⁹ *Knott*, 5 S.E. at 268.

⁵⁰ *See, e.g.*, *Adams v. Avirett*, 250 A.2d 891, 893 (Md. 1969); *Pennsylvania Oil Prods. Ref. Co. v. Willrock Producing Co.*, 196 N.E. 385, 387-88 (N.Y. 1935). The *Imbesi* court explained: "In the absence of a written contract construed to embody the full agreement of the parties, an equitable lien may be found only where the sum total of the circumstances of the dealings between the parties fairly may be said to evidence an intent to create such a lien." *Equitable Trust Co. v. Imbesi*, 412 A.2d 97, 102 (1980). "[I]n all . . . cases the intent to create a mortgage is the essential feature of the transaction." 1 LEONARD A. JONES, A TREATISE ON THE LAW OF MORTGAGES OF REAL PROPERTY 262 (8th ed. 1928).

prior lender all or part of what otherwise would have been the later lender's collateral.

Knott itself accordingly involved questions of intent, as the court recognized.⁵¹ But true to its formalist inclination, the court disposed of the intent question by looking solely to the "express[ly] negative" language of the agreement.⁵² A more modern court more likely would have looked to all relevant circumstances, including those lying outside the document.⁵³ Interestingly, on the facts of *Knott*, the more modern court would probably reach the same result:

The negotiations were carried on for some time before the loan was effected. It was at one time proposed to fix the amount of the loan at \$10,000, and secure it by a trust deed upon the property of the company. Pursuant to this proposition such deed was prepared and submitted to Knott, but upon his objecting to some of its conditions, this deed was canceled, and by agreement of the parties the amount of the loan was fixed at \$7,500, . . . and according to the final agreement between the parties, the company delivered to Knott an obligation [including the negative pledge covenant] which was accepted by him.⁵⁴

This quid pro quo could hardly be clearer: the borrower accepted a lower sum rather than encumber its property.⁵⁵ Thus, the court appears to have been entirely correct in holding that there was no intent to encumber. Though the court does not admit any reliance on these extrinsic facts, they must nonetheless have comforted the court as it reached the decision on narrower grounds.

The intent of borrowers and lenders is, unfortunately, rarely so clear, and a number of courts have held that a negative pledge covenant does give the negative pledgee an equitable lien on the property covered by the covenant. These cases usually have involved negative pledge clauses drafted in more elaborate language than that in *Knott*.

⁵¹ See *Knott*, 5 S.E. at 268.

⁵² *Id.*

⁵³ "[T]he meaning of a writing 'can only be found by interpretation in the light of all the circumstances that reveal the sense in which the writer used the words.' . . . Accordingly, rational interpretation requires at least a preliminary consideration of all credible evidence offered to prove the intention of the parties." *Pacific Gas & Elec. Co. v. G.W. Thomas Drayage & Rigging Co.*, 442 P.2d 641, 645 (Cal. 1968) (Traynor, J.) (quoting *Universal Sales Corp. v. California Press. Mfg. Co.*, 128 P.2d 665, 679 (Cal. 1942) (concurring opinion)). *But see* E. ALLAN FARNSWORTH, *CONTRACTS* § 7.12, at 475-76 (3d ed. 1998) (noting that the plain meaning approach to interpretation retains some vitality in the contracts field).

For cases finding an equitable lien despite the absence of corresponding contractual language, see ROBERT A. HILLMAN ET AL., *COMMON LAW AND EQUITY UNDER THE UNIFORM COMMERCIAL CODE* ¶ 19.03[2][c], at 19-27 n.106 (1985).

⁵⁴ *Knott*, 5 S.E. at 266.

⁵⁵ Such an arrangement provides one example of the kind of bargaining dynamics that are sketched *infra* in Part I.E.

In an unusually sharp oxymoron, commentators sometimes call these more elaborate covenants "affirmative negative pledge covenants,"⁵⁶ as distinguished from the "purely negative" ones heretofore discussed. Like purely negative ones, affirmative negative pledge covenants prohibit encumbrances, but they also set forth a further element of one of two types. The first type affirmatively covenants that if the borrower gives security for a loan from a third party, then the borrower will equally and ratably secure the negative pledgee. The second type provides that, notwithstanding the covenant's general prohibition on encumbrances, an encumbrance is permitted if, by its own terms, it gives equal and ratable security to the negative pledgee (although this type of clause itself neither explicitly imposes any lien nor promises to do so).

One must analyze the two types of affirmative negative pledge covenants differently. The language of the first type seems clearly to bespeak an intent to grant the negative pledgee an interest in property, albeit only upon a contingency, as a bargained-for remedy for a wrong. Thus, it is not surprising that courts do impose equitable liens in cases involving these clauses.⁵⁷ By contrast, the language of the

⁵⁶ See, e.g., Matthew H. Hurlock, *New Approaches to Economic Development: The World Bank, the EBRD, and the Negative Pledge Clause*, 35 HARV. INT'L. L.J. 345, 348 (1994); Jonathan Stone, *The "Affirmative" Negative Pledge*, 1991 NEW ZEALAND L.J. 364; see also Steven L. Schwarcz, *The Easy Case for the Priority of Secured Claims in Bankruptcy*, 47 DUKE L.J. 425, 451-52 (1997) (discussing use of such covenants in public debt, where waivers may be difficult to obtain).

⁵⁷ See, e.g., *Connecticut Co. v. New York, New Haven and Hartford R.R.*, 107 A. 646, 652-57 (Conn. 1919). Even this case, however, was decided by a three-to-two vote (insofar as the equitable lien was concerned). The dissenters' reasoning is not reported, but a contemporary commentator remarked of the case that an equitable lien "could hardly have been within the intent of the parties." Note, *Effect in Equity of a Conditional Contract to Mortgage*, 33 HARV. L. REV. 456, 457 (1920).

See also *Citibank, N.A. v. Export-Import Bank of the United States*, No. 76 Civ. 3514 (CBM) (S.D.N.Y. filed Aug. 9, 1976) (involving a suit based on this theory concerning loans made to the Republic of Zaire). For a discussion of the case, see Lee C. Buchheit & Ralph Reisner, *The Effect of the Sovereign Debt Restructuring Process on Inter-Creditor Relationships*, 1988 U. ILL. L. REV. 493, 499.

With work, one could obtain a result similar to the imposition of an equitable lien through the UCC's own rules (as opposed to the UCC's accommodation of other law, see *infra* note 71 and accompanying text). Reaching this result would involve favoring a negative pledgee with a security agreement specifying that (1) only a pro rata portion of the debt is to be secured and (2) attachment is delayed until such time as a third party acquires a security interest. See U.C.C. § 9-203(2) (1995). Under the perfection principle, the third party would ordinarily take free of this security interest unless the negative pledgee had previously filed a financing statement. Cf. Coogan et al., *supra* note 41, at 265-66 (opposing a proposal that security interests arising from affirmative negative pledge covenants be excluded from Article 9 because of burden on indenture trustees). This approach and a true equitable lien differ in that the latter requires actual notice or knowledge, see *infra* note 73 and accompanying text, in place of Article 9's more formalized and less fact-intensive dependence on constructive notice as discussed *infra* in Part I.D. In that respect, this Article's proposal harmonizes with Article 9 rather than with equitable lien doctrine. See *infra* Part II.A.

second type of clause seems to be, from plaintiffs' point of view, at best unclear about the parties' intent⁵⁸ and, at worst a mere exception to the negative pledge covenant.⁵⁹ Under this common-sense reading of the second type of affirmative negative pledge covenant, the borrower who grants a security interest that the carve-out does not permit simply breaches a contract in a way for which the sole bargained-for remedy is damages.⁶⁰ Nonetheless, several courts have held that clauses of the second type, too, give rise to equitable liens.⁶¹ These cases are quite troubling because no reason, other than the obvious and unpersuasive linguistic one, distinguishes them from the cases denying equitable liens in the "purely negative" covenant cases discussed above.

⁵⁸ "Undoubtedly to the nonlegal mind the formula 'if we do x, we will do y' and the formula 'we will not do x unless we do y' come to the same thing. To the legal mind, trained since infancy to distinguish between conditions precedent and conditions subsequent, the two formulas might seem as different as day and night."

² GILMORE, *supra* note 31, § 38.2, at 1002.

Some observers believe that negative pledge covenants attract duplicitous drafting, a point that makes the notion of an actual joint lender and borrower intent even more dubious here than in other contractual matters. See, e.g., *Connecticut Co.*, 107 A. at 652 ("[T]he intent to charge the property with the performance of the obligation is apparent, or else the covenant is a mere blind calculated to create expectations and confidences which the maker has no intention of carrying out."); Note, *Restrictive Covenants in Debentures: The Insull Case*, 49 HARV. L. REV. 620, 631 ("Under the [District Court] decision in [*Kelly v. Central Hanover Bank & Trust Co.*, 11 F. Supp. 497 (S.D.N.Y. 1935), remanded by 85 F.2d 61 (2d Cir. 1936)], such covenants are grossly deceptive, giving the debenture the appearance of a bond without the legal protection its holders are led to anticipate."). Indeed, based in part on the events of the *Kelly* case, the youthfully ambitious Securities and Exchange Commission concluded that "[p]erhaps negative pledge clauses in securities should be outlawed." SECURITIES AND EXCHANGE COMMISSION, REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES 15 (1936).

⁵⁹ See PETER GABRIEL, LEGAL ASPECTS OF SYNDICATED LOANS 90 (1986) (discussing U.K. law); Stone, *supra* note 56, at 368 (discussing New Zealand law). For further discussion of exceptions to negative pledge covenants, see *supra* note 14.

⁶⁰ In other words, the legal issue is the same as that posed by the purely negative covenants in *Knott* and the cases cited *supra* in note 40. The legal response should thus normally be denial of an equitable lien, as it was in those cases.

⁶¹ See *Kelly v. Central Hanover Bank & Trust Co.*, 85 F.2d 61, 63 (2d Cir. 1936) (implying conclusion that plaintiff had established the intent element of equitable lien claim by remanding for determination of other facts related to the claim); *Kaplan v. Chase Nat'l Bank*, 281 N.Y.S. 825, 827 (Sup. Ct. 1934); *Chase Nat'l Bank v. Sweezy*, 281 N.Y.S. 487, 493 (Sup. Ct. 1931), *aff'd mem.*, 259 N.Y.S. 1010 (App. Div. 1932), *aff'd mem.*, 185 N.E. 803 (N.Y. 1933). These cases are explored in some detail in 2 GILMORE, *supra* note 31, § 38.2, at 1000-07.

The lack of persuasive reasoning in these cases, coupled with the fact that they were brought by public debenture holders in the Depression, led Gilmore to conclude that they were simply result-driven: "Reasons of public policy no doubt explain the favorable treatment accorded to the debenture holders; the courts tempered the depression winds to these shorn lambs of the affluent society of the 1920's." 2 *id.* § 38.4, at 1015.

Even more troubling is *Coast Bank v. Minderhout*,⁶² a noted case in which the California Supreme Court, led by Justice Traynor, held that a purely negative pledge covenant—one with no affirmative aspect at all—could create an equitable lien.⁶³ The plaintiff, Coast Bank, had made a series of loans to the Enrights in exchange for promissory notes accompanied by an “Agreement not to Encumber or Transfer” a particular piece of land that the Enrights wished to use the loans to improve.⁶⁴ The Enrights later sold the land to Minderhout, who admitted that he had knowledge of the agreement, and Coast Bank sued “to foreclose the equitable mortgage”⁶⁵ that it claimed the agreement had created. Inexplicably, Minderhout demurred to Coast Bank’s allegation that the Enrights and Coast Bank had intended to create a lien on the land, and procedure accordingly required the court to accept the allegation so long as the pleaded meaning was one to which the agreement was “reasonably susceptible.”⁶⁶ The court held that the agreement was, indeed, reasonably susceptible to being read as intending to create a lien. In support of this conclusion, the court cited a weak handful of facts, the only faintly plausible of which was that the agreement authorized Coast Bank to record it.⁶⁷

The effect of *Minderhout* has always been limited by its peculiar procedural posture, and has also been limited, if only tacitly, by a later case.⁶⁸ Nonetheless, the influence of the deciding court, coupled with the opinion’s relatively modern vintage, highlights the fact that actors in today’s commercial transactions have reason to remain concerned with the imposition of equitable liens. For one thing, a steady stream of reported cases reveals negative pledgees trying for the same good luck that Coast Bank had.⁶⁹ Moreover, reported cases do not provide a reliable barometer of the amount of conflict in this area; instead,

⁶² 392 P.2d 265 (Cal. 1964).

⁶³ See *id.* at 265.

⁶⁴ The central language of the agreement was simple: “[Borrower] will not . . . create or permit any lien or other encumbrances (other than those presently existing and/or securing the payment of loans and advances made to them by Bank) to exist on said real property . . .” *Id.* at 266 n.2. The agreement also contained a covenant not to convey the property. See *id.*

⁶⁵ *Id.* at 266.

⁶⁶ *Id.* at 267.

⁶⁷ The other facts relied on were perfectly consistent with an intent to create no lien: the agreement restricted the rights of the borrower in dealing with the property for the lender’s benefit, described itself as “For use with Property Improvement Loan,” and specifically described the property covered. *Id.*

⁶⁸ In *Tahoe National Bank v. Phillips*, 480 P.2d 320 (Cal. 1971), the court held (over a vigorous dissent) that an agreement very similar to that in *Minderhout* was not reasonably susceptible to construction as a mortgage. The court distinguished *Minderhout* principally by emphasizing that in that case, the borrower had breached its obligation not to convey the property, “confront[ing] the court with a difficult problem in fashioning a remedy,” while in the case then at bar, the borrower had not. *Id.* at 328.

⁶⁹ These attempts are generally unsuccessful. See *supra* text accompanying note 42.

these claims tend to settle, particularly when the negative pledgee and the secured party are repeat players in the lending market and belong to a common network of business relationships.⁷⁰ And finally, Article 9 at least arguably preserves the life of the equitable lien; even the perfection principle, that fundamental idea that a perfected security interest is effective against creditors, may be vitiated by the Code's preservation of "principles of equity."⁷¹ Since the advent of Article 9, there appear to have been no reported cases imposing equitable liens due to negative pledge covenants, but rational actors can justifiably expect it to be only a matter of time.

Secured lenders must therefore investigate their prospective borrowers' prior activity, not only to discover perfected security interests (a task that Article 9's filing system supposedly makes simple) but also

⁷⁰ See Buchheit & Reisner, *supra* note 57, at 499 ("The common and largely correct assumption is that these matters are usually sorted out over lunch at the local banker's club.").

⁷¹ "Unless displaced by the particular provisions of [the UCC], the principles of law and equity . . . shall supplement its provisions." U.C.C. § 1-103 (1995).

Official Comment 5 to U.C.C. § 9-203 purports to displace equitable lien doctrine, at least insofar as that doctrine would permit a lien to be found in the absence of a signed agreement creating it. See U.C.C. § 9-203 cmt. 5; see also *Shelton v. Erwin*, 472 F.2d 1118, 1120 (8th Cir. 1973) ("Although no precise words are required in the Code, the definitions given indicate that there must be some language in the agreement actually conveying a security interest."). However, this reasoning has little impact on equitable liens founded on negative pledge covenants because such covenants almost invariably appear in signed agreements. Moreover, even when no signed agreement exists, it is "off base" to believe that § 9-203's displacement of equitable lien doctrine is absolute. HILLMAN ET AL., *supra* note 53, ¶ 19.03[2][c], at 19-21. Gilmore himself admits that in writing Comment 5, he "overshot the mark." 1 GILMORE, *supra* note 31, § 11.4, at 345. Among other things, to the extent that U.C.C. § 9-203 continues to impose formal requirements on the creation of security interests, equitable liens retain their time-honored function of vindicating the parties' intent. See HILLMAN ET AL., *supra*, note 53, ¶ 19.03[2][c].

With respect to third parties, courts have occasionally been known to use equitable liens to change the priorities that would otherwise result from Article 9's "pure race" system. See, e.g., *General Ins. Co. of America v. Lowry*, 412 F. Supp. 12, 14 (S.D. Ohio 1976), *aff'd*, 570 F.2d 120 (5th Cir. 1978) ("Although courts should hesitate to invoke equity powers to disturb the operation of a statute, nothing in the Uniform Commercial Code precludes the imposition of an equitable lien in narrowly-circumscribed situations."). Nothing prevents courts from applying this theory more broadly to protect negative pledgees against perfected secured parties. Indeed, Gilmore assures us that courts will expand the doctrine, at least with respect to affirmative negative pledge covenants:

We might pause, in brief nostalgia, to inquire whether Article 9 has somehow affected the humanitarian result which the courts reached in the 1920's and 1930's in construing [affirmative negative pledge covenants] [W]e can be sure that a later generation of debenture holders will fare no worse, § 9-311 to the contrary notwithstanding, than did their predecessors in the financial wasteland of the great depression.

2 GILMORE, *supra* note 31, § 38.5, at 1019.

On equitable liens and U.C.C. § 1-103 in general, see HILLMAN ET AL., *supra* note 53, ¶¶ 19.03, 24.05; 4 JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE § 33-20 (4th ed. 1995); Steve H. Nickles, *Rethinking Some U.C.C. Article 9 Problems—Subrogation; Equitable Liens; Actual Knowledge; Waiver of Security Interests; Secured Party Liability for Conversion Under Part 5*, 34 ARK. L. REV. 1, 41-103 (1980).

to discover negative pledge covenants.⁷² This investigation is particularly crucial because the uncertainty flowing from possible oversights may cause particular harm to asset-based lenders, that is, those who extend credit based largely on the value of collateral rather than on the borrower's general business health. Compelling an asset-based lender to share even a small portion of its collateral with an unexpected equitable lienor can upset the rationality of an entire transaction.

An equitable lien does not usually bind a third party without notice or knowledge thereof,⁷³ and one might think that this rule would spare prospective secured lenders the burden of investigation. However, when the prospective lender is a business enterprise of some size, one cannot predict what notice or knowledge on the part of which individuals a court might impute to the lender as an entity. Rarely can a prospective lender evaluate all of its representatives' past conversations with all of the borrower's representatives (let alone with competitors of or prior lenders to the borrower), not to mention its familiarity with the usual financing patterns of entities in the borrower's business sector,⁷⁴ closely enough to feel confident that it has no notice or knowledge of a negative pledge covenant.⁷⁵ In addition,

⁷² The investigation process is sometimes called "due diligence," borrowing the colloquial term with which securities underwriters refer to their investigations taken in response to § 11(b)(3) of the Securities Act of 1933. The term is not a reference to U.C.C. § 1-201(27), discussed *infra* in note 75.

⁷³ See, e.g., *Sayers & Scovill Co. v. Doak*, 89 So. 917, 918 (Miss. 1921); 4 JOHN NORTON POMEROY, A TREATISE ON EQUITY JURISPRUDENCE § 1235, at 696 (4th ed. 1941) (stating that "an equitable lien . . . is enforceable against the property in the hands of . . . purchasers or incumbrancers with notice"). The notice referred to is presumably of the lien itself or of the parties' intent to create it. Because Article 9 and similar public notice statutes do not cover equitable liens, formalized constructive notice rules are inapplicable, and the concept of notice tends to blur into the concept of knowledge.

Similarly, equitable liens are ineffective against a bankruptcy trustee. See 11 U.S.C. § 544(a)(3) (1994); *Shubert v. Jeter* (*In re Jeter*), 171 B.R. 1015, 1021 (Bankr. W.D. Mo. 1994), *aff'd*, 73 F.3d 205 (8th Cir. 1996); HILLMAN ET AL., *supra* note 53, at 19-19 n.94.

⁷⁴ See U.C.C. § 1-201(25) (providing that a person has notice of a fact when "from all the facts and circumstances known to him at the time in question he has reason to know that it exists," or when he knows of it or has been notified of it). The UCC's provisions on notice do not directly apply to equitable liens, but UCC principles often influence adjoining areas of the law. See, e.g., 1 ARTHUR LINTON CORBIN, CORBIN ON CONTRACTS § 1.22 (Joseph M. Perillo rev. ed., 1993). As Gilmore remarks in a different context, "It would not . . . be surprising if these common law rules tended to become identical with the statutory rules. This type of statutory radiation beyond the precisely defined limits of coverage is a not uncommon and a desirable phenomenon." 1 GILMORE, *supra* note 31, § 10.7 at 315.

⁷⁵ The UCC's provision concerning organizations' notice of facts (which, again, might be applied to the field of equitable liens) is of little guidance:

Notice, knowledge or a notice or notification received by an organization is effective for a particular transaction from the time when it is brought to the attention of the individual conducting that transaction, and in any event from the time when it would have been brought to his attention if the organization had exercised due diligence. An organization exercises due diligence if it maintains reasonable routines for communicating significant

a secured lender's "pure heart, empty head" defense may seem feeble when weighed after the fact against the forceful equitable claims of an injured negative pledgee.

The prospective lender's investigation can involve substantial costs. The lender's and the borrower's time, not to mention that of their attorneys, is expensive,⁷⁶ and any legal doctrine that imposes such a dead weight on common commercial transactions is *prima facie* open to objection. At least as troubling as the expense, however, is the uncertainty of result that usually emerges from the investigation: most established business borrowers will indeed be subject to a number of negative pledge covenants, and although the prospective lender can vet these covenants to ensure that none of them contains affirmative elements, the lender cannot feasibly go much further than that in discerning the borrower's and prior lender's intent.⁷⁷ Courts deciding whether to impose equitable liens may have the luxury of considering extrinsic evidence—whether or not formally admissible⁷⁸—but this evidence is generally unavailable to a prospective

information to the person conducting the transaction and there is reasonable compliance with the routines. Due diligence does not require an individual acting for the organization to communicate information unless such communication is part of his regular duties or unless he has reason to know of the transaction and that the transaction would be materially affected by the information.

U.C.C. § 1-201 (27).

⁷⁶ One source of attorney cost is the opinion of counsel. Many commercial lending transactions require, as a condition precedent to closing, that the borrower's attorneys deliver an opinion letter to the effect that, among other things, the transaction will not violate the borrower's prior contracts (including negative pledge covenants therein) and will not "result in the creation or imposition of any lien, charge, encumbrance on, or security interest in, any assets" of the borrower. Philip R. Lochner, Jr., *Legal Opinions on Corporate Matters* 29, 79, in *DRAFTING LEGAL OPINION LETTERS* (M. John Sterba ed., 1988); see also SCOTT FITZGIBBON & DONALD W. GLAZER, *FITZGIBBON & GLAZER ON LEGAL OPINIONS IN FINANCIAL TRANSACTIONS* §§ 16.3, 16.4 (1992) (addressing legal opinions that the transaction does not violate other agreements or result in liens on property). The quoted opinion becomes easy to give with respect to equitable liens once the attorney has concluded that no negative pledge covenants are being violated, but this latter conclusion can be difficult and costly to reach.

⁷⁷ Theoretically, a prospective lender could reach beyond the written agreement by means of U.C.C. § 9-208, which binds a secured party to its response to the debtor's inquiry about collateral. See HILLMAN ET AL., *supra* note 53, at 19-28 n.109. However, it is one thing to expect the prospective lender to invoke this procedure with respect to existing lenders who are clearly secured parties, and another thing to ask it to do so with respect to all existing negative pledgees (or, indeed, all unsecured creditors) of the borrower. Apart from the delay (U.C.C. § 9-208 gives the existing lender up to two weeks to respond) and labor involved, the debtor may well resist directing so many of its unsecured lenders' attention directly to its need for further, secured credit. Thus, as a practical matter, the U.C.C. § 9-208 procedure is rarely used in this setting.

⁷⁸ See *Tahoe Nat'l Bank v. Phillips*, 480 P.2d 320, 332 (Cal. 1971) (dissenting opinion) (discussing the negotiation history); *Orange County Teachers Credit Union v. Peppard*, 98 Cal. Rptr. 533, 538 (Ct. App. 1971) (assuming negative pledgee's testimony to be admissible but finding it insufficient to establish intent to grant lien); *Connecticut Co. v. New York, New Haven and Hartford R.R.*, 107 A. 646, 656-57 (Conn. 1919) (considering legisla-

lender. It is one thing to be on notice of a covenant's contents, but quite another and more nebulous thing to be on notice of the covenanting parties' intent. Thus, the prospective lender remains vulnerable, despite its efforts to protect itself against a third party who may never assert a claim.

Equitable liens are not bad things: they offer important leeway for courts to reach right results under otherwise impermissible circumstances.⁷⁹ They are, nonetheless, markedly at odds with commercial law's important value of predictability,⁸⁰ especially when their specter haunts purely negative pledge covenants. This Article's proposal, by contrast, can reach results that are at least as "right" as those that the equitable lien cases reach, while at the same time preserving predictability.⁸¹

tive committee testimony and Public Utilities Commission filings); *Knott v. Shepherdstown Mfg. Co.*, 5 S.E. 266, 266 (W. Va. 1888) (reciting negotiation history). *But see* *Equitable Trust Co. v. Imbesi*, 412 A.2d 96, 106-07 (Md. 1980) (rejecting extrinsic evidence); *Weaver v. Tri City Credit Bureau*, 557 P.2d 1072, 1076-77 (Ariz. Ct. App. 1976) (rejecting extrinsic evidence but, as a factor in construing negative pledge, considering legal prohibition on negative pledgee holding a junior mortgage). Depending on the jurisdiction, extrinsic evidence will generally be used for purposes of interpretation whenever the court finds the contract to be ambiguous; the court may make the threshold decision about ambiguity before considering the extrinsic evidence, *see, e.g.*, *Steuart v. McChesney*, 444 A.2d 659, 661 (Pa. 1982), or afterwards, *see, e.g.*, *Pacific Gas & Elec. Co. v. G.W. Thomas Drayage & Rigging Co.*, 442 P.2d 641, 644 (Cal. 1968) (Traynor, J.).

⁷⁹ *See* 1 GILMORE, *supra* note 31, § 11.1, at 336 ("[I]f the equitable lien . . . had not existed, it would have been necessary to invent it; if the Code in some sense abolishes the equitable lien, it will have to be invented all over again."); 1 *id.* § 11.4, at 345 ("[T]he choice [cannot] be reduced to the simple one between a Code security interest and nothing . . ."); HILLMAN ET AL., *supra* note 53, at ¶ 19.03[2][c].

⁸⁰ *See* HILLMAN ET AL., *supra* note 53, ¶ 19.03[2][c][ii], at 19-29 to 19-31 (recognizing the predictability point but viewing effectuation of parties' intent as a stronger value). Professor White holds it

[b]etter to leave an occasional widow penniless by the harsh application of the law than to disrupt thousands of other transactions The saved costs that would otherwise be spent in negotiations and preparation of deals and in contention and litigation after the fact should not be underestimated. . . . [P]itiful strays such as . . . the equitable lien . . . carry the lice that will infect us all.

⁴ WHITE & SUMMERS, *supra* note 71, § 33-20 at 377.

⁸¹ *See infra* Part II. Gilmore laments that under current law,

[B]eyond the area of the institutionalized transaction, there stretches a no-man's land, in which strange creatures do strange things. For these strange things there are no rules; it makes no sense to measure them against the rules which professionals have developed for professional transactions. The best that can be done is to let the courts pick their way from case to case, working out their solutions ad hoc and ad hominem.

¹ GILMORE, *supra* note 31, § 11.1, at 337. My proposal would rationalize Gilmore's no-man's land, letting borrowers and negative pledgees enforce their heretofore "strange creatures" with greater predictability. As a result, these creatures may become part of Gilmore's "institutionalized transaction."

Despite this greater enforceability, the certainty interests of third parties would remain protected. One should note that the proposal's effect on third party interests would be harsher than under equitable lien doctrine (subordinating them to the full extent of the

2. Injunction

Negative pledgees may often be entitled to injunctions against grants of security interests in covered property.⁸² No reported case appears to have reached a holding on the matter,⁸³ but this is unsurprising for two reasons. First, the negative pledgee may not learn of the security interest until after the debtor has granted it, making an injunction proceeding moot. Second, a prospective secured lender's profits are largely fungible. Thus, at the first indication that a negative pledgee objects to the impending secured transaction, the prospective secured lender is likely to abandon it in favor of a less contentious substitute transaction.⁸⁴ The costs of even a short round of litigation can easily exceed the profits that a prospective secured lender might earn from the contested transaction.

Standard transaction documentation further confirms that lenders avoid transactions in which they foresee litigation—even litigation in which they would likely prevail. Lending agreements commonly require the borrower to represent to the lender something to the ef-

negative pledgee's debt rather than a pro rata portion thereof), but this consequence follows from fidelity to the *nemo dat* principle. See *infra* Part II.A.

⁸² The only question here is whether the negative pledgee has an adequate remedy at law. The negative pledgee that is denied an injunction can, of course, sue for damages for violation of the covenant, but as discussed in Part I.A, if many or all of the borrower's assets are encumbered and the proceeds of the secured loan are dissipated, the damages will not be collectible.

On whether a right to uncollectible damages constitutes an adequate remedy at law, the cases are mixed, but the modern trend is to hold that it does not, making injunctions available. See DAN B. DOBBS, *LAW OF REMEDIES* 86-97 (2d ed. 1993); DOUGLAS LAYCOCK, *THE DEATH OF THE IRREPARABLE INJURY RULE* (1991); Thomas C. Mitchell, *The Negative Pledge Clause and the Classification of Financing Devices: A Question of Perspective*, 60 *AM. BANKR. L.J.* 153, 168-72 (1986) (collecting authorities and arguing for the availability of injunction); cf. *Knott*, 5 S.E. at 269 (holding that for equitable lien purposes, a suit for uncollectible damages is an adequate remedy at law; "courts do not provide the means to pay debts, but only the means of enforcing their payment. Whether the debtor is solvent or insolvent is immaterial").

⁸³ The courts' brief discussions of injunctions to protect negative pledgees have appeared exclusively in the equitable lien cases. See, e.g., *Coast Bank v. Minderhout*, 392 P.2d 265, 268 (Cal. 1964) (stating that enforcement by injunction of a negative pledge covenant or covenant not to transfer "is another question. It is open to doubt whether such a promise would be a reasonable restraint when, as in this case, plaintiff had the additional protection of a security interest and the right to declare the entire debt due in the event of default"); *Chase Nat'l Bank v. Sweezy*, 281 N.Y.S. 487, 491 (Sup. Ct. 1931) ("It cannot be gainsaid, however, that the debenture holders could have secured injunctive relief against a proposed violation of the covenant by the company. The fact that the contingency has already occurred should not defeat their rights . . ."), *aff'd mem.*, 259 N.Y.S. 1010 (App. Div. 1932), *aff'd mem.*, 185 N.E. 803 (N.Y. 1933); *Knott*, 5 S.E. at 269 ("It is possible the plaintiff might, by injunction, have restrained the company from executing any trust deed in violation of its covenant; but this suit is for no such purpose, and it is therefore unnecessary to consider that question.").

⁸⁴ Exceptions to this pattern would emerge in cases in which demand for the lender's funds is low or when the borrower is able to propose a three-way peace treaty.

fect of the following: "there is no threatened or pending action that may materially adversely affect the ability of the Borrower to perform its duties under the loan and security agreements."⁸⁵ The opinion of borrower's counsel, required as a condition to the closing of lending transactions, typically includes similar assurances.⁸⁶

When litigation prevents or, more likely, leads the lender to abandon a transaction, all of the time, effort, and other expenses that the parties have theretofore put into it become losses. Well-drafted commitment letters generally shift these losses to the prospective borrower,⁸⁷ but whichever party bears the loss, it remains a disadvantage of current law.

3. *Liability for Tortious Interference with Contract*

No lender wants unexpectedly to become a debtor, especially a judgment debtor. Tort liability can disrupt lender expectations even more than sharing collateral pursuant to an equitable lien or than having an injunction prevent the consummation of a transaction.

Such a fate is precisely what befell at least one modern lender that took a security interest in violation of a negative pledge covenant. In *First Wyoming Bank v. Mudge*,⁸⁸ the Mudge family sold its welding business to Redding and, as protection during Redding's completion of delayed payments for the business, obtained from him a negative pledge covenant covering the business's assets.⁸⁹ Shortly thereafter, Redding violated the covenant by giving First Wyoming Bank a security interest in the business's equipment and inventory as part of an unrelated loan transaction. The jury found that the bank had knowledge of the negative pledge covenant⁹⁰ and had damaged the Mudges

⁸⁵ See, e.g., STERN, *supra* note 14, ¶ 3.09[1], at 3-27 (presenting typical language).

⁸⁶ See, e.g., FITZGIBBON & GLAZER, *supra* note 76, § 17.1, at 485 ("To the best of our knowledge after due inquiry there are no pending or overtly threatened actions or proceedings affecting the Borrower . . . which purport to affect the legality, validity, binding effect or enforceability of the Loan Agreement or any of the Notes. . . .").

⁸⁷ See STERN, *supra* note 14, ¶ 1.08[9], at S1-43.

⁸⁸ 748 P.2d 713 (Wyo. 1988).

⁸⁹ The covenant was purely negative, that is, it contained neither variety of affirmative negative pledge language discussed above. See *id.* at 714-15.

⁹⁰ The Wyoming Supreme Court upheld the denial of the bank's motion for a directed verdict on the knowledge issue, somewhat facilely (although probably properly in light of the procedural posture). The court observed that (1) Redding's loan file contained an unsigned copy of the agreement containing the negative pledge covenant and (2) the bank's president had testified that, as a matter of policy, the bank would want to examine the agreement based on the size of the welding business and the size of the bank loan. See *id.* at 716. These facts, in combination with appellate courts' usual deference to factual determinations made by a jury, caused the court to leave the verdict undisturbed.

The jury's decision is easier to fault than the appellate court's, and the details serve as a useful reminder of how difficult it can be to determine who knows what and when. The date that the bank received the agreement was a matter of dispute, and so was the identity of the bank officers who had seen it. See *id.* at 715. Depending on the evidence, arguments

by intentionally and unjustifiably interfering with Redding's obligations to them. The jury accordingly reached a verdict against the bank. On appeal, the state supreme court upheld the verdict.⁹¹

Although *Mudge* seems to be the only reported case of its kind to date, it is no aberration. Commentators have long taken this tort seriously in the context of negative pledge covenants.⁹² Whether a court will find tortious interference on any given set of facts remains nebulous enough⁹³ to encourage negative pledgees' attorneys to feel relatively free to press their luck, and the opportunity for a large jury verdict, complete with punitive damages,⁹⁴ provides them with an in-

could also have been made that (1) "seeing" a document is not the same as reading it and understanding its contents, and (2) because the copy of the loan agreement was unsigned, whoever did see it supposed it to be a draft.

⁹¹ See *id.* at 717-18.

⁹² For early discussions, see Zechariah Chafee, Jr., *Equitable Servitudes on Chattels*, 41 HARV. L. REV. 945, 969-77 (1928); Francis W. Jacob, *The Effect of Provision for Ratable Protection of Debenture Holders in Case of Subsequent Mortgage*, 52 HARV. L. REV. 77, 108-16 (1938); see also 2 GILMORE, *supra* note 31, § 38.4, at 1016 ("The outer boundaries of *Lumley v. Gye* [, 188 Eng. Rep. 749 (Q.B. 1853),] have never been precisely mapped: its domain should certainly not include . . . the area we have been exploring."). *Lumley v. Gye* is a seminal case in the area of tortious interference with contract that grew out of the even more well-known case of *Lumley v. Wagner*, 42 Eng. Rep. 687 (Ch. 1852), in which the court declined to enjoin opera singer Johanna Wagner from singing at the theater of plaintiff's rival.

More recent commentators include LoPucki, *supra* note 9, at 1927; Jonathan Stone, *Negative Pledges and the Tort of Interference with Contractual Relations*, 1991 NEW ZEALAND L.J. 411.

⁹³ Tortious interference with contract is

a rather broad and undefined tort in which no specific conduct is proscribed and in which liability turns on the purpose for which the defendant acts, with the indistinct notion that the purposes must be considered improper in some way . . . [T]he courts have more or less continuously expanded the tort, with the effect, perhaps, that the uncertainties in its definition have become more rather than less significant.

W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS 991 (5th ed. 1984).

Suits can evidently succeed based on a fairly weak showing of "knowledge," as illustrated by *Mudge* itself. See *supra* note 90. A fairly weak showing of "improper interference" can also pass muster, as illustrated by the multi-factor balancing test that many courts employ. See RESTATEMENT (SECOND) OF TORTS § 767 (1979) (balancing the nature of the conduct, the motive, the competing interests of plaintiff and defendant, the competing social interests, the proximity of the defendant's conduct to the interference, and the relations of the parties). Naturally, any doctrine depending on an actor's actual knowledge or purpose tends to exacerbate uncertainty. For example, how does one determine where strong suspicion ends and actual knowledge begins?

Alan Schwartz surmises that few tortious interference actions are brought by negative pledgees because "the later lender . . . must induce the breach rather than lend to a debtor that had already decided to breach. Most debtors that approach later lenders have already made the breach decision." Schwartz, *supra* note 10, at 210 n.5. However, predicated upon tortious interference liability is "intentional and improper interference," of which inducement is only one variety. See *Mudge*, 748 P.2d at 715; RESTATEMENT (SECOND) OF TORTS § 766.

⁹⁴ "Since the tort [of intentional interference with contractual relations] is an intentional one, punitive damages are recovered in these actions under appropriate circumstances." RESTATEMENT (SECOND) OF TORTS § 774A, cmt. a.

centive to continue their efforts.⁹⁵ As a result, prospective lenders face another reason to undertake the costly and inconclusive investigation of borrowers that is described above.⁹⁶ Prospective lenders are both overdeterred by the threat of a large judgment and underdeterred by the tort device's cumbersome dependence on litigation.

D. Third-Party Notice as a Crucial Element of Both Negative Pledge Law and Article 9

The foregoing survey of the case law reveals that, contrary to the traditional view, negative pledge covenants and security interests are closely akin in one important, structural way. A single principle accounts for the effect, or lack thereof, of both devices: the need to protect third parties who are without notice of the fact that the borrower and lender are using the device. This section first briefly reviews the importance of third-party notice under Article 9 and then shows that third-party notice plays a parallel role under the current law of negative pledge covenants. It concludes with a preliminary discussion of how this Article's proposal to make perfected negative pledge covenants enforceable against subsequent secured parties would remain consistent with these concerns.

Perfection is the keystone of Article 9's edifice of protection for secured parties, and the steps that Article 9 requires for perfection are generally designed to afford to third parties notice of the security interest.⁹⁷ Requiring a secured party to give notice of its interest protects third parties against the debtor's fraudulent assertion that a competing interest was previously conveyed to a secured party,⁹⁸ reduces the evidentiary burdens of establishing priority,⁹⁹ and may protect certain third parties from extending credit on the presumption that the debtor's property is unencumbered.¹⁰⁰ The more lend-

⁹⁵ For example, attorneys for Citibank asserted this cause of action in the Zaire litigation referred to *supra* in note 57. One can see other evidence of these continuing attempts in the creative efforts of some lawyers to use the Article 9 filing system to infect searchers with the knowledge that is an element of the tort. See *infra* note 119.

⁹⁶ See *supra* notes 72-78 and accompanying text.

⁹⁷ These steps, and some limitations on the general principle stated in the text, are briefly discussed *infra* in note 109.

⁹⁸ See Charles W. Mooney, Jr., *The Mystery and Myth of "Ostensible Ownership" and Article 9 Filing: A Critique of Proposals to Extend Filing Requirements to Leases*, 39 ALA. L. REV. 683, 750 (1988); cf. *Twyne's Case*, 76 Eng. Rep. 809 (Star Ch. 1601).

⁹⁹ See Mooney, *supra* note 98, at 751.

¹⁰⁰ Perfection thus shares a concern with the doctrine of equitable estoppel, which would allow a secured party to take priority over the interest of a prior secured party if the latter created an appearance of nonencumbrance on which the former justifiably and detrimentally relied. See ABRAM I. ELKUS & GARRARD GLENN, *A TREATISE ON SECRET LIENS AND REPUTED OWNERSHIP* §§ 38-52, at 29-38 (1910). As implemented by Article 9, however, the concept's kinship with equitable estoppel is diminished, because Article 9 has dispensed with questions of reliance, justifiable or otherwise, in this context. This move is consistent

ers and other commercial actors need to concern themselves with facts that are difficult to determine, the less readily they will engage in transactions.¹⁰¹ Article 9 attempts to preclude these problems by pro-

with commercial law's general impulse toward minimizing factual inquiries, *see infra* note 101.

In the absence of a filing or other recognized perfection step (notably possession by the secured party), would the third party actually conclude that the collateral was unencumbered? Even if so, would the third party's conclusion be justifiable? These questions raise the question of ostensible ownership. (The verb "to ostend," now rare, means "to show, reveal; to manifest, exhibit." 10 OXFORD ENGLISH DICTIONARY, *supra* note 47, at 971. The link to the more common English word "ostentatious" is clear.) Some scholars suggest that Article 9's perfection requirements are justifiable by reference to the idea of ostensible ownership, that is, that the law should facilitate a presumption that the possessor of property owns it unless there is notice to the contrary. The leading work here is Douglas G. Baird & Thomas H. Jackson, *Possession and Ownership: An Examination of the Scope of Article 9*, 35 STAN. L. REV. 175 (1983). The idea also has fascinating historical antecedents. *See, e.g.*, Boris Kozolchyk, *Transfer of Personal Property by a Nonowner: Its Future in Light of Its Past*, 61 TUL. L. REV. 1453, 1479-83 (1987) (explaining that under medieval Spanish law, a possessor, even if a thief, had power to transfer good title unless the rightful owner hired "shouters" to publicize the theft). *See also* Thomas E. Plank, *Sacred Cows and Workhorses: The Sale of Accounts and Chattel Paper Under the U.C.C. and the Effects of Violating a Fundamental Drafting Principle*, 26 CONN. L. REV. 397, 413-16 (1994) (discussing the early debates over whether to require filing for sales of accounts).

In recent years the idea's unbelievers have outnumbered its believers. *See, e.g.*, LoPucki & Warren, *supra* note 22, at 384-93; Harris & Mooney, *supra* note 11, at 2055-59; Mooney, *supra* note 98; David Morris Phillips, *Flawed Perfection: From Possession to Filing Under Article 9—Part I*, 59 B.U. L. REV. 1, 6 (1979); Jeanne L. Schroeder, *Some Realism About Legal Surrealism*, 37 WM. & MARY L. REV. 455 (1996) [hereinafter Schroeder, *Legal Surrealism*].

Third parties might not, in fact, rely on appearances to draw a conclusion of ownership. *See* Schroeder, *Legal Surrealism, supra*, at 485-89; *see also* Ludwig Wittgenstein, *PHILOSOPHICAL INVESTIGATIONS* ¶ 28 (G.E.M. Anscombe trans., 1953) ("[A]n ostensive definition can be variously interpreted in every case."). Moreover, even if parties do so interpret appearances, they should perhaps not be entitled to: it is presumptuous, leads to superficial evaluations, and discourages creditors from knowing their debtors in a meaningful sense of the word. *See infra* Part IV.B. Perhaps the variety and level of detail of business affairs in today's world (in contrast with the world of *Twyne's Case*) make it inappropriate to insist upon so one-dimensional a rule. One court already suspected as much over a century ago, stating "it is obvious that to prohibit altogether the separation of the title from the possession of personal property, would be incompatible with an advanced state of society and commerce . . ." *Davis v. Turner*, 45 Va. (4 Gratt.) 422, 441 (1848); *cf.* Jeanne L. Schroeder, *Is Article 8 Finally Ready This Time? The Radical Reform of Secured Lending on Wall Street*, 1994 COLUM. BUS. L. REV. 291, 399 [hereinafter Schroeder, *Radical Reform*] (explaining that secured lenders to securities intermediaries have automatic perfection because there is "a presumption of encumbrance—ostensible non-ownership"); Schroeder, *Legal Surrealism, supra*, at 493-95, 497-503 (discussing possession as a legal conclusion).

¹⁰¹ *See* Baird & Jackson, *supra* note 100, at 175; Thomas H. Jackson & Anthony T. Kronman, *Secured Financing and Priorities Among Creditors*, 88 YALE L.J. 1143, 1149-50 (1979).

The policy of freeing commercial actors from inquiring into facts also characterizes a different branch of commercial law rules: those relating to good faith purchase. *See, e.g.*, U.C.C. § 2-403(1) (1995) (providing for negotiability of goods in cases of voidable title); *id.* § 2-403(2) (entrusting); *id.* § 3-306 (providing that a holder in due course takes free of competing claims); *id.* § 8-303 (providing that a protected purchaser takes free of adverse claims); *id.* §§ 8-502, 8-510 (providing that entitlement holders and persons whose interests derive from entitlement holders are protected from adverse claims); *id.* § 9-307(1) (providing that a buyer in ordinary course of business takes free of security interests even if perfected). In a sense, Article 9's perfection requirements are just another version of the

viding that security interests are not effective against competing claimants to the collateral unless perfected.

Protecting third parties without notice can be viewed as an exception to the principle of *nemo dat quod non habet*: no one may give what he does not have.¹⁰² This principle, also known as the derivation principle,¹⁰³ dictates that if an owner transfers widgets to one buyer, she generally may not thereafter transfer the same widgets to a later buyer. Similarly, and more germane to the present discussion, if the owner grants a security interest to one lender, the *nemo dat* principle standing alone would dictate that the owner may not thereafter grant a security interest of the same or greater priority to a later lender.¹⁰⁴ The principle has strongly intuitive justificatory force; even children understand the power of the righteous claim, "I had it first!"¹⁰⁵ However, Article 9 heavily overlays the *nemo dat* principle with third-party notice exceptions, briefly discussed in subsections (1) through (3) below.¹⁰⁶

1. Secured Party Versus Lien Creditor

The perfection principle provides the clearest example of Article 9's concerns with third-party notice, particularly when one begins with the original version of the rule (as opposed to the current version, approved in 1972). The original rule provided, in relevant part:

bona fide purchaser rules, albeit one denatured by removing questions of knowledge and notice.

¹⁰² The verb of which "dat" is one conjugation refers only to gratuitous transfers. CHARLTON T. LEWIS & CHARLES SHORT, *A LATIN DICTIONARY* 654 (1962). Nonetheless, the maxim applies to commercial exchanges as well as to donative transfers. The phrase dates back at least to Justinian's Digest, which credits the Roman jurist Ulpian with the phrase "*nemo plus iuris ad alium transferre potest quam ipse habet*" (no one can transfer more legal rights than he himself has). See 11 *THE CIVIL LAW* ¶ 54, at 302 (S.P. Scott trans., 1932) ("No one can transfer to another a right which he himself does not possess.").

¹⁰³ See DOUGLAS G. BAIRD & THOMAS H. JACKSON, *CASES, PROBLEMS, AND MATERIALS ON SECURITY INTERESTS IN PERSONAL PROPERTY* 3-8 (2d ed. 1987); Schroeder, *Radical Reform*, *supra* note 100, at 296 & n.6.

¹⁰⁴ However, the owner may, consistent with *nemo dat*, grant to the second lender a security interest having a lesser priority. This is because the owner's grant to the first lender does not transfer all of the owner's rights in the property; the owner retains equity, however small or contingent, from which the lesser priority interest of the second lender can be derived. See *United States v. Whiting Pools, Inc.*, 462 U.S. 198, 211 (1983); U.C.C. § 9-311.

¹⁰⁵ See, e.g., JOSEPH WILLIAM SINGER, *PROPERTY LAW* 12-15 (2d ed. 1997) (collecting and commenting on the strength of first-in-time and related arguments); Carol M. Rose, *Possession as the Origin of Property*, 52 U. CHI. L. REV. 73 (1985).

¹⁰⁶ Section 9-201 encapsulates this tension between *nemo dat* and third-party notice. That section provides in relevant part, "Except as otherwise provided by this Act a security agreement is effective according to its terms . . . against purchasers of the collateral and against creditors." U.C.C. § 9-201. This section itself, seemingly providing that even unperfected security interests are effective against third parties, enacts a *nemo dat* rule. But the most important exception to which it refers is based on the need for notice to third parties. This exception, in § 9-301(1)(b), is discussed immediately below.

"[A]n unperfected security interest is subordinate to the rights of . . . (b) a person who becomes a lien creditor without knowledge of the security interest and before it is perfected . . ." ¹⁰⁷ A "lien creditor" is simply an unsecured creditor that acquires an interest in the debtor's property, whether by means of individualized judicial process or by means of a collective process such as bankruptcy.¹⁰⁸ Thus, this statute protected unsecured creditors against security interests unless the security interest was perfected or the unsecured creditor had knowledge of it. Both of these exceptions are attributable to third-party notice concerns: security interests can generally be perfected only by steps that give public notice,¹⁰⁹ and creditors with knowledge of a security interest (whether or not it is perfected) obviously have notice of it, too.¹¹⁰

The 1972 amendments to Article 9 deleted the knowledge exception because it was "completely inconsistent in spirit with the rules of priority between security interests, where knowledge plays a very minor role."¹¹¹ This change does not undermine the rule's grounding in third-party notice concerns; it merely strengthens the rule's response to those concerns. In effect, the current version of the rule is so intent on encouraging public notice of security interests that it increases the punishment of secured parties who fail to perfect, subordi-

¹⁰⁷ U.C.C. § 9-301(1) (1962).

¹⁰⁸ See *id.* § 9-301(3) (1995). The 1962 provisions deemed bankruptcy trustees and similar representatives to be without knowledge of the security interest unless all the creditors represented had knowledge of it. See *id.* § 9-301 (1962).

¹⁰⁹ See *id.* § 9-302(1) (1995) (financing statement must be filed to perfect all security interests, with certain exceptions); *id.* § 9-302 cmt. 1 ("The cases recognized [as exceptions to the filing requirement] are those where suitable alternative systems for giving public notice of a security interest are available."). Article 9's major alternative to filing, possession of the collateral by the secured party or its agent, is also widely agreed to serve the purpose of putting third parties on notice of the security interest. See, e.g., U.C.C. § 9-302 cmt. 1; Baird & Jackson, *supra* note 100, at 180-81. But see LoPUCKI & WARREN, *supra* note 22, at 384-86.

Other perfection devices do not directly serve a public notice function, but these tend to be confined to transactions of a narrow type in which borrowers are widely presumed not to have unencumbered ownership anyway. See, e.g., U.C.C. § 9-302(1)(d) (providing for automatic perfection for purchase money security interests in consumer goods); *id.* § 9-115(4)(c) (providing for automatic perfection for security interests in investment property granted by broker or securities intermediary); see also Schroeder, *Radical Reform*, *supra* note 100, at 399 ("[T]he securities industry has a presumption of encumbrance—ostensible non-ownership."). Another perfection device, control of security entitlements or uncertificated securities by agreement, may indirectly serve a public notice function in that the parties to a control agreement are likely to negotiate for representations about whether any conflicting prior agreements exist. See U.C.C. §§ 8-106(c)(2), 8-106(d)(2), 9-115(4)(a); SANDRA M. ROCKS & CARL S. BJERRE, *THE ABCS OF THE UCC, ARTICLE 8* 85-86 (1997).

¹¹⁰ See U.C.C. § 1-201(25) (defining actual knowledge as one form of notice).

¹¹¹ Official Reasons for 1972 Change, 3A U.L.A. 11 (1992). These rules of priority are briefly discussed immediately below in Part I.D.2.

nating their security interests even to creditors who acquired notice by other means.¹¹²

2. Secured Party Versus Secured Party

The priority principle represents a second important instance of Article 9's concerns about third-party notice. As already observed,¹¹³ this principle provides that an earlier perfected security interest has priority over most later perfected security interests (just as, under the perfection principle, it has priority over subsequent lien creditors). The other side of the coin is that, if an earlier secured party does not perfect, a later secured party can take priority over the earlier one, and thus cannot be harmed by its security interest. Like the perfection principle in its current incarnation, the priority principle frees secured parties from subordination to prior, unperfected security interests regardless of whether the secured party has actual knowledge of the prior security interest,¹¹⁴ and the information-imparting value of perfection is the same here as discussed above.¹¹⁵

3. Negative Pledgee Versus Subsequent Secured Party: Current Law

Despite the predominant view that negative pledge covenants are mere contracts and not property interests, a debtor who agrees to a

¹¹² Although the statute uses unsecured creditors as a force to accomplish its goal of effectuating third-party notice of security interests, it does not do so for the benefit of unsecured creditors. As Baird writes, the filing system provides virtually no assistance to them. See Douglas G. Baird, *Notice Filing and the Problem of Ostensible Ownership*, 12 J. LEGAL STUD. 53, 55 (1983). Even if the unsecured creditor verifies that an asset is in fact unencumbered at the time the loan is extended, the perfection principle will deprive the unsecured creditor of that asset to the extent that it is later subjected to a security interest. Accordingly, some unsecured creditors will refrain from relying on their debtors' assets, but others can rationally so rely using other stratagems. See LoPucki, *supra* note 9, at 1924-47 (discussing "asset-based unsecured lending" and "cash-flow surfers").

¹¹³ See *supra* note 30 and accompanying text.

¹¹⁴ See U.C.C. § 9-312 example 2 ("[I]t makes no difference whether . . . he knows of the other interest at the time he perfects his own."). That is, U.C.C. § 9-312(5) (a) is a pure race statute rather than a race/notice statute. This is the "almost unanimous opinion of the courts." See CLARK, *supra* note 23, ¶ 3.08[1][a], at 3-854; HILLMAN ET AL., *supra* note 53, ¶ 24.05[2], at 24-75.

In an interesting article, David Carlson argues that § 9-312(5) (a) should, in fact, be read as a race/notice statute. Among other things, he adduces historical evidence from the drafting process and points out that the statute does not expressly provide that knowledge is irrelevant (unlike, for example, § 9-307(1)). See David Gray Carlson, *Rationality, Accident, and Priority Under Article 9 of the Uniform Commercial Code*, 71 MINN. L. REV. 207 (1986).

¹¹⁵ In the case of the priority principle (unlike that of the perfection principle, see *supra* note 112), the class benefitted by a secured party's failure to perfect is identical to the class benefitted by the provision of third-party notice. "The secured creditor is able to offer a lower rate of interest precisely because he does not rely solely on the debtor's honesty and general financial health. He is thus necessarily interested in discovering which assets a debtor owns and what claims others might have upon those assets." Baird & Jackson, *supra* note 100, at 183-84.

negative pledge covenant does, in a sense, give something away—the right to grant third parties a security interest.¹¹⁶ Accordingly, considerations related to those underlying the *nemo dat* principle would tend to call for making subsequently granted security interests void or, at least, subordinate in some way to the rights of the negative pledgee.

But the current law of negative pledge covenants does not apply such considerations alone; it subjects them to an exception for third-party notice, just as Article 9 does. Concerns over third-party notice provide a means by which to reconcile cases like *Knott*¹¹⁷ on one hand and cases like *Minderhout* and *Mudge*¹¹⁸ on the other. When (as in *Knott*) the subsequent secured party has neither notice nor knowledge of the negative pledge covenant, or of the parties' intent to create a lien by means of it, the secured party prevails over the negative pledgee, but when the secured party does have notice or knowledge (as in *Minderhout* and *Mudge*), the secured party does not prevail. However, as shown above, courts' decisions in this latter group of cases have often been poorly reasoned, confusing, and mutually inconsistent, resulting in an uncertainty that hinders commercial actors in planning their affairs.

A further problem with the case law in this area is its inconsistency with the framework of Article 9. Not only have prospective secured parties lacked any reliable means of determining the effect of taking a security interest, but also negative pledgees have lacked any means analogous to perfection with which to reliably provide third-party notice. For example, no public filing system gives a notice relating to a negative pledge covenant the legal effect of subordinating other lenders' interests,¹¹⁹ and a negative pledgee's possession of the property subject to the covenant does not interfere with the rights of a subsequent secured party.¹²⁰ With constructive notice unavailable as a

¹¹⁶ Under current law, the debtor nonetheless retains the power (though not the right) to do so. This Article's proposal would allow the debtor to part with the power as well as the right. See *infra* Parts II.A, IV.C, and IV.D.

¹¹⁷ See *supra* Part I.B.

¹¹⁸ See *supra* Part I.C.

¹¹⁹ Occasionally, lawyers will include information about negative pledge covenants in their Article 9 filings. See, e.g., Peter A. Alces, *Abolish the Article 9 Filing System*, 79 MINN. L. REV. 679, 695-96 (1995) (discussing use of the filing system as a bulletin board). The purpose of including this information is not, however, to take advantage of Article 9's rules for the ordering of property claims, but rather to bootstrap into other bodies of law, specifically equitable liens and tortious interference with contract. See *supra* Part I.C. As a way of dramatizing this potential of the Article 9 filing system, one creative lawyer jokes that he uses it as a medium for help-wanted ads when his firm needs a new commercial law associate. See Interview with Robert A. Zadek, Partner, Buchalter, Nemer, Fields & Younger (Nov. 15, 1997). By contrast, this Article's proposal would allow negative pledgees to benefit from the filing system's traditional purpose—allocation of property rights. See *infra* Parts I.D.4 and II.A.1.

¹²⁰ The attachment and perfection rules of Article 9 do not set forth any applicable exceptions.

tool for negative pledgees, they must rely on the fortuity of third parties' having actual notice.

In short, the close kinship between the concerns of Article 9 and those of the law of negative pledge covenants has gone unrecognized, and the structures of the two bodies of law have remained imperfectly aligned with each other. Now that this kinship has been identified, however, we are free to exploit the potential for structural similarity by modifying the law of negative pledge covenants based on the model of Article 9.

4. *Negative Pledgee Versus Subsequent Secured Party: This Article's Proposal*

If the law recognized a means of providing all third parties with notice of negative pledge covenants, then no justification would remain for keeping the covenants unenforceable against subsequent secured parties. (Traditionalists might hold to the *Knott*-style tenet that negative pledge covenants are merely contractual in nature, but this view is a legal conclusion rather than a reason.) Moreover, a number of affirmative reasons would support making negative pledge covenants enforceable against subsequent secured parties, just as security interests become so enforceable when their holders cure the corresponding third-party notice problem by perfecting. First, making negative pledge covenants enforceable in this way (and thereby bringing them into the realm of property) would carry forward the *nemo dat* principle which, as discussed above, carries strong justificatory force of its own.¹²¹ In addition, enforcing negative pledge covenants against subsequent secured parties would enrich the possible outcomes of bargaining between borrowers and lenders, increase party autonomy, reduce uncertainty and other costs currently borne by third parties, and reduce cross-subsidization of borrowers.¹²²

This Article proposes to achieve these ends by expanding Article 9's filing and other perfection rules so that they apply to negative pledge covenants. Part II considers in detail how this might be done. Under the proposal, a negative pledgee who took advantage of the perfection mechanisms would generally prevail over a subsequent secured party (in contrast to current law, under which the perfection principle causes the subsequent secured party to prevail because the negative pledgee is simply an unsecured creditor¹²³). On one level, this outcome would of course depart somewhat from the perfection principle as we know it today. However, such a departure is fully justi-

¹²¹ See *supra* note 104 and accompanying text. Concerning the property-like nature of a perfected negative pledge covenant, see *infra* Part II.A.1 and 2.

¹²² See *infra* Parts I.E, IV.A, and IV.C.

¹²³ See *supra* Part I.B.

fied by the perfection principle's own animating forces—that is, *nemo dat* as modified by third-party notice concerns.

E. By the Way, Why Don't All Lenders Just Take Security? A Glance at the Dynamics of Negative Pledge Debt

Some may wonder why, given their weakness, costs, and difficulties, lenders bother with negative pledge covenants at all. An initial answer is that the covenants do offer some protection because most debtors tend to abide by them, whether because of integrity or reputational concerns,¹²⁴ because their long-term relationship with the negative pledgee is of greater value to them than the short-term benefit of a breach,¹²⁵ or because their later lenders are averse to the risks involved in taking a security interest in the face of the covenant.¹²⁶ On the other hand, borrowers have strong incentives to breach the covenant if necessary financing is available only on a secured basis.¹²⁷ When a debtor subject to a negative pledge covenant finds its financial condition worsening and feels the need to borrow on a secured basis, it must either breach the covenant or approach the negative pledgee for a waiver; the covenant thus has the additional value of helping to trigger an early warning of trouble.¹²⁸

We lack empirical data indicating what proportion of borrowers breach or do not breach, but it is clear that the covenants abound,¹²⁹ and one must therefore conclude that lenders find the covenants' benefits worth their costs. Indeed, the costs under current law are often quite low: the language of negative pledge covenants (including the accompanying permitted liens provisions¹³⁰) tends to be highly standardized;¹³¹ no public recordation is required to make negative

¹²⁴ See generally David Charny, *Nonlegal Sanctions in Commercial Relationships*, 104 HARV. L. REV. 373, 393-94 (1990) (explaining that loss of reputation operates as a nonlegal sanction).

¹²⁵ See *id.* at 392-93 (describing the "sacrifice of a relationship-specific prospective advantage" as a nonlegal sanction (emphasis omitted)).

¹²⁶ See *supra* Part I.C.

¹²⁷ Cf. Barry E. Adler, *An Equity-Agency Solution to the Bankruptcy-Priority Puzzle*, 22 J. LEGAL STUD. 73, 80 (1993) (observing that misbehavior is likeliest "when the firm is troubled and management sees misbehavior as a last resort for survival"); Scott, *supra* note 14, at 946 (noting that "misbehavior heightens in circumstances of business stress").

¹²⁸ See Schwarcz, *supra* note 56, at 446-49.

¹²⁹ See 2 WOOD, *supra* note 14, § 6.02[1], at 6-6 ("By far the most pervasive covenant in international loans is the negative pledge."); Bebchuk & Fried, *supra* note 7, at 922 & nn.199-200 (describing the use of negative pledge covenants as "tremendously widespread"); Morey W. McDaniel, *Are Negative Pledge Clauses in Public Debt Issues Obsolete?*, 38 BUS. LAW. 867, 867 (1983) ("The most common covenant, found even in the debentures of triple-A companies, is the negative pledge clause.").

¹³⁰ See *supra* note 14.

¹³¹ See, e.g., STERN, *supra* note 14, ¶ 5.03; WOOD, *supra* note 14, § 6.02[8][b].

pledge covenants effective within their present weak range;¹³² and lenders have persuasive grounds for convincing borrowers to agree to them,¹³³ making negotiations relatively inexpensive.¹³⁴

The foregoing simply raises, however, the broader question of why lenders ever agree to lend on an unsecured basis, with or without a negative pledge covenant, if collateral is available. All things being equal, any lender would obviously prefer to be secured; a security interest protects the lender against dilution by unsecured creditors,¹³⁵ confers self-help remedies on the lender in the event of default,¹³⁶ and protects the lender against the risk that unprofitable operations in bankruptcy will consume the debtor's assets.¹³⁷ All things rarely are equal, though, in the real world, and it should not be surprising that unsecured debt is common among even the most sophisticated lenders.¹³⁸

The essential point is that the decision whether to secure debt is the outcome not of the lender's preferences alone, but of bargaining and other interactions between the lender and the borrower, taking place under the constraints of fairly competitive markets and well-established industry practices. A large number of factors play themselves out in surprisingly rich ways, some of which I touch on in this section. It is worthwhile briefly to examine here borrowers' decisions whether to secure debt because, as more fully explained below,¹³⁹ many of the same factors that influence that decision apply equally well to help explain borrowers' smaller-scale decisions whether to bind themselves by a negative pledge covenant. Thus, in demonstrat-

¹³² See *supra* note 31 and accompanying text. This Article's proposal would not alter the effectiveness of negative pledge covenants as a contractual matter without filing, but would make filing available to render them effective against third parties. Thus, the costs associated with them would tend to rise somewhat.

¹³³ After all, the argument runs, if the present lender is willing to lend on an unsecured basis, why would future lenders not do so? Moreover, if the borrower's financial condition deteriorates to the point where future lenders would require security, should not the present lender be entitled to learn about that fact by forcing the borrower to approach it for a waiver? See BUCHHEIT, *supra* note 4, at 80-84.

¹³⁴ Under this Article's proposal, the increased effectiveness of negative pledge covenants would cause the opportunity cost to borrowers bound by them to tend to rise. Hence, negotiations associated with negative pledge covenants would tend to become more costly. See *infra* Part I.E.

¹³⁵ This is simply the perfection principle. See *supra* Part I.A.1, I.C.

¹³⁶ See *supra* note 7.

¹³⁷ See 11 U.S.C. § 363(e) (1994) (requiring a bankruptcy court to condition use of the debtor's property on provision of adequate protection to, among others, holders of security interests in that property).

¹³⁸ See, e.g., Bebchuk & Fried, *supra* note 7, at 921 & n.198; James R. Booth, *Contract Costs, Bank Loans, and the Cross-Monitoring Hypothesis*, 31 J. FIN. ECON. 25, 40 n.10 (1992); LoPucki, *supra* note 9, at 1925 & n.148. For detailed discussions of why some debt is unsecured, see, for example, Mann, *supra* note 14, at 658-68; Paul M. Shupack, *Solving the Puzzle of Secured Transactions*, 41 RUTGERS L. REV. 1067 (1989).

¹³⁹ See *infra* Part I.E.2.

ing the rationality and importance of unsecured debt, I indirectly establish the importance of negative pledge covenants. Moreover, in pointing out the complexity of factors influencing parties' decisions, I bolster the case for enlarging the range of possible bargaining outcomes, including, notably, perfectible negative pledge covenants.

1. *The Secured/Unsecured Decision*

One might broadly group the disparate decision-influencing factors into three major types: (1) costs versus expected benefits, (2) differing creditor abilities, and (3) the balance of power between borrower and lender. In the context of the secured/unsecured decision (as opposed to the decision whether to adopt a negative pledge covenant, discussion of which immediately follows¹⁴⁰), most of these factors previously have been discussed as the by-product of a large literature¹⁴¹ that explores whether secured credit is efficient (that is, wealth-creating for society as a whole) or merely redistributive (that is,

¹⁴⁰ See *infra* Part I.E.2.

¹⁴¹ See, e.g., Adler, *supra* note 127; Douglas G. Baird, *The Importance of Priority*, 82 CORNELL L. REV. 1420 (1997); Bebchuk & Fried, *supra* note 7; 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); James W. Bowers, *Groping and Coping in the Shadow of Murphy's Law: Bankruptcy Theory and the Elementary Economics of Failure*, 88 MICH. L. REV. 2097 (1990); F.H. Buckley, *The Bankruptcy Priority Puzzle*, 72 VA. L. REV. 1393 (1986); David Gray Carlson, *On the Efficiency of Secured Lending*, 80 VA. L. REV. 2179 (1994) [hereinafter Carlson, *Efficiency*]; David Gray Carlson, *Secured Lending as a Zero-Sum Game*, 19 CARDOZO L. REV. 1635 (1998) [hereinafter Carlson, *Zero-Sum Game*]; Harris & Mooney, *supra* note 11; Steven L. Harris & Charles W. Mooney, Jr., *Measuring the Social Costs and Benefits and Identifying the Victims of Subordinating Security Interests in Bankruptcy*, 82 CORNELL L. REV. 1349 (1997); Jackson & Kronman, *supra* note 101; Hideki Kanda & Saul Levmore, *Explaining Creditor Priorities*, 80 VA. L. REV. 2103 (1994); Kenneth N. Klee, *Barbarians at the Trough: Riposte in Defense of the Warren Carve-Out Proposal*, 82 CORNELL L. REV. 1466 (1997); Homer Kripke, *Law and Economics: Measuring the Economic Efficiency of Commercial Law in a Vacuum of Fact*, 133 U. PA. L. REV. 929 (1985); Saul Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 YALE L.J. 49 (1982); Lynn M. LoPucki, *Should the Secured Credit Carve Out Apply Only in Bankruptcy? A Systems/Strategic Analysis*, 82 CORNELL L. REV. 1483 (1997); LoPucki, *supra* note 9; Mann, *supra* note 14; Ronald J. Mann, *The Role of Secured Credit in Small-Business Lending*, 86 GEO. L.J. 1 (1997); Randal C. Picker, *Security Interests, Misbehavior, and Common Pools*, 59 U. CHI. L. REV. 645 (1992); Schwarcz, *supra* note 56; Alan Schwartz, *The Continuing Puzzle of Secured Debt*, 37 VAND. L. REV. 1051 (1984) [hereinafter Schwartz, *Continuing Puzzle*]; Alan Schwartz, *Priority Contracts and Priority in Bankruptcy*, 82 CORNELL L. REV. 1396 (1997) [hereinafter Schwartz, *Priority Contracts*]; Schwartz, *supra* note 8; Alan Schwartz, *Taking the Analysis of Security Seriously*, 80 VA. L. REV. 2073 (1994); Schwartz, *supra* note 10; Scott, *supra* note 14; Robert E. Scott, *The Truth About Secured Financing*, 82 CORNELL L. REV. 1436 (1997); Shupack, *supra* note 138; Triantis, *supra* note 14; Elizabeth Warren, *Making Policy with Imperfect Information: The Article 9 Full Priority Debates*, 82 CORNELL L. REV. 1373 (1997); James J. White, *Efficiency Justifications for Personal Property Security*, 37 VAND. L. REV. 473 (1984) [hereinafter White, *Efficiency Justifications*]; James J. White, *Work and Play in Revising Article 9*, 80 VA. L. REV. 2089 (1994); William J. Woodward, Jr., *The Realist and Secured Credit: Grant Gilmore, Common-Law Courts, and the Article 9 Reform Process*, 82 CORNELL L. REV. 1511 (1997); Memorandum from Elizabeth Warren, Harvard Law School, to Council of the American Law Institute (April 25, 1996) (on file with author).

transferring wealth to secured creditors from unsecured creditors without creating new value) and whether secured credit as a whole is otherwise a desirable social institution. Because those questions are not of central concern here,¹⁴² the following brief discussion addresses only the private benefits or costs of security to the borrower and lender, without concerning itself with the net social benefits or costs.¹⁴³

First, there are often significant costs entailed in taking and perfecting a security interest and in gathering the information about the collateral needed to ensure that the security interest will offer real protection. Taking security may also entail opportunity cost, as the borrower may prefer to keep its assets unencumbered while possible, holding them in reserve for later use as collateral in the event that secured borrowing becomes its only option.¹⁴⁴ In a competitive market, lenders will ask debtors to pay these costs (including the lenders' own costs, which are passed through to borrowers by means of interest or up-front fees) only if these costs are less than the lenders' expected benefit. This expected benefit will tend to be lower when the loan period is relatively short, when the borrower has a relatively long history of tapping the credit markets and performing reliably, and when the lender acts in a risk-preferring way (whether by design or as a result of agency costs).

Second, creditors have different strengths, just as competitors in the state of nature do. During the life of the loan, some creditors are able to minimize ongoing costs associated with collateral, but others, though less adept in that respect, are better able to monitor their debtors' general financial health, and the latter are likelier to remain unsecured.¹⁴⁵ Other creditor strengths relate to optimizing the benefits of collateral in the event of a default; lenders that are in the business of buying and selling particular kinds of asset will tend more often to take security interests (particularly purchase money security interests) in those assets than other lenders. It is far more expensive

¹⁴² *But see infra* Part IV.C.

¹⁴³ In discussing a subject so complex, one must choose between superficiality and massive prolixity. I have opted for the former on the grounds that it will make the discussion more accessible (as a mere set-up for Part I.E.2 should be), and in the hope that I will be forgiven by those to whose admirably thorough work I fail to do justice. In this pursuit of brevity I have had to shear the discussion of most footnote citations, qualifications and cross-references. However, most of the works cited *supra* in note 141 will provide a gateway to deeper discussions of the issues touched on here. Perhaps the best overall starting place is Mann, *supra* note 14.

¹⁴⁴ *See* Schwarcz, *supra* note 56, at 446-49.

¹⁴⁵ *See* Levmore, *supra* note 141, at 53; Mann, *supra* note 14, at 678; Schwartz, *supra* note 8, at 11 n.28; Shupack, *supra* note 138, at 1123; Triantis, *supra* note 14, at 242.

for a bank to foreclose on a fleet of delivery vans and to sell it for its optimum price, than for an auto and truck dealership to do so.¹⁴⁶

Third, and last for purposes of this very abbreviated overview, securing a debt dramatically affects the balance of power between borrower and lender. This fact is attributable both to the great certainty, ease, and speed of recovery that secured lenders enjoy, and to earlier indirect consequences thereof, such as increased influence over borrower behavior during the life of the loan. Some debtors may find this shift in the balance of power an acceptable price to pay (whether for the interest rate savings or otherwise), but other debtors are likely to resist it,¹⁴⁷ in order, for example, to prevent their assets from being held hostage, to reduce the power of the lender's pressure to act conservatively, or to ensure that the debtor will have a comfortable period of time in which to recover from possible default.¹⁴⁸ Whether a borrower can successfully resist conferring the power of security will depend in part on the degree of the debtor's access to alternative lenders, and this degree of access, in turn, will depend on many of the other factors examined above. In other words, the extremely visible power relationship manifested in the secured/unsecured decision is itself the result of subtler, pre-existing power relationships.

I do not suggest that the factors or forces alluded to here provide a complete explanation of unsecured debt in general, or even of any given single instance thereof. It is probably futile to search for any such complete explanation; the world of this type of commerce seems too richly patterned for a single principle to explain.¹⁴⁹ As Ronald

¹⁴⁶ See Mann, *supra* note 14, at 677-82 (discussing trade creditors); Shupack, *supra* note 138, at 1092 (explaining the effects of lenders valuing the same collateral differently).

¹⁴⁷ See Bechuk & Fried, *supra* note 7, at 903; Carlson, *Efficiency*, *supra* note 141, at 2188; Mann, *supra* note 14, at 656; Schwartz, *supra* note 8, at 15.

¹⁴⁸ See, e.g., Mann, *supra* note 14, at 648-49, 664-65; Triantis, *supra* note 14, at 246-47 (explaining that secured debt allows a creditor to influence a debtor's behavior more extensively than does unsecured debt); Oliver E. Williamson, *Credible Commitments: Using Hostages to Support Exchange*, 73 AM. ECON. REV. 519, 536-37 (1983).

¹⁴⁹ See Mann, *supra* note 14, at 633 (reflecting that "no single factor can capture the multiple and interrelated considerations that motivate borrowers and lenders as they structure their various transactions"); *id.* at 631 (noting the "richness and ambiguity" of borrower/lender relations); Scott, *supra* note 14, at 912 ("It is unlikely that a single explanation can rationalize all of these various forms of security."); Shupack, *supra* note 138, at 1110 (observing that prior literature is a "series of partial explanations . . . [that] might all contain some form of contingent truth, even if they contain no general truth"); Triantis, *supra* note 14, at 256 (propounding two theories and "recognizing that [they] . . . operate in distinct contexts").

This viewpoint contrasts with the more analytically ambitious one of Alan Schwartz, who writes: "Combining explanations . . . is an unsatisfactory response to the difficulties that each explanation faces. . . . [I]t is wrong to say that the world is well understood because our theories account for all relevant events. The world is poorly understood because two weak theories exist." Schwartz, *supra* note 8, at 29. Schwartz makes this statement in the context of his search for reasons why security may be efficient, but his standards are equally demanding when he turns to distributional matters. See *id.* at 30-33.

Mann writes, "Secured credit is an area in which broad conclusions are likely to be incorrect [A] complicated theory with explanatory value is preferable to a simple and unitary theory that bears no relation to the actual world of lending."¹⁵⁰ Nor do I wish to imply that these factors are self-contained or have a pre-ordained integrity. On the contrary, as my short discussion of the borrower/lender balance of power mentions (and as a fuller discussion would further demonstrate), each is linked to the others, and one can view many of them as subsets of others.

2. *The Negative Pledge Covenant Decision*

This rich pattern of dynamics does not affect only the parties' choice between secured debt and unsecured debt. Among parties who choose unsecured debt, many of the same dynamics will also affect the decision whether to adopt a negative pledge covenant. Negative pledge covenants present out-of-pocket costs¹⁵¹ and opportunity costs¹⁵² that may outweigh the benefits to the lender.¹⁵³ Some creditors face a substantial risk that their debtors will breach the covenants in a harmful manner or, due to risk aversion, place substantial weight on that risk. Some creditors are better able to monitor debtors to ensure that the covenant is not breached, and conversely, some debtors are easier or harder than others to monitor in this respect.¹⁵⁴ And

It may well be, as Schwartz suggests, that we poorly understand this facet of the world. In many branches of study, poor understanding is not unusual, and may be accepted or even celebrated as part of the human condition. Whether the same attitude is acceptable in commercial law depends on whether one views it as more closely analogous to physics or to psychology.

¹⁵⁰ Mann, *supra* note 14, at 682; see also Shupack, *supra* note 138, at 1123 ("Explanatory theories for actual behavior must be derived from the particular situations of the specific debtors and creditors.").

¹⁵¹ Under current law, to be sure, negative pledge covenants cost far less than security interests. Indeed, simple negative pledge clauses amount to no more than a couple of lines of type in a loan agreement. Many negative pledge clauses, however, are far more elaborate: they, the permitted liens clauses that accompany them, and the accompanying negotiations and opinions of counsel have become an art form in themselves. See BUCHHEIT, *supra* note 4, at 80-90 (scripting a typical *pas de deux* for negotiators). See generally STERN, *supra* note 14, ¶ 5.03 (presenting typical provisions); WOOD, *supra* note 14, § 6.02 (presenting an overview of the standard provisions of negative pledge covenants).

Under this Article's proposal, the out-of-pocket costs would increase, approaching but not equalling the level of costs for security interests. The proposal would implicate filing fees and related costs, together with more negotiation over the agreement.

¹⁵² Borrowers adverting to the covenants will either be denied the chance to obtain later financing at the lower interest rate that results from borrowing on a secured basis or, at least, will be put to the costs of negotiating a waiver from the negative pledgee. Under this Article's proposal, the simple decision to breach would no longer be available.

¹⁵³ The weighing of benefits of a negative pledge covenant is complicated by questions of free riding. See *infra* text accompanying note 262; *infra* note 331.

¹⁵⁴ See, e.g., Bebchuk & Fried, *supra* note 7, at 888; see also *infra* note 324 (discussing current law and the proposal's effect on this disparity in monitoring ability).

finally, some borrowers have more power than others to resist lenders' desire for the covenants.

It is unsatisfying that under current law, this complex, delicately balanced pattern of forces must resolve itself into one of only two pigeonholes. The debt must be secured or unsecured, and even when the parties choose to enrich their unsecured debt with a negative pledge covenant, the difference from other unsecured debt is small.¹⁵⁵ This Article's proposal, outlined immediately below, enriches the possible bargaining outcomes. It thereby better accommodates the full range of the parties' preferences, while concomitantly increasing party autonomy¹⁵⁶ and efficiency.¹⁵⁷

II

THE PROPOSAL UP CLOSE: THREE BILATERAL RELATIONSHIPS

This Article proposes amending Article 9 to make negative pledge covenants enforceable against subsequent secured parties on condition that the negative pledgee perfects, that is, provides notice to third parties in the manner that Article 9 already requires for security interests.¹⁵⁸ In further keeping with Article 9's principles, the proposal would implement this third-party enforceability by subordinating any security interest granted in violation of the perfected negative pledge covenant.¹⁵⁹ As a result, the security interest would be prevented from depleting the cushion of unencumbered assets that the negative pledgee has bargained to protect.¹⁶⁰ In these

¹⁵⁵ See *supra* Part I.A.2. Indeed, as discussed in Part I.A.3, negative pledge debt has generally been classified simply as unsecured debt.

¹⁵⁶ See *infra* Part IV.A.

¹⁵⁷ See *infra* Part IV.C.

¹⁵⁸ I previously raised this idea in Carl S. Bjerre, *Bankruptcy Taxes and Other Filing Facts: A Commentary on Professor Bowers*, 79 MINN. L. REV. 757 (1995). Ronald Mann and I later presented thoughts on the subject to the Article 9 Drafting Committee. See Memorandum from Ronald J. Mann, Associate Professor, Washington University School of Law, to Article 9 Drafting Committee (May 13, 1996) (on file with author); Memorandum from Carl S. Bjerre, Assistant Professor, University of Oregon School of Law, to Article 9 Drafting Committee (June 5, 1996) (on file with author). Alan Schwartz has recently voiced support for a more general form of the idea (without addressing the idea's relationship to the structure of Article 9). See Schwartz, *Priority Contracts*, *supra* note 141, at 1398, 1418; *infra* note 302.

¹⁵⁹ The subordination would affect only the security interest, not the debt owed to the secured party. See *infra* note 239.

An alternative means of implementation would be simply to render any such security interests void. This alternative would have several virtues or arguable virtues, not least among them a simplicity that this Article's proposal cannot claim. It would also depart markedly from the principles of current Article 9, but whether that would be a virtue or not is at bottom an ideological question. I discuss the alternative in Part III.A, and present subordination as the central proposal of this Part II principally because of the greater light that it helps to cast on current law. See also *infra* notes 168, 175, 235, and 239.

¹⁶⁰ See *infra* Part II.A. This Article addresses only the conflict between a negative pledgee and a subsequent secured party, not that between a negative pledgee and other

cases, current Article 9 would, so to speak, turn existing Article 9 inside out—unsecured creditors would have priority over secured creditors, so long as they had a perfected negative pledge covenant.

The proposal, although perhaps initially surprising, is at bottom profoundly conservative. It leaves virtually all of Article 9 untouched,¹⁶¹ and modifies Article 9's present secured/unsecured hierarchy only to the degree consistent with the statute's own underlying principles: *nemo dat* with an exception for third parties without notice. In fact, the proposal itself would constitute an extension of these same underlying principles: a debtor subject to a perfected negative pledge covenant would part with the power (and not merely the right, as under current law) to give third parties a security interest that is senior to the rights of the negative pledgee. This point is worth pausing over. Simple enforcement of contracts has, of course, nothing to do with the *nemo dat* principle, because the promisor continues to "own" the power (though not the right) to breach the contract. However, this Article's proposal goes beyond simple enforcement of negative pledge covenants, making them in effect unbreachable. Thus, as explored in Part II.A.1 and 2, the proposal treats the perfected negative pledgee as having a property right rather than a contract right.

purchasers. Negative pledge covenants have never protected their promisees against such other purchasers; the protection is simply that roughly equivalent consideration usually comes into the debtor's hands upon the sale (and if it does not, fraudulent conveyance law provides the remedy). The negative pledge covenant will, if well drafted, cover that new property. Cf. U.C.C. § 9-306(2) (1995) (providing that a security interest continues in proceeds received by the debtor).

Also not directly at issue for the moment is any conflict between negative pledgee and judgment creditor. That subject is considered in Part II.C, below.

¹⁶¹ It would be premature to propose language fully implementing the proposal, but the following preliminary sketch comes very close to doing so, and demonstrates how simple the changes to Article 9 would be:

(a) A security interest, even if perfected, is subordinate to the rights of a negative pledgee which, prior to the perfection of such security interest, perfects the negative pledge covenant in a manner that this Article provides for security interests in the same property. If, upon default, the secured party exercises remedies with respect to the collateral, he holds it and its proceeds in trust for the negative pledgee. This section (a) does not apply to purchase money security interests governed by § 9-312(3) or (4), or to other interests having a superpriority [e.g., § 9-115(5)(a), (c), or (d)].

(b) A security interest subject to section (a) is also subordinate to the interest of a creditor executing on a judgment after the security interest is perfected, but only to the extent of the debt of the negative pledgee referred to in section (a).

(c) A person executing on a judgment with respect to property that, but for the presence of a perfected negative pledge covenant, would have been encumbered by a security interest perfected before the execution, shall compensate the negative pledgee in an amount equaling x% of the value of the encumbrance prevented.

Paragraph (a) is discussed in Part II.A, paragraph (b) is discussed in Part II.B, and paragraph (c) is discussed in Part II.C.

Under this view, it becomes perfectly apt to view the perfected negative pledgee as being protected by the *nemo dat* principle.

One important example of the proposal's basic conservatism also introduces some of its ramifications. The proposal would principally affect only the relationship between the negative pledgee and a subsequently perfecting secured party, and would not affect current law's treatment of two other commercial relationships. First, the property interest of a secured party would, if perfected, continue to be superior to the rights of unsecured creditors other than the negative pledgee (even if the secured party perfects after the negative pledgee).¹⁶² And second, unsecured creditors without perfected negative pledge covenants would continue to rank equally with the perfected negative pledgee, so that if one of the other unsecured creditors executed on a judgment prior to the negative pledgee, that unsecured creditor would prevail over the negative pledgee.¹⁶³

The foregoing clarifies that the proposal bears, at least indirectly, on three kinds of commercial actors. This Part schematizes these actors' interests as a set of three bilateral relationships and discusses them one at a time: negative pledgee versus subsequent secured party,¹⁶⁴ secured party versus subsequently executing creditor,¹⁶⁵ and executing creditor versus negative pledgee.¹⁶⁶ This discussion will show that the proposal's effect on the first (but only the first) of these relationships, subordinating the subsequent secured party to the prior perfected negative pledgee, is pathbreaking. The other relationships are already provided for by strong principles of existing law, or are minor adjustments to existing law that are necessary to govern the first relationship on a sound basis.¹⁶⁷

¹⁶² In other words, the perfection principle would generally continue to apply. See *infra* Part II.B, which also sets forth a minimal necessary modification to the principle: secured parties perfecting after a negative pledgee perfects become subordinate not only to the rights of the negative pledgee, but also (to the extent of the negative pledgee's debt) to the rights of the other unsecured creditors who execute judgments after the secured party perfects.

¹⁶³ In other words, the *pari passu* principle would generally continue to apply. See *infra* Part II.C. Part II.C.2 sets forth a narrow exception to the principle which, like the one discussed in the prior footnote, is narrowly tailored to permit the Article's main proposal to work sensibly.

¹⁶⁴ See *infra* Part II.A.

¹⁶⁵ See *infra* Part II.B.

¹⁶⁶ See *infra* Part II.C. When the unsecured creditor is represented by a trustee in bankruptcy rather than acting individually by executing on a judgment, the third relationship presents different questions. See *infra* Part II.D.

¹⁶⁷ Specifically, the relationship in Part II.B is simply the perfection principle (as modified to preserve the vulnerability of negative pledgee status), and the relationship in Part II.C is in essence simply the *pari passu* principle.

A. Negative Pledgee Versus Secured Party

The simple core of this Article's proposal is, again, to strengthen negative pledge covenants by making them enforceable against subsequent secured creditors in a way that parallels Article 9's treatment of perfected security interests. This would enable a new stratum of lending to emerge: a mezzanine between the current, relatively impoverished choices of secured and unsecured lending.¹⁶⁸

One can implement these ideas by adapting, in a few straightforward ways, one of Article 9's most powerful and beautiful features: its system of priorities. As discussed earlier, this system is generally founded on the principles of *nemo dat* and third-party notice: a prior secured party's security interest is enforceable against a later secured party if, and only if, the prior secured party perfects before the later one does.¹⁶⁹ Negative pledge covenants, I submit, should behave in exactly the same way: a negative pledgee's interest¹⁷⁰ should be enforceable against a later secured party if, and only if, the negative pledgee perfects before the secured party does.¹⁷¹

The central mechanical step with which I propose to implement this rule is simple and familiar to the world of commercial actors. To protect itself against later security interests, a negative pledgee would simply file a financing statement in the same manner and with the same public office that Article 9 currently requires for security interests.¹⁷² This filing would thereby put the world on constructive notice

¹⁶⁸ The existing system of secured credit would not be unduly affected by this change if a perfected negative pledge covenant did not interfere with the rights of third parties any more than a perfected security interest does. The proposal takes care to serve this goal. See, e.g., *infra* note 173; Part II.A.3. Thus, the proposal's principal effect on existing patterns of commerce would be simply to alleviate the costs of current doctrine discussed in Part I.C.

If, in the alternative, perfected negative pledgees were protected by voiding subsequently granted security interests, the potential would emerge for substantial change to existing patterns of commerce. See *supra* note 159; *infra* Part III.A.

¹⁶⁹ See *supra* Part I.D. The text's statement is simplified because the exceptions are irrelevant here. Similar exceptions would apply under this Article's proposal. See *infra* notes 172-73.

¹⁷⁰ See *infra* Part II.A.1 and 2 for a discussion of negative pledgees as holders of property interests.

¹⁷¹ Current case law already so provides in instances in which the secured party does not have notice of the negative pledge covenant, while also imposing other negative consequences on secured parties. See *supra* Part I.B, C, and D. This Article's proposal would largely replace the case law, tame the results, and give negative pledgees a simple, reliable way to provide notice to all third parties. Apropos of this reliability, I have noted elsewhere that the Article 9 perfection system serves what Lon Fuller calls a "channeling function," see Bjerre, *supra* note 158, at 762 n.23, because it offers a "channel[] for the legally effective expression of intention." Lon L. Fuller, *Consideration and Form*, 41 COLUM. L. REV. 799, 801-03 (1941). This Article's proposal expands the range of effectiveness of Article 9's channeling.

¹⁷² As briefly discussed *supra* in note 109, Article 9 makes various other perfection devices available in certain cases, at occasional sacrifice to the public notice function of

of the negative pledge covenant, just as it provides notice of a security interest. Any later perfecting secured party¹⁷³ would accordingly be subordinate to the negative pledgee, just as a later perfected secured party is subordinate to a prior one.¹⁷⁴ The proposal would thus modify the perfection principle—a seemingly radical move. But this modification of the perfection principle actually remains true to the first principles of secured credit: *nemo dat* as limited by public notice concerns. The move modifies the perfection principle only in a way that makes it truer to its own foundations; it is therefore simultaneously radical and conservative.

If the proposal were enacted, commercial actors contemplating extending secured credit would adjust to the presence in a debtor's credit profile of one of these new creatures in the same way, and to the same extent, that they currently adjust to prior perfected security interests. The Article 9 perfection procedures to which the new creatures owe their existence would facilitate this adjustment. Secured creditors tend to be adjusting creditors,¹⁷⁵ unlike many unsecured

perfection. Feeling no need to be truer to Article 9's principles than Article 9 is itself, I am at least initially inclined to accept all of these other devices for perfection of negative pledge covenants as well.

When a financing statement is used, its formal requisites would generally be the same as those for a security interest. Collateral descriptions would describe as much or as little of the debtor's property as is covered by the covenant, depending on the bargain between the debtor and the negative pledgee. The "double filter" rule (as well as most other familiar aspects of secured transactions) would apply: the negative pledge covenant's enforceability against a later-perfecting secured party would be limited to the narrower of the description in the financing statement and the description in the negative pledge covenant. See CLARK, *supra* note 23, ¶ 2.02[3][c].

One aspect of the financing statement's formal requisites bears further consideration. Should it be required to indicate (e.g., by means of a box to be checked) that it relates to a negative pledge covenant rather than a security interest? Such an indication would further the proposal's effect of freeing debtors from an unnecessary component of their interest costs. See *infra* Part IV.C. The ultimate answer to this question depends also on (1) whether one prefers the proposal or its alternative discussed in Part III.A, (2) within the proposal, where one comes out on certain enforcement questions examined in Part II.A.3, and (3) whether one believes that a perfected negative pledgee should be able, with the debtor's agreement, to change to a perfected secured party while retaining its former priority.

¹⁷³ The text's statement is, again, simplified. At a greater level of detail, the proposal would permit the same superpriorities over previously perfected negative pledge covenants that current Article 9 permits over previously perfected security interests, under the same conditions and for the same reasons. See, e.g., U.C.C. §§ 9-115(5) (a), (c), (d), 9-312(3), (4) (1995). The point is not necessarily to endorse all of those superpriorities on their merits, but rather for perfected negative pledge covenants to supplement, rather than to change, existing patterns of secured credit.

¹⁷⁴ The secured party would not, however, ipso facto be junior to all creditors that are *pari passu* to the negative pledgee. See *infra* Part II.B.

¹⁷⁵ See, e.g., LoPucki, *supra* note 9, at 1909; Shupack, *supra* note 138, at 1100-01. Exceptions certainly exist, but to the extent that these exceptions represent an objection to the proposal, they also represent an objection to existing law. See Ronald J. Mann, *The First Shall Be Last: A Contextual Argument for Abandoning Temporal Rules of Lien Priority*, 75 TEX. L.

creditors who, in the literature exploring secured credit's desirability, have been a central source of concern.¹⁷⁶

1. *Priority Without Property?*

The decision whether to secure a particular debt is an important and delicate matter of private ordering,¹⁷⁷ and this Article's proposal achieves its ends without interfering with that process. The proposal would not convert negative pledgees into secured parties, for just as under current law, negative pledgees (1) would remain vulnerable to other unsecured creditors who execute first on judgments and (2) would have no self-help rights against the debtor's property, though they would retain the rights that they now have to obtain and execute on judgments of their own.

Would a perfected negative pledgee nonetheless have a property interest? Such an abstract question is not easy to answer, as Part II.A.2 will further explore. Under current law, the distinction between secured and unsecured corresponds neatly to the distinction between property rights and their absence. One generally thinks of secured creditors as having property rights in the debtor's property¹⁷⁸ and un-

REV. 11 (1996). The alternative to this Article's proposal discussed in Part III.A would have a more severe effect on such imperfectly adjusting secured parties than would the proposal itself.

¹⁷⁶ See *supra* note 138 and accompanying text; see also, e.g., Bebchuk & Fried, *supra* note 141, at 1295-1304 (discussing non-adjusting creditors); LoPucki, *supra* note 9, at 1896 ("The few data available suggest that a substantial portion of unsecured creditors do not consent to their status in any meaningful sense."); *id.* at 1916 ("A grant of security exploits not only creditors who are forced into unsecured status but also creditors who accept unsecured status on the basis of an underestimation of the risk").

¹⁷⁷ See *supra* Part I.E.

¹⁷⁸ Steve Harris and Chuck Mooney make a simple and strong case for this view on the grounds that a security interest carries with it the core bundle of rights usually thought to constitute property (e.g., the rights to possess, use, and dispose of a thing, and the right to exclude others from doing so). See Harris & Mooney, *supra* note 11, at 2051 & n.83; see also BAIRD & JACKSON, *supra* note 103, at 67 (stating that a secured party gains a property right in the collateral upon the attachment of its security interest); James W. Bowers, *Whither What Hits the Fan?: Murphy's Law, Bankruptcy Theory, and the Elemental Economics of Loss Distribution*, 26 GA. L. REV. 27, 59 n.85 (1991) ("Security interests provide for a form of co-ownership in the collateral between the debtor and the secured party. The Bankruptcy Code does not accord a priority to secured lenders. It simply . . . distributes property to those who own it."); Kripke, *supra* note 141, at 950 ("[M]onitoring that can usefully supplement loan terms . . . depends on security, that is, property rights . . ."); Schwartz, *supra* note 10, at 213 (noting that security confers certain "ownership rights"); cf. U.C.C. § 1-201(37) (defining "security interest" in part as "an interest in personal property or fixtures that secures payment of an obligation"); Knippenberg, *supra* note 32, at 1974 n.31 ("[T]here is a strong consensus that security is property. The conveyance metaphor pervades doctrine and the literature.").

Lynn LoPucki appears less to question the point that security interests are property than to argue that that label, with its associated concepts of free alienability, is not a valid justification for a robust regime of secured credit. See LoPucki, *supra* note 9, at 1952-54. Similarly, Jim Rogers does not argue that security interests are not property, but rather that

secured creditors as having none. For example, secured creditors have self-help remedies, but unsecured creditors do not. But property interests should not be conflated with self-help rights, even in the narrow context of security interests.¹⁷⁹ In fact, security interests without the right to foreclose are not uncommon; subordination agreements routinely deprive secured parties of this right, and the Bankruptcy Code does the same. The latter's automatic stay provision prohibits a secured party from foreclosing without special relief,¹⁸⁰ and though the Code provides for relief from the stay in cases of lack of adequate protection of an interest in property, the Supreme Court has interpreted this provision as not requiring compensation for the delay in foreclosing imposed on undersecured creditors.¹⁸¹

However, because property interests and self-help rights have so generally travelled together in the secured lending context, this Article's proposal has the effect of troubling the accepted boundary between property and nonproperty, between ownership and its absence.¹⁸² The proposal enriches a palette that, today, is impover-

bankruptcy laws' impairment of those property rights does not violate the Takings Clause. See James Steven Rogers, *The Impairment of Secured Creditors' Rights in Reorganization: A Study of the Relationship Between the Fifth Amendment and the Bankruptcy Clause*, 96 HARV. L. REV. 973, 977-97 (1983). See also *infra* notes 217-23 and accompanying text (examining the resemblance of a security interest to a prototypical kind of property).

However, the idea that security interests are a form of property must not be taken for granted. As Steve Knippenberg and Lawrence Ponoroff have shown (using linguistic ideas associated with those that I explore in Part II.A.2), such an idea is simply a metaphor—a means of understanding that not only can be useful, but also can be dangerously ensnaring when left unexamined. See Knippenberg, *supra* note 32, at 1968-73; F. Stephen Knippenberg, *Future Nonadvantage Obligations: Preferences Lost in Metaphor*, 72 WASH. U. L. Q. 1537 (1994); Lawrence Ponoroff & F. Stephen Knippenberg, *The Immoveable Object Versus the Irresistible Force: Rethinking the Relationship Between Secured Credit and Bankruptcy Policy*, 95 MICH. L. REV. 2234, 2279-89 (1997); see also *infra* note 184 (addressing the consequences of labeling as property a security interest). As Cardozo warned, "Metaphors in law are to be narrowly watched, for starting as devices to liberate thought, they end often by enslaving it." *Berkey v. Third Ave. Ry.*, 155 N.E. 58, 61 (N.Y. 1926).

¹⁷⁹ See, e.g., Schwartz, *supra* note 10, at 213 (referring to both priority and self-help, but calling only the latter an ownership right). But see *id.* at 250 (explaining that a financier, not technically secured under Schwartz's rules, see *infra* Part III.C, has property right due to its priority). Bebchuk and Fried distinguish well between the two. See Bebchuk & Fried, *supra* note 7, at 860.

¹⁸⁰ 11 U.S.C. § 362(a), (d)(1), (d)(2) (1994).

¹⁸¹ *United States Sav. Ass'n of Texas v. Timbers of Inwood Forest Assoc.*, 484 U.S. 365, 371-72 (1988) (construing 11 U.S.C. § 362(d)(1)).

¹⁸² In this respect, the proposal is consonant with the disaggregation of property that began with Hohfeld and the Legal Realists. See Wesley Newcomb Hohfeld, *Fundamental Legal Conceptions as Applied in Judicial Reasoning*, 26 YALE L.J. 710, 746 (1917) ("[The] 'legal interest' or 'property' relating to the tangible object that we call *land* consists of a complex aggregate of rights (or claims), privileges, powers, and immunities."); see also Thomas C. Grey, *The Disintegration of Property*, in *PROPERTY: NOMOS XXII* 69, 81 & n.40 (J. Roland Pennock & John W. Chapman eds., 1980) (propounding realist bundle-of-rights conception of property); Thomas E. Plank, *Outer Boundaries of the Bankruptcy Estate*, 47 EMORY L.J. 1193 (1998) (deploying the "bundle of sticks" metaphor in construing certain Bankruptcy Code

ished and bipolar: secured or unsecured, property rights or none, black or white. The proposal thus creates a classificatory problem: is this particular shade of gray black or is it white? Or does the question present a false dichotomy?

The proposal does confer upon the negative pledgee a property interest, in certain senses of the word.¹⁸³ In particular, by subordinating later perfected security interests, the proposal gives the perfected negative pledgee the right to exclude subsequent secured lenders from its portion of the debtor's assets, and the right to exclude is "one of the most essential sticks in the bundle of rights that are commonly characterized as property."¹⁸⁴ On the other hand, I do not insist on calling the negative pledgee's interest property, for strategic (as well as analytic¹⁸⁵) reasons. To speak of a perfected negative pledgee as having no property highlights an interesting side effect of the proposal—it allows the *unbundling of property and priority*. Article 9 has always

provisions); Thomas Ross, *Metaphor and Paradox*, 23 GA. L. REV. 1053, 1055-63 (1989) (examining the evolution of the same metaphor). For a rich treatment of this and other ideas, see Jeanne L. Schroeder, *Chix Nix Bundle-O-Stix: A Feminist Critique of the Disaggregation of Property*, 93 MICH. L. REV. 239 (1994).

¹⁸³ See *infra* Part II.A.2 concerning the term's flexibility and metaphoricity.

¹⁸⁴ *Kaiser Aetna v. United States*, 444 U.S. 164, 176 (1979); *accord Dolan v. City of Tigard*, 512 U.S. 374, 384 (1994); see also *International News Serv. v. Associated Press*, 248 U.S. 215, 250 (1918) (Brandeis, J., dissenting) ("An essential element of individual property is the legal right to exclude others from enjoying it."). Tending to pull in the opposite direction, although paying lip service to *Kaiser Aetna*, is *Pruneyard Shopping Center v. Robins*, 447 U.S. 74 (1980) (holding that the Takings Clause is not violated by state constitutional requirement that private shopping centers allow access for political speech purposes).

Whether the "property" label is affixed to a concept or not matters only because of legally operative rules, presumptions or other conceptual baggage that the label may entail. See Knippenberg, *supra* note 32, at 1975-76 (arguing that LoPucki shows the property label for security interests to be only a rationalization, rather than a justification, for current law); Knippenberg & Ponoroff, *supra* note 178, at 2282 n.198, 2285-89 (describing risk that entailments of metaphor will suppress important differences between concepts); see also MARK JOHNSON, *THE BODY IN THE MIND* 130-38 (1987) (discussing entailments of metaphor generally). What Knippenberg says about security interests is equally true of negative pledge covenants: "[T]he creation of a security interest is not *innately* a conveyance, a contract, or anything else, for that matter." Knippenberg, *supra* note 32, at 1974. But because, under this Article's proposal, perfected negative pledgees would have the right to exclude, it would be entirely traditional to consider them as having property rights, and to think in terms of associated principles, especially *nemo dat* (as limited to protect third parties without notice).

LoPucki isolates one aspect of security as the inability of the debtor to convey inconsistent rights to others, calling this "encumbrance." LoPucki, *supra* note 9, at 1921 & n.131. Under this Article's proposal, this would also be one aspect of a perfected negative pledge covenant. Indeed, LoPucki's more general point is that one should not categorically distinguish between secured lenders and other lenders (including negative pledgees) because their respective devices can have similar effects (a point that seemingly dovetails with his argument, see *supra* note 178, that security interests should not be called property). See *id.* at 1921-23, 1926-28. One can turn this point on its head: because perfected negative pledge covenants would be much like security interests, one should consider them property to the same extent security interests are so considered.

¹⁸⁵ See *supra* note 178.

tied the two concepts together, with the former a prerequisite to the latter. Thus, unperfected secured parties are generally considered to have a property right¹⁸⁶ but no (or only a minimal) priority right,¹⁸⁷ while perfected secured parties are generally considered to have both. This Article's proposal, by contrast, would place a perfected negative pledgee in the unique position of having a priority right without a property right.¹⁸⁸

In a more abstract context, Douglas Baird makes a similar point about the possible unbundling of property and priority. He writes:

Property rights and priority rights are conceptually distinct. Either one could exist without the other. We could, for example, live in a world in which a creditor could bargain for the right to repossess its debtor's property in the event of default, but could not bargain for the right to put itself at the front of the line even if someone else was first to levy on a particular asset or take possession. Having a right to repossess does not necessarily mean that one trumps other creditors who have not bargained for such a right.¹⁸⁹

Baird's example illustrates property without priority. Though Baird writes here at a high level of generality, addressing secured parties vis-à-vis the entire universe of competing creditors, his point is equally valid when narrowed to the context of secured parties vis-à-vis negative pledgees. Under this Article's proposal, the secured party could bargain (as Baird's secured party above can) for the right to repossess; but if another creditor perfects its negative pledge covenant before the secured party perfects, then the secured party cannot bargain (as Baird's secured party above cannot) for the right to be ahead of that negative pledgee in line. The proposal would give secured creditors property without priority, or more accurately, property without the aspect of current law's priority that has made negative pledge covenants so problematic.

Baird continues:

¹⁸⁶ In other words, the security interest has attached, *see* U.C.C. § 9-203 (1995), and the secured party accordingly has the power to exercise self-help remedies, *see id.* §§ 9-501 to 9-507.

¹⁸⁷ Unperfected security interests are subordinate to the rights of just about everyone, *see id.* §§ 9-312(5) (a), 9-301(1) (b), except for marginal characters such as buyers not in the ordinary course that have knowledge of the security interest, *see id.* § 9-301(1)(c), and other unperfected secured parties who attach later in time, *see id.* § 9-312(5)(b).

¹⁸⁸ The decoupling of these two concepts is, again, consonant with the Realist disaggregation of property. *See supra* note 182.

¹⁸⁹ Douglas G. Baird, *Property Rights, Priority Rights, and Ostensible Ownership: The Deep Structure of Article 9*, in 1 SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE § 1.01[2], at 1-3 to 1-4 (1996); *see also* LoPucki, *supra* note 9, at 1921-22 & n.131 (dissecting a secured creditor's rights somewhat differently, but similarly asserting that not all attributes are present in every arrangement that qualifies as security).

Similarly, we could live in a world in which every creditor had to reduce its claim to judgment, but in which one creditor could bargain for a priority position against all the other creditors with respect to a particular asset. A creditor could have the right to come first even though it had to follow the same procedures in reducing its claim to judgment and executing on it, even though it was not in fact the first to use these procedures.¹⁹⁰

This scenario illustrates the converse situation: priority without property.¹⁹¹ It, too, translates well to the narrower context of secured party vis-à-vis perfected negative pledgee. Under the proposal, negative pledgees would have to reduce their claim to judgment, but could nonetheless bargain for the right to come before a later-perfecting secured party.¹⁹² Thus, under the proposal, as in the first of Baird's alternative worlds described above, the perfection principle yields. But under the proposal, it yields only to the minimum degree necessary to render negative pledge covenants more effective, and only in a way that remains true to both the *nemo dat* and the public notice principles that Article 9 has always applied to security interests.

2. *Interlude: Property as a Radially Structured Category*

The abstract but intriguing question remains: is the interest of a perfected negative pledgee a property interest? Different theories of property, of course, will yield different answers, and I do not here propound any of them. Instead, I want to apply a more general theory of reasoning, one that applies not only to property but also to many other legal terms and, indeed, to much of human language in general.¹⁹³ My intent is to show that the concept of property has a

¹⁹⁰ Baird, *supra* note 189, § 1.01[2], at 1-4.

¹⁹¹ Cf. LoPucki, *supra* note 9, at 1922-23 ("One does not need security to achieve priority; subordination agreements may serve just as well. If the intent is priority as to only a particular asset, this priority can be achieved by isolating the asset in a separate corporation.") This Article's proposal accomplishes the same priority (whether as to all or particular assets, depending on the parties' choices) without the transaction costs of subordination agreements or corporate veils. See *infra* Part III.B.

¹⁹² The negative pledgee could only bargain for the right to come before subsequently perfected secured creditors, not before all creditors. As under current law, unsecured creditors who execute on a judgment before the negative pledgee does would generally come before the negative pledgee. Part II.C below addresses this subject.

Alan Schwartz proposes a set of rules in which certain creditors could bargain for the right to precede all creditors. See Schwartz, *supra* note 10, at 218-26. See *infra* Part III.C for a discussion of this proposal.

¹⁹³ George Lakoff and Mark Johnson have developed many of the ideas in the philosophy of language that underlie this Part II.A.2. See JOHNSON, *supra* note 184; GEORGE LAKOFF, *WOMEN, FIRE, AND DANGEROUS THINGS* (1987); GEORGE LAKOFF & MARK JOHNSON, *METAPHORS WE LIVE BY* (1980) [hereinafter LAKOFF & JOHNSON, *METAPHORS*]; GEORGE LAKOFF & MARK JOHNSON, *PHILOSOPHY IN THE FLESH* (forthcoming); George Lakoff, *The Contemporary Theory of Metaphor*, in *METAPHOR AND THOUGHT* (Andrew Ortony ed., 2d ed. 1993). Eve Sweetser has done intriguing related work in the field of historical semantic change. See EVE SWEETSER, *FROM ETYMOLOGY TO PRAGMATICS* (1990). Steve Winter has

radial structure and that, accordingly, one can sensibly consider the interest of a perfected negative pledgee to be property, at least for commercial law purposes.¹⁹⁴ As a result, one should not hesitate to bring Article 9 to bear on negative pledge covenants, even though the covenants have traditionally been viewed as mere contracts while the statute has traditionally been viewed as grounded in property.

Much of human reasoning and language depends on categorization.¹⁹⁵ We can neither communicate nor function in other basic ways without reducing the chaos of sensory data to a somewhat coherent, standardized format. This basic truth is particularly important to the law because so much of it consists of arranging the world into language-based categories: "property," "contract," "good faith," "consent," "proximate cause," "security under section 2 of the '33 Act," and so many more.¹⁹⁶ The crucial question is: how do we go about applying these categories?

Scholars and laypersons alike tend to assume that our mental categories are structured in terms of necessary and sufficient features.¹⁹⁷

done sustained and in-depth work in bringing these ideas to bear in the law. See, e.g., Steven L. Winter, *The Metaphor of Standing and the Problem of Self-Governance*, 40 STAN. L. REV. 1371 (1988) [hereinafter Winter, *Standing*]; Steven L. Winter, *Transcendental Nonsense, Metaphoric Reasoning, and the Cognitive Stakes for Law*, 137 U. PA. L. REV. 1105 (1989) [hereinafter Winter, *Transcendental Nonsense*]. In these few pages, I can only adumbrate some of the ideas in this area, and in the interest of accessibility I have simplified much of the rigorous analysis of the pioneering work cited here.

¹⁹⁴ I stress, however, that I am only propounding one useful view of the interest of a perfected negative pledgee. As with the related issue of how to characterize security interests, one must not treat any metaphorical characterization as ineluctable. See *supra* note 178. Historically, analysts have chosen to characterize negative pledge covenants as contracts, see *supra* Part I.B, and one need not wholly discard that view in order to enrich the field with this alternative characterization.

¹⁹⁵ See LAKOFF, *supra* note 193, at 5-11. Lakoff suggests that "[t]here is nothing more basic than categorization to our thought, perception, action, and speech." *Id.* at 5.

¹⁹⁶ "Legal thought is, in essence, the process of categorization. . . . Categorizing phenomena determines how they will be treated by the legal system. . . . [T]he process is the core of legal thought." Kenneth J. Vandevelde, *The New Property of the Nineteenth Century: The Development of the Modern Concept of Property*, 29 BUFF. L. REV. 325, 327 (1980).

Tennyson's famous and frightening concept of a "wilderness of single instances" applies well to any field or endeavor that lacks categorization, but it is particularly telling that he conceived it as a description of pre-Blackstonian English law:

Mastering the lawless science of our law,
That codeless myriad of precedent,
That wilderness of single instances,
Thro' which a few, by wit or fortune led,
May beat a pathway out to wealth and fame.

ALFRED LORD TENNYSON, *Aylmer's Field*, in THE WORKS OF ALFRED LORD TENNYSON 463, 480 (Hallan Lord Tennyson ed., 2d. ed. 1908).

¹⁹⁷ See Mark Johnson, *Introduction: Metaphor in the Philosophical Tradition*, in PHILOSOPHICAL PERSPECTIVES ON METAPHOR 3 (Mark Johnson ed., 1981); LAKOFF, *supra* note 193, at 6 (asserting that this view predominated "[f]rom the time of Aristotle to the later work of Wittgenstein"). Thus, a child learns that "a cup is a rounded container used for drinking liquids," and a law student learns that "a properly filed financing statement is one that

Each time we consider a stimulus, the assumption runs, we mentally compare it to a category's list of necessary and sufficient features and, if the stimulus satisfies the entire list, it qualifies for membership in the category. Every categorization question thus has a simple, yes or no answer; the object either belongs or does not belong, and no intermediate result is possible.¹⁹⁸ Under this view, we categorize stimuli based solely on objective criteria that are independent of the imagination of the persons categorizing them. The categorization process is computer-like in its objectivity, impersonality and bipolarity.¹⁹⁹

Recently, however, scholars of cognitive linguistics have advanced the view that most of our categories function in a less objective and less mechanistic way. Instead, they argue, most instances of categorization depend, at their base, on creative human imagination.²⁰⁰ One important way that this imagination asserts itself is through the pervasive use of radial categories.²⁰¹ Radial categories are constituted not by necessary and sufficient conditions, but by degrees of sharing of prototypical characteristics. We include or exclude stimuli from a radial category based on whether, and to what degree, they possess the prototypical characteristics as a literal or non-literal matter,²⁰² and the

correctly sets forth the data in § 9-402 and has been presented with the appropriate fee to filing officer(s) in the jurisdictions specified in §§ 9-103 and 9-401," or that "a security under Section 2 of the '33 Act is an investment in a common enterprise with the expectation of profits from the efforts of others." See, e.g., SEC v. W.J. Howey Co., 328 U.S. 293, 298-99 (1946); SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 477 (5th Cir. 1974).

¹⁹⁸ The link to the law of the excluded middle is clear. See *supra* note 20 and accompanying text.

¹⁹⁹ Lakoff and Johnson use the term "objectivism" to describe this and associated views. See LAKOFF, *supra* note 193, at 157-84; JOHNSON, *supra* note 184, at ix-xiii; Winter, *Transcendental Nonsense*, *supra* note 193, at 1107-08.

Another consequence of the objectivist view is that all category members are equally legitimate representatives of the category. See LAKOFF, *supra* note 193, at 7, 17. Thus, for example, no cup is more of a cup than any other. This follows from the fact that the only criterion for belonging to the category is whether a stimulus satisfies the list of necessary and sufficient conditions. This equal legitimacy contrasts strikingly with the characteristics of radial categories discussed immediately below.

²⁰⁰ See JOHNSON, *supra* note 184, at ix ("Without imagination, nothing in the world could be meaningful. Without imagination, we could never make sense of our experience. Without imagination, we could never reason toward knowledge of reality"). The contrasts between this view of categorization and the traditional one discussed above resemble those between classical and Realist legal thought. "Perhaps the most fundamental architectural idea of legal orthodoxy was embodied in its faith in the coherence and integrity of bright-line boundaries. . . . In all areas of thought, early twentieth-century thinkers challenged the naturalism and essentialism of existing social practices, as well as the categories that legitimated them." HORWITZ, *supra* note 26, at 199. See generally *id.* at 3-31, 193-212 (tracing the development and legacy of Legal Realism).

²⁰¹ Another, perhaps even more important, is the pervasive and often unconscious use of metaphor. See *infra* note 216 and accompanying text.

²⁰² Four so-called "principles of extension" from the center of a radial category have been isolated: the metaphoric, the metonymic, the image schematic, and the propositional. See LAKOFF, *supra* note 193, at 113-14, 204. The one most important to this discussion is the metaphoric, which is seen at work below in connection with sources of

strength or weakness of a category member's possession of these characteristics leads us to consider that category member as more or less representative of, or "central" to, the category. Thus, the various members of a radial category radiate out, so to speak, from a common center (although they may otherwise have little in common).²⁰³

One relatively simple example is the noun "cup."²⁰⁴ One could construct a list of necessary and sufficient conditions for cups; for example, one could decide that a stimulus is a cup if and only if it holds liquid, is usually used for drinking, and is small enough to hold in one hand. However, any such list would fail to account for the way that we actually apply the category in the real world.²⁰⁵ The radial approach offers a much more satisfactory explanation: the prototypical characteristics of a cup can be said to be exemplified by a coffee cup or a teacup,²⁰⁶ and everything else to which we apply the word "cup"

protection, proceeds and the right to exclude. See *infra* notes 221-23, 228 and accompanying text. One can see the metonymic principle of extension at work *infra* in notes 207 and 220, in connection with the cup of sugar and the security interest. One can see the image-schematic principle of extension at work *infra* in note 219, in connection with the cognitive transformation of a floating lien. And one can see the propositional principle of extension at work in much of the rest of this subsection: it consists of asserting that one stimulus is like another in that the two have specified traits in common as a literal matter.

At some point, the resemblance of a stimulus to a prototype grows weak enough (though it may still exist) that people do not include the stimulus in the category. This point is determined not by any objective measure, but by tacit social convention. This convention is presumably based, in turn, on a balance between the usefulness and the confusion that would result from inclusion. Cf. WITTGENSTEIN, *supra* note 100, ¶ 71, at 34e (explaining that concepts with indistinct boundaries are nonetheless concepts and, indeed, are sometimes more useful because of this indistinctness). Radial categories bear out Holmes's declaration that "[g]eneral propositions do not decide concrete cases." *Lochner v. New York*, 198 U.S. 45, 76 (1905) (Holmes, J., dissenting).

²⁰³ Cognitive linguistics also contemplates other types of categories (such as scalar or graded categories), but these are not germane to the present discussion of property. See LAKOFF, *supra* note 193, at 287-88. The theory also acknowledges that one may indeed determine some categories, though many fewer than traditionally thought, by reference to necessary and sufficient conditions. See Lakoff, *supra* note 193, at 205 ("[T]here is nonetheless an extensive range of nonmetaphorical concepts. A sentence like 'the balloon went up' is not metaphorical, nor is the old philosopher's favorite 'the cat is on the mat.'").

²⁰⁴ I am indebted to Mark Johnson for this example and much of the following discussion of it. For an interesting discussion of the word "hand," another relatively simple example, see Winter, *Transcendental Nonsense*, *supra* note 193, at 1149-50 (using radial category structure as an alternative to Benjamin Whorf's contextualist view of the word).

²⁰⁵ The list of conditions in the text is neither necessary nor sufficient. The conditions are not all necessary because certain items that we call cups do not satisfy them all. For example, a cup of sugar (i.e., the amount rather than the container of the amount) does not hold liquid, trophy cups may be too big to hold in one hand, and golf cups and dice cups are not used for drinking. Nor, on the other hand, are the listed conditions sufficient, because certain items not considered cups do fulfill them: a milk carton, a beer bottle, or a teaspoon of cough medicine.

²⁰⁶ It is not simple, however, to identify prototypical characteristics or to identify central category members. See *infra* note 208. It will be useful to identify here the characteristics that are salient to this example. It has a somewhat flared cylindrical shape, a flat bottom, a handle, and a saucer. Its purpose is to hold hot liquid, and its material is porce-

shares one or more of those characteristics according to various principles.²⁰⁷

The category "property," I submit, is structured radially. Its prototypical characteristics seem best to be exemplified by that basic concept, the house, with or without the house's very frequent concomitant, the plot of land.²⁰⁸ To isolate precisely which characteristics of the house figure in speakers' decisions to call a stimulus prop-

lain or ceramic. It is used in the social context of gatherings or meals. It often has a modest aesthetic dimension, for example, a graceful flare or a painted skein of flowers.

²⁰⁷ For example, a paper cup may share much of the coffee cup's shape, although the saucer is absent and the handle, if any, is vestigial. It also shares much of the coffee cup's purpose, though the paper cup is intended for cold liquids at least as often as for hot. Its social context is different: the take-out counter of a diner, the water cooler or the desktop. And its aesthetics are nil or minimal (though it's hard not to enjoy the Greek-style lettering and images of ruins on the paper coffee cups of some New York City diners).

A cup of sugar (again, the amount rather than the container of the amount) is related to the prototypical cup in part through resemblance in size, but also (and more important) through the linguistic device of metonymy. That is, references to the container of the amount (e.g., "a half cup") stand for references to the amount.

A trophy cup does not share the prototypical cup's purpose, but does share something of its shape (excluding the flat bottom but including handles), its modest aesthetic dimension, and a variation of its social context (in that it represents a moment in which people come together).

Without continuing with other examples (golf cup, buttercup, etc.), it should be clear that even the very simple word "cup" applies to a startling variety of items, each of which shares a complex of the prototypical characteristics as a literal or non-literal matter.

²⁰⁸ While this choice is not inevitable, it is strongly justifiable. In my own unscientific survey of academics, lawyers and laypersons, the image most strongly called to nearly everyone's mind by the word property was the single-family house surrounded by land. It is also the meaning most likely to be carried by a layperson's use of the term: "Get off of my property!" Cf. Rogers, *supra* note 178, at 992 n.74 (noting the "perception of the mortgage on Blackacre as the paradigm of secured financing"). However, most central category members have that status only as a contingent, conventional, cultural matter; they are nothing more or less than what most people think of as the best representative of the category. See LAKOFF, *supra* note 193, at 204-05. (An exception exists for central members of categories such as color names. The work of Berlin, Kay, Rosch and others seems to show these central members to be neurophysiologically determined, although the boundaries of the colors named are not. See JOSEPH F. KESS, *PSYCHOLINGUISTICS* 257-59 (1993); LAKOFF, *supra* note 193, at 24-30).

Because most central members are culturally determined, they are also historically situated, and the house with land has historical roots that are stronger by far than anything else that we call property today. Beginning with the Industrial Revolution, the growth of manufacturing has caused goods to emerge as an important form of property, and perhaps this process has caused the house with land to become less unambiguously prototypical. See *infra* note 217. During the 20th century, the spread of patents, trademarks, securities investments and other incorporeal forms of property may have had a similar effect. Nonetheless, the house with land remains a powerful force in our society. See U.S. DEP'T OF COMMERCE, *STATISTICAL ABSTRACT OF THE UNITED STATES* 723 (117th ed. 1997) (reporting that in 1995, over 60% of housing units in the United States were single family and detached in structure). Even if this force is no longer truly dominant (a far from foregone conclusion), the past exerts power over our language and imagination. Cf. Grey, *supra* note 182, at 73 (arguing that the concept of ownership is influenced by the fact that houses and lots with unitary ownership were the predominant form of wealth in the pre-industrial age).

erty is an undertaking beyond the scope of this short discussion, but among the crucial characteristics would doubtless be most of the following. It is a physical location. It persists stably through time. It is useful, for example as a source of protection from predation. It is a form of wealth. It is alienable.²⁰⁹ The owner has the right to use it as she pleases, at least within certain broad limits. It results from (or is improved by) the owner's labor. Its grounds are cultivable and fertile, and the owner generally has the right to what grows on it. It is habitable, and the owner uses it for that purpose. And the owner has the right to exclude others, that is, the right to keep them off of the land or out of the house. (Indeed, the owner of the house generally has not only the right to exclude, but also actual exclusion: the house functions to actually keep others out.) It should be clear that many or most of these characteristics will be present, to a greater or lesser degree, in many other stimuli that we call property, but also that, from among these and the other rich characteristics of a house,²¹⁰ it would be vain to attempt to declare particular ones to be necessary and sufficient to qualify it, or anything else, as property.

Speakers and writers include disparate stimuli within the category of property because, in my view, each of the stimuli represents a radial extension from the central case exemplified by a house with land.²¹¹ A thorough demonstration of this proposition would require more space than is available here, but a serviceable overview of the idea can be had by examining two noteworthy examples: patents and security interests. Patents certainly share some of the attributes of the house

²⁰⁹ To further illuminate the historically situated nature of category members, particularly central ones, one should note that between the time of William the Conqueror and the end of the thirteenth century, English law prevented alienation of land. See A.W.B. SIMPSON, *A HISTORY OF THE LAND LAW* 51-56 (2d ed. 1986).

²¹⁰ Other vital characteristics of the house with land include the facts that, for example, it is a repository of other wealth; it is the face that the owner presents to the world and a means of self-definition; it is a realm of private rather than public power; and it is a sanctuary either for solitude or for interaction with intimates. (There is much to be said about the contrast between the prevailing U.S. conception of the house as a means of exclusion, referred to in the text, and other cultures' conception of the house as a means of inclusion.) Although certain theories of property hold these or other characteristics to be crucial, we can neglect them for this discussion's limited purpose.

²¹¹ To take just a few simple examples, we generally apply the label "property" to investment real estate (even though the owner does not use it for habitation), unfenced land in grizzly bear territory (even though it is not a source of protection), money (even though it is not a physical location), and stock (even though, due to the separation of ownership and control, it is not cultivable by the owner in even a metaphorical sense). "Many forms of property recognized by the law are really metaphoric extensions of the physical objects that are prototypical property, which is probably why lawyers refer to land as *real* property." Winter, *Standing*, *supra* note 193, at 1496 n.699. To quibble with only a tangential aspect of Winter's point, the usage of the word "real" that he mentions seems actually to derive from the notion of a *res* having physical existence. 13 OXFORD ENGLISH DICTIONARY, *supra* note 47, at 272-74. On the possible prototypicality of personal property, see *infra* note 217.

with land as a literal matter.²¹² More interesting, however, is the fact that patents also share some of those characteristics on a metaphorical level. Most notably, while patents are not physical locations, we conceive of them as if they were. This is revealed by the way we speak of them (and, relatedly, of ideas in general): an idea can fall *within the bounds* protected by a patent,²¹³ an infringer invades the patentee's *turf*, and ideas or experts are *in* certain *fields* (or *areas*). In the jargon of patent law, the precise scope of a patent is called its *metes and bounds*.²¹⁴ And, most tellingly, a patentee is said to have the *right to exclude* others from his or her metaphorical territory.²¹⁵ For purposes of radial category analysis, these metaphorical resemblances to the prototype are no less important than the literal ones. (In fact, for all purposes, the right to exclude is more important than the literal ones; it is the core of a patentee's rights). Moreover, the metaphorical expressions isolated here are not merely rhetorical embellishments, but rather the ordinary way that one speaks of patents. One of the most powerful insights of cognitive linguistics is that metaphor is more than a poetic device. Instead, it pervades ordinary language, helping to

²¹² Patents are a form of wealth. They result from the owner's labor. They are alienable. They persist through time, at least for the 20-year period specified by law. See 35 U.S.C. § 154(a)(2) (1994).

This sharing of certain, if not all, attributes with another category member is what Wittgenstein terms "family resemblance"—"a complicated network of similarities overlapping and criss-crossing: sometimes overall similarities, sometimes similarities of detail." WITTGENSTEIN, *supra* note 100, ¶¶ 66-69, at 31e-33e. His classic illustration is the category "game": we attach that label to each of football, poker, solitaire, and ring-around-the-rosy, even though no set of attributes is common to all of them. See *id.*

²¹³ See, e.g., Robert P. Merges & Richard R. Nelson, *On the Complex Economics of Patent Scope*, 90 COLUM. L. REV. 839, 911 (1990) (arguing that "[i]f an improvement represents a very significant advance, it should be held not to infringe—even if it is within the literal bounds of the patentee's claim").

²¹⁴ See, e.g., *Brenner v. Manson*, 383 U.S. 519, 534 (1966) ("Until the process claim has been reduced to production of a product shown to be useful, the metes and bounds of that monopoly are not capable of precise delineation."); ROBERT PATRICK MERGES, *PATENT LAW AND POLICY* 10 (1992) ("Innumerable patent cases . . . analogize claims to the 'metes and bounds' of a real property deed.").

²¹⁵ "Every patent shall contain . . . a grant to the patentee . . . of the right to exclude others from making, using, offering for sale, or selling the invention throughout the United States or importing the invention into the United States . . ." 35 U.S.C. § 154(a)(1). Similarly, Edmund Kitch speaks of the patent system as allowing patentees to stake a claim. See Edmund W. Kitch, *The Nature and Function of the Patent System*, 20 J.L. & ECON. 265, 271-75 (1977). On the importance of the right to exclude in property analysis generally, see *supra* note 184 and accompanying text.

Moreover, the metaphorical links between patents and a house with land go beyond the idea of physical location. We also speak of ideas as being habitations (the inventor *lives in her own world*) and as being fertile (after years of toil *in the vineyards*, the idea has begun to *bear fruit*). On the other hand, we also speak of patents or ideas using metaphors related to objects rather than locations. See *infra* note 217.

constitute many of our abstract concepts,²¹⁶ including our concept of property.

Security interests, like patents, are radial extensions from the central case exemplified by a house with land. At the literal level, security interests share some of the central case's attributes, though even fewer than patents do.²¹⁷ At non-literal levels, however, security interests are closely related to the central case. First, although the house with land persists stably through time and the collateral subject to a floating lien

²¹⁶ See LAKOFF & JOHNSON, *METAPHORS*, *supra* note 193, at 10-32, 56, 210-11. Lakoff and Johnson explained that "most of our normal conceptual system is metaphorically structured; that is, most concepts are partially understood in terms of other concepts." *Id.* at 56; see also Lakoff, *supra* note 193, at 202-03 (arguing that the longstanding presumption that metaphor is "a matter of language, not thought" is false, and that principles of metaphor "apply not just to novel poetic expressions, but to much of ordinary everyday language"); GEORGE LAKOFF & MARK TURNER, *MORE THAN COOL REASON: A FIELD GUIDE TO POETIC METAPHOR*, at xi (1989) (declaring that metaphor is "indispensable not only to our imagination but also to our reason").

The pervasiveness of metaphor makes us all a bit like Monsieur Jourdain, who in mid-life took it upon himself to learn the basics of, among other things, literature. "Good Heavens!" he exclaims. "For more than forty years I have been speaking prose without knowing it!" MOLIÈRE, *LE BOURGEOIS GENTILHOMME*, act II, sc. iv.

²¹⁷ Security interests are alienable (that is, assignable), at least in connection with an assignment of the debt secured. They might be thought of as a form of wealth, although this attribute is perhaps better expressed by the idea of metaphorical protection, discussed in the text. Security interests may or may not, however, be thought to result from the owner's labor in the same sense as patents are; the antique prejudice persists that lending is not productive work.

Jeanne Schroeder presents an interesting, enjoyable discussion of the supposed primacy in Article 9 of the grasped object. See Schroeder, *Legal Surrealism*, *supra* note 100, at 491. Although she does not share this view, and does not discuss radial categories, her discussion raises the question of whether the most central example of property (at least in the Article 9 context) is a possessed object, rather than a house with land. In part because Article 9 is, after all, concerned with personal rather than real property, this is an attractive idea, and one can make the case. (For example, debtors are said to *give* as well as to *grant* lenders a security interest.) As noted *supra* in note 215, one could make a similar case for patents or ideas. Thus, patents prevent others from *stealing* my idea; some ideas are hard to *grasp*; Bell Labs *holds* the rights to certain inventions. In fact, an early meaning of the verb "to infringe" was to break or shatter. See, e.g., FRANCIS QUARLES, *DIVINE FANCIES* (1632), *quoted in* 7 OXFORD ENGLISH DICTIONARY, *supra* note 47, at 951 ("It is a potent science that infringes Strong Prison Doors, and heaves them from their hinges."); see also Knippenberg, *supra* note 178, at 1572-73 (discussing security interests as objects); Winter, *Standing*, *supra* note 193, at 1494-96 (discussing ideas as objects).

The next question, though, is why the grasped object itself is thought of as property. Perhaps the reason is that generations of language users have understood it in terms of its similarities to the house with land. Alternatively, perhaps the category of property has two equally central members, much as some planetary systems revolve around two stars. See Malcolm W. Browne, *Image Is Believed to Be the First of a Planet Beyond Solar System*, N.Y. TIMES, May 29, 1998, at A1. This supposition is particularly plausible when the category itself is undergoing social evolution. See *supra* note 208. See also Winter, *Transcendental Nonsense*, *supra* note 193, at 1155-56 (using radial category with dual core as an alternative description of prior work on the category "lie"); Winter, *Standing*, *supra* note 193, at 1493 ("The more important the concept, the more likely that the concept is structured in terms of many different and richer, structural metaphors.").

does not,²¹⁸ we nonetheless conceptualize such collateral as a single, persisting mass.²¹⁹ Second, although the house and land are tangible, and the security interest is not, security interests often include the contingent right to seize tangible items.²²⁰ Third, although the house protects from predators and the security interest does not, we nonetheless think of security interests as protection from those metaphorical predators, other lenders.²²¹ Fourth, although the house owner has the right to that which grows on the property and the secured party does not, we might nonetheless metaphorically think of the secured party's rights to proceeds as the fruit of a tree.²²² Finally, although the

²¹⁸ That is, the property subject to the security interest is continually sold or dissipated and replaced by new property. See CLARK, *supra* note 23, ¶ 10.01; William E. Hogan, *Games Lawyers Play with the Bankruptcy Preference Challenge to Accounts and Inventory Financing*, 53 CORNELL L. REV. 553, 560 (1968) (both the businessperson debtor and the professional lender probably view a security interest in accounts as a "Heracleitean river," remaining the same though constantly changing); cf. Rogers, *supra* note 178, at 992-93 ("[T]he identity of the specific property involved is the matter of least importance to the secured creditor. . . . [A] bankruptcy court may freely take away a secured creditor's rights against his specific collateral and substitute a lien on other property of the debtor having equal value.").

²¹⁹ Thus, the mass is deemed simply to shrink or grow over time, and not to wholly disappear and be replaced. See, e.g., 11 U.S.C. § 547(c)(5) (1994); *In re Portland Newspaper Publ. Co.*, 271 F. Supp. 395, 399 (D. Or. 1967) (addressing litigant's argument that "all of the accounts should be considered as a unit or a floating mass"). This phenomenon of treating multiple items as a single mass is common; we do it whenever we think of multiple cars as "traffic," multiple water droplets as "rain," or multiple students as "a class" or "the student body." Lakoff and Johnson refer to this phenomenon as an "image-schema transformation," and specifically as a transformation from multiplex to mass. JOHNSON, *supra* note 184, at 25-28, 104; LAKOFF, *supra* note 193, at 440-44. This aspect of security interests exemplifies the fourth of the principles of extension referred to *supra* in note 202, the image-schematic extension, which is based on similarity of overall perceived form, or gestalt. See JOHNSON, *supra* note 184, at 41-64.

²²⁰ See U.C.C. § 9-503 (1995). At work here (as with the cup of sugar example *supra* note 207) is a metonymy: when we speak of a security interest as property, we understand the right to seize the collateral in terms of the collateral itself.

²²¹ See, e.g., BUCHHEIT, *supra* note 4, at 80 (likening competing creditors to Hobbesian combatants); Peter F. Coogan, *The New UCC Article 9*, 86 HARV. L. REV. 477, 513-14 (1973) (discussing "protection" of secured parties making future advances); Steven L. Schwarcz, *Rethinking A Corporation's Obligations to Creditors*, 17 CARDOZO L. REV. 647, 663 (1996) ("Trade creditors seeking additional protection can even demand purchase money security interests to secure repayment.").

²²² We use this concept even with proceeds that are intangible, such as accounts receivable. See, e.g., R. Wilson Freyermuth, *Rethinking Proceeds: The History, Misinterpretation and Revision of U.C.C. Section 9-306*, 69 TUL. L. REV. 645, 700 (1995) (describing assets earned by the debtor through use of the collateral as "fruits of the macliine's productive capacity"); see also 11 U.S.C. § 552(b)(1) (addressing proceeds in conjunction with "product, offspring, or profits" of property); Revised U.C.C. § 9-102(a)(64)(C) (1998) (defining "proceeds" to include "rights arising out of collateral").

This metaphor has not fit very well with current law's requirement that, in most cases, proceeds arise from a "disposition" of the original collateral. U.C.C. § 9-306(1). As Ken Kettering remarked on a draft of this Article, proceeds has resembled picking fruit from a tree less than it has resembled chopping the tree down and selling it to Weyerhaeuser. Recently, however, the disposition requirement has receded in importance, perhaps in part because of conceptual pressure from the metaphor in question. In 1994, the "anti-

secured party has no physical land or house from which to bar intruders, we nonetheless say that the perfected secured party has the right to exclude,²²³ that is, to prevent others from acquiring a superior claim to the collateral.

Along this line of analysis, it is only natural to accept the interest of a perfected negative pledge as another radial extension from the same central case. A perfected negative pledge covenant shares certain literal attributes with a house with land,²²⁴ and also shares many of the same non-literal attributes of the prototype that security interests do.²²⁵ Moreover, while negative pledge covenants have no physical aspect (and lack even the contingent right to seize physical objects that security interests have), we nonetheless clearly understand them in terms of a metaphorically physical location. Thus, the debtor's unencumbered assets are said to be a *margin* of comfort, the lender desires to *fence them off*, purchase money security interests or other liens may be agreed upon as *carve-outs*,²²⁶ and perfection would prevent the negative pledgee from being vulnerable to a *breach* (i.e., to an intrusion through a gap in a protective barrier²²⁷). And finally, as dis-

Hastie" amendment to § 9-306(1) added the idea that all distributions with respect to investment property collateral are proceeds. In 1998, Revised Article 9 expanded the distributions idea to apply to other types of collateral, and also included "rights arising out of collateral" as proceeds. Revised U.C.C. § 9-102(a)(64)(B), (C) (1998).

²²³ See, e.g., Harris & Mooney, *supra* note 11, at 2051 n.83. Similarly, Baird applies Kitch's claim-staking metaphor, *supra* note 215, to security interests. See Baird, *supra* note 112, at 62-63 (citing ALAN SCHWARTZ & ROBERT E. SCOTT, COMMERCIAL TRANSACTIONS 596-97 (1982)). For an examination of this and related metaphors for security interests, see Bjerre, *supra* note 158, at 758-59 & nn.5-6 and *supra* notes 204-15 and accompanying text.

²²⁴ Like the security interest, the negative pledge covenant is a form of wealth (though here, too, it might be better to think in terms of metaphorical protection). It is also alienable (that is, assignable), at least in connection with an assignment of the underlying debt. To these similarities must be added the obvious common social function: both the secured party's and the negative pledgee's interests are conferred by contract for the purpose of increasing the assurance of repayment of an outstanding loan.

²²⁵ The negative pledge covenant provides metaphorical protection against predators. If properly drafted, it covers things metaphorically grown on the property subject to the negative pledge. And if the documentation so provides, it "floats," that is, persists through time like a single mass, despite changes in items to which it applies.

It is also worth noting perfected negative pledge covenants' non-literal similarity to patents: as Ronald Mann pointed out while this Article was in draft, both concepts consist of rights to exclude evidenced by a public record. Radial categories are often characterized by such relations among radii, in addition to relations of each radius to the center of the category. LAKOFF, *supra* note 193, at 287 ("Noncentral categories may be 'subcenters,' that is, they may have further center-periphery structures imposed on them.").

²²⁶ See *supra* note 14.

²²⁷ See, e.g., WILLIAM SHAKESPEARE, KING HENRY V, act 3, sc. 1 ("Once more unto the breach, dear friends, once more,/Or close the wall up with our English dead!"); JOHN SMITH, OCCURRENCES AND ACCIDENTS OF NOTE IN VIRGINIA 174 (1608) ("The salt water . . . entered at the large breaches of their poore wooden castle"), quoted in 2 OXFORD ENGLISH DICTIONARY, *supra* note 47, at 503.

One should not allow a single metaphor to prove too much; for instance, one speaks of "breach" in connection with contracts other than negative pledge covenants, but no one

cussed earlier, this Article's proposal extends to negative pledgees the *right to exclude*,²²⁸ in the same metaphorical sense that patentees and secured parties have that right. In fact, in this respect the proposal brings negative pledgees even closer to the central case: by bringing to bear Article 9's self-executing mechanism for allocating rights, the proposal actually prevents secured parties from taking priority. Perfected negative pledgees, like perfected secured parties and homeowners, have actual exclusion rather than merely the right to exclude.

Thus, there is a sensible, coherent case for accepting the interest of a perfected negative pledgee as property—a case at least as strong as, for example, the fairly uncontroversial ones for patents and security interests. Others have rightly observed that there is no ineluctable reason to consider even security interests as property,²²⁹ at least for all purposes.²³⁰ The converse point is that there is no ineluctable reason not to consider perfected negative pledge covenants as property, at least for some purposes. I take no position on whether negative pledge covenants are property under, for instance, the Takings Clause,²³¹ but for purposes of Article 9, the case is strong.²³² As a result, the interest of a perfected negative pledgee may well naturally come to be thought of as property. Language evolves without deliberate guidance, and in this case it should, too, once speakers recognize

would argue that every contract should therefore be thought of as property. What distinguishes the perfected negative pledge covenant from other contracts here is the strength of its network of other similarities to a house with land, most notably the right to exclude, discussed in the text immediately below.

Another, earlier meaning of "breach" (as of "infringe," see *supra* note 217) is the breaking of an object. JOHN GAULE, *HOLY MADNESSE* 295 (1629) (referring to "the casual breach of a Crystall Glass"), quoted in 2 *OXFORD ENGLISH DICTIONARY*, *supra* note 47, at 503. Other object-based metaphors used in conjunction with negative pledge covenants include the debtor's unencumbered assets being a *cushion* that the lender wishes to protect against *dissipation* or *depletion*. As with the object-based metaphors for patents or security interests, these do not necessarily undermine the role of the house with land as a central exemplar of the category of property. See *supra* notes 208, 216.

²²⁸ See *supra* notes 183-84 and accompanying text.

²²⁹ See Knippenberg, *supra* note 178, at 1572; Knippenberg, *supra* note 32, at 1972; LoPucki, *supra* note 9, at 1952-54; Ponoroff & Knippenberg, *supra* note 178, at 2260-63.

²³⁰ See Rogers, *supra* note 178, at 993-94.

²³¹ See *id.* at 1029 (arguing that security interests are also not property for these purposes); see also *infra* note 256 and accompanying text (proposing that a perfected negative pledge covenant not be considered property for purposes of a judgment creditor's levy on a debtor's interest in property).

²³² At the risk of getting irretrievably lost in meta-metaphor, one might say that the radii from central case to negative pledgee on one hand, and from central case to secured party on the other, form an angle of only a few degrees and are of comparable length. Alternatively, one might say that the radius from central case to negative pledgee is a short extension of that from central case to secured party.

(consciously or not) the strength of the links between the house with land and the interest of a perfected negative pledgee.²³³

3. *Enforcing the New Priority Rule*

It is one thing to decide that perfected negative pledgees will have priority over subsequent secured parties, but quite another to grapple with the more practical problem of how to enforce the idea.²³⁴ When a negative pledgee perfects, and a junior secured party wants to foreclose or exercise other self-help remedies, what happens? With this question, unlike with most others, the proposal's conservatism fails it: most of the devices with which Article 9 implements analogous priority rules between two secured parties are not readily transferable to this context.

A variety of possible devices are, nonetheless, available. One simple if severe possibility would be to bar the secured party from exercising its self-help remedies altogether.²³⁵ Another possibility, equally simple and more moderate, would be simply to declare by statute that the taker of a security interest in violation of a perfected negative pledge covenant is deemed to have subordinated its security interest to the rights of the negative pledgee, leaving law other than Article 9 to fill in the details. A further option, discussed below, would be to impose a constructive trust on the subordinated secured party who exercises remedies. No doubt other devices could also be invented.

²³³ Similar expansions of categories are not uncommon phenomena. During the 1970s, Wittgenstein's exemplary concept of game expanded to include video games. See LAKOFF, *supra* note 193, at 16. During the 19th century, the concept of property itself expanded to include trademarks, trade secrets and other assets. See Vandeveldt, *supra* note 196. In recent decades, the same concept has expanded dramatically, though in some aspects temporarily, in the context of public benefits, property settlements and other matters. See, e.g., Charles A. Reich, *The New Property*, 73 YALE L.J. 733 (1964); Charles A. Reich, *The New Property After 25 Years*, 24 U.S.F. L. REV. 223 (1990); MARY ANN GLENDON, *THE NEW FAMILY AND THE NEW PROPERTY* (1981).

Samuel Johnson beautifully expresses similar points on a much more general basis:

[S]ounds are too volatile and subtle for legal restraints; to enchain syllables, and to lash the wind, are equally the undertakings of pride [Some causes of linguistic change,] though slow in their operation, and invisible in their progress, are perhaps as much superiour to human resistance, as the revolutions of the sky, or intumescence of the tide. . . . The tropes of poetry will make hourly encroachments, and the metaphorical will become the current sense

SAMUEL JOHNSON, *A DICTIONARY OF THE ENGLISH LANGUAGE* 2 (Longman reprint 1990) (1755).

²³⁴ Compare BANANAS (United Artists 1971), in which the new dictator of a fictional South American nation announces a roster of reforms: "From this day on, the official language of San Marcos will be Swedish!"

²³⁵ The simplicity of such an approach grows perhaps more attractive as one grapples with the issues (explored in the remainder of this Part II) that are raised by leaving subsequent secured parties with such rights. For a discussion of related issues, see *supra* note 159; *infra* Part III.A.

Musing over possible enforcement mechanisms for a different rule at an Article 9 Drafting Committee meeting, Co-Reporter Chuck Mooney remarked, "Personally, I've always kind of liked the idea of making violations a Class B felony."

My purpose here is not to propound any particular system for regulating the subordinated relationship of secured party to prior perfected negative pledgee. The principal reason for this relatively hands-off approach is that, as a practical matter, the problem would probably be quite minor. The relationship between the two actors in question is actually just a single facet of much bigger, longstanding Article 9 questions concerning the competing rights of senior secured parties and remedy-exercising junior parties. Article 9 has survived quite successfully for almost forty years without a close resolution of those questions, and even in the process of revising Article 9, the consensus was that no exhaustive resolution of them was necessary.²³⁶ One reason that these issues have not been problematic under current law is that multiple security interests in personal property are fairly rare.²³⁷ It is reasonable to expect that under this Article's proposal, security interests taken in violation of a perfected negative pledge covenant would become similarly rare. If rules are chosen, however, they should serve at least three goals: making violation of negative pledge covenants unpalatable to third parties; avoiding unpredictabilities similar to those that afflict current law;²³⁸ and (if the proposal's conservatism is to be a guide) avoiding other hindrances to commerce, including present patterns of secured lending.²³⁹

²³⁶ The Permanent Editorial Board's Article 9 Study Group explained:

The Committee recognizes that a comprehensive statutory treatment of the issues surrounding enforcement by Juniors would require significant changes to Part 5 [the self-help provisions]. It encourages the Drafting Committee to consider all of the issues. But, given the relative infrequency of multiple security interests in the same collateral, the Committee believes that many of the problems are not significant enough to warrant comprehensive revision.

PERMANENT EDITORIAL BD. FOR THE UNIF. COMMERCIAL CODE, PEB STUDY GROUP UNIFORM COMMERCIAL CODE ARTICLE 9: REPORT § 30(c), at 218 (1992).

²³⁷ The fact that future advances generally have the same priority as initial advances, *see* U.C.C. § 9-312(7) (1995), keeps a subordinate creditor from having any confidence that the collateral will ultimately support its recovery. In addition, as Baird notes, personal property is less likely than land to appreciate, and it is costly for junior lenders to procure a subordination agreement. *See* Baird, *supra* note 112, at 65.

²³⁸ *See supra* Part I.C.

²³⁹ This last criterion would rule out both the simplest enforcement rule, banning the secured party from exercising remedies, and the related idea of delaying its exercise of remedies until the negative pledgee had the opportunity to reduce its claim to judgment and execute thereon. *But see supra* note 159; *infra* Part III.A.

Whatever the rules chosen, the secured party must be able to recover judicially on its debt to the same extent that an unsecured party can. In other words, the proposal subordinates a secured party's property interest, not its debt; no creditor, by acquiring a security interest, has ever been thought to lose its rights as an unsecured creditor. *See* U.C.C. § 9-

In contests between two secured parties, the principal restriction on the junior is simply an application of the *nemo dat* principle: the junior, or its buyer at a foreclosure sale, holds the collateral subject to the senior's continuing security interest.²⁴⁰ We cannot exactly replicate this workable, tried-and-true pattern in the context of a perfected negative pledge covenant because the negative pledgee has no security interest to which one can force the foreclosing junior, or the buyer at a foreclosure sale, to hold subject.²⁴¹ But the pattern is nonetheless instructive: one can borrow from it the more general idea that the senior has rights against the junior. Just as a senior secured party has a security interest enforceable against the junior secured party who forecloses, a perfected negative pledgee could have an unsecured claim against the subordinated secured party who forecloses. One would achieve this result statutorily by simply imposing a subordination rule, for example, that a secured party who perfects after a negative pledge is deemed to have contracted to subordinate its property rights to the rights of the negative pledgee. As a result, the negative pledgee would have a claim against the secured party in the event of any exercise of remedies.

This rule alone would be unsatisfactory because it would impose on the negative pledgee a debtor different from the one that it bargained for. When the foreclosing junior is an established bank or other creditworthy entity, this imposition is not troubling, but in many other cases it could be. Prospective negative pledge lenders cannot generally foresee the creditworthiness of a later secured party. Thus, simply giving the perfected negative pledgee an unsecured claim against the foreclosing subordinated secured party would not adequately achieve one important goal of this Article's proposal, which is to reduce uncertainty for negative pledgees.

A stronger measure is necessary, one that will free the negative pledgee from worry about the secured party's creditworthiness, but still permit the secured party to foreclose. One such measure would be to impose a constructive trust on the foreclosing secured party and in favor of the negative pledgee (although not in favor of other un-

501(1) (providing that a secured party "may reduce [its] claim to judgment"). By the same token, if the debtor makes voluntary payments to the secured party before paying the negative pledgee, the secured party should be able to keep those payments, subject to a bankruptcy trustee's avoidance powers. See *infra* Part II.D.

²⁴⁰ See U.C.C. § 9-201; see also *id.* § 9-504(4) (conspicuously omitting security interests senior to the one being foreclosed from the list of those of which the buyer takes free). In addition, some case law exposes junior foreclosing secured parties to conversion or to other liability toward seniors, unless the junior pays over the proceeds toward the senior's debt. See CLARK, *supra* note 23, ¶ 4.06[5][e].

²⁴¹ In other words, the negative pledgee has priority without an affirmative kind of property. See *supra* Part II.A.1.

secured creditors²⁴²). Common sense, the black letter of constructive trust law,²⁴³ and precedent from other statutory schemes²⁴⁴ all support this idea. So does one interesting case that enforced a subordination agreement by imposing a constructive trust on the subordinated creditor in favor of the senior creditor.²⁴⁵ One could use the same remedy to enforce this Article's proposal, even though the proposal's subordination is imposed by statute rather than by agreement.

Support for the constructive trust idea is also to be found in the equitable lien cases.²⁴⁶ Under the proposal as in those cases, a secured party taking in violation of a negative pledge covenant would be subject to a property interest of the negative pledgee. The differences, however, are even more compelling than the similarities. The proposal frees the negative pledgee and the secured party from concern over equitable lien doctrine's nebulous questions about the bor-

²⁴² The proposal's conservatism as to both the perfection principle and the *pari passu* principle calls for altering these other creditors' rights only when necessary. The negative pledgee is akin to the other unsecured creditors only insofar as they all can recover only by filing suit and executing on a judgment. The negative pledgee differs from other unsecured creditors in having priority over later secured parties if it perfects. The other unsecured creditors have not bargained for a negative pledge covenant (or at least, have not perfected one); hence, they are not wronged by the secured party's taking a security interest and achieving priority over them.

²⁴³ The prevailing view is that a constructive trust is simply a remedy, available even when no fiduciary relationship exists between the person receiving the property and the person claiming the benefit of the trust. See RESTATEMENT OF RESTITUTION § 160 cmt. a (1937). It is even available in the absence of wrongdoing by the person against whom the remedy is asserted. RESTATEMENT (SECOND) OF RESTITUTION § 30 cmt. 1 (Tentative Draft No. 2, 1984).

The idea of constructive trust is flexible enough to apply to only a portion of the value of the collateral: the secured party should keep, free of the trust, the portion of the collateral that exceeds the negative pledgee's debt at the time of the foreclosure. "A court of equity in decreeing a constructive trust is bound by no unyielding formula. The equity of the transaction must shape the measure of relief." *Beatty v. Guggenheim Exploration Co.*, 122 N.E. 378, 381 (N.Y. 1919) (Cardozo, J).

The negative pledgee asserting such a constructive trust would not be entitled to self-help remedies; just as it must execute on a judgment in order to assert a property interest against the debtor, so must it execute on a judgment against the constructive trustee.

²⁴⁴ See, e.g., CAL. CIV. CODE §§ 2223, 2224 (West 1985 & Supp. 1998) (imposing involuntary trust on those who "wrongfully detain[]" a thing or obtain it through "fraud, accident, mistake, undue influence, the violation of a trust, or other wrongful act"); IND. CODE § 29-1-2-12.1 (1997); N.D. CENT. CODE § 32-07.1-01 (1996); 23 PA. CONS. STAT. ANN. § 3505(d) (West 1991); TEX. FAM. CODE ANN. § 9.011(b) (West Supp. 1998) (imposing a constructive trust in certain domestic and criminal contexts).

²⁴⁵ See *In re Dodge-Freedman Poultry Co.*, 148 F. Supp. 647 (D.N.H. 1956). Freedman agreed with Delaware Mills to subordinate his claim against the debtor to Delaware Mills's claim. The debtor, in a bankruptcy proceeding, was able to pay 15% on each creditor's claim, but Freedman, who was president and principal stockholder of the debtor corporation, waived his claim. Freedman's motivation was to keep the money in the corporation because, if he collected it himself, the subordination agreement would have required him to pay it over to Delaware Mills. The court held that Freedman's claim against the debtor was subject to a constructive trust in favor of Delaware Mills. See *id.* at 651-52.

²⁴⁶ See *supra* Part I.C.1.

rower's and negative pledgee's intent and about the secured party's knowledge thereof. All of the uncertainties of the equitable lien cases would be replaced by the certainty of Article 9's perfection rules. Moreover, the constructive trust idea parallels in a reasonably close manner Article 9's longstanding treatment of junior secured parties who sell the collateral at a foreclosure sale or accept it in satisfaction of the obligation secured: the senior secured party has property rights against the junior in those circumstances,²⁴⁷ and the constructive trust idea simply confers similar rights on the perfected negative pledgee.²⁴⁸

Whatever the particular rules chosen, the overall goal of the enforcement mechanism should be, as nearly as possible, to free perfected negative pledgees from concern over junior secured parties to the same degree that senior secured parties enjoy such freedom. At the same time, any enforcement mechanism should alleviate the uncertainty affecting secured parties and negative pledgees under current law. Perhaps, for these purposes, even a constructive trust is not strong enough: perhaps the negative pledgee should have summary judicial proceedings available against the foreclosing junior secured party,²⁴⁹ or perhaps statutorily-fixed penalties²⁵⁰ should be imposed on the foreclosing secured party who fails to pay over the trust property upon demand by the negative pledgee. Either or both of these devices would enhance the subordination effect of the proposal without perpetuating uncertainty for secured lenders because the devices

²⁴⁷ See *supra* note 240 and accompanying text. The precise contours of these property rights are, however, somewhat unclear. Once the junior sells to a third party, are the proceeds of that sale received by the junior also subject to a claim by the senior? Article 9 does not so state, and conspicuously omits seniors from the list of those to whom foreclosure sale proceeds are to be applied. See U.C.C. § 9-504(1) (1995). Case law has muddied these waters, sometimes permitting seniors to seize the proceeds and sometimes imposing conversion liability on juniors who do not turn the proceeds over. See CLARK, *supra* note 23, ¶ 4.06[5][e].

²⁴⁸ The constructive trust idea is less parallel to Article 9's treatment of junior secured parties who, as a remedy, collect payments owed by an account debtor or the obligor on an instrument. See U.C.C. § 9-502. In many such cases, Article 9 simply gives no property rights to the senior over the junior. See PEB COMMENTARY NO. 7 (March 10, 1990). Thus, Article 9 is simply inconsistent on this point, depending on what remedy the junior exercises. (This reflects in part the tension between property rights and commercial values that pervades the UCC.) An enactment of this Article's proposal could go either way on this subject, depending on which one valued more: effectiveness and internal consistency on one hand, or noninterference with security interests on the other.

²⁴⁹ "The legislature can make quick, easy remedies available without tying them to security." LoPucki, *supra* note 9, at 1923 (citing CAL. CIV. PROC. CODE § 483.010 (West 1979 & Supp. 1994) (granting an attachment remedy for unsecured creditors of a business debtor)). Draft U.C.C. Article 2B provides for expedited hearings as to prejudgment relief regarding a licensee's postbreach use of licensed information, and as to the availability of electronic self-help. See U.C.C. §§ 2B-715(d), 2B-716(c) (Tentative Draft 1998).

²⁵⁰ Cf. U.C.C. § 9-507(1) (fixing a minimum recovery for a secured party's violation of constraints on remedies with respect to consumer goods).

would be imposed only on those who have statutorily imposed constructive notice.²⁵¹

Perhaps, ultimately, no enforcement mechanism should be specified at all. Instead, courts could be charged with the comparatively open-ended task of protecting the perfected negative pledgee by subordinating, but not penalizing, later-perfecting secured parties. Secured parties would no longer fear the tort damages that they now risk under current law, but because of the relative certainty flowing from Article 9's perfection procedures, they would have to take the threat of losing priority much more seriously than they currently must under equitable lien doctrine.

B. Secured Party Versus Subsequently Executing Creditor

The second of the three bilateral relationships involves the secured party who perfects after the negative pledgee (and whose property interest therefore is subordinated to the negative pledgee's rights²⁵²) and an unsecured creditor who, under the *pari passu* principle, ranks equally with the negative pledgee and can assert a property interest by executing on a judgment.²⁵³ This conflict only indirectly involves the negative pledgee itself. If the logical principle of transitivity applied, the outcome would be clear: because the secured party is subordinate to the negative pledgee, and the unsecured creditor is equal to the negative pledgee, the secured party must be subordinate to the unsecured creditor. But commercial law is not wholly founded on principles as simple as transitivity, and the resolution of this conflict should not be, either.

A dilemma presents itself. Which should be sacrificed—the perfection principle or the *pari passu* principle? If the secured party were simply subordinate to an executing creditor, then the perfection principle would in effect be repealed whenever a prior perfected negative pledgee were present, and such security interests would be rendered worthless. On the other hand, if the secured party had priority over the executing creditor, then the *pari passu* principle would be

²⁵¹ If a detailed enforcement regime is enacted, one should also consider whether current law's devices, examined in Part I.C, should concomitantly be abolished (or, in the language of U.C.C. § 1-103, "displaced"). Injunctions would presumably become unavailable of their own accord because the statutory enforcement mechanism would prevent negative pledgees from facing irreparable harm. Similarly, tortious interference with contract would become a negligible threat because the damages would generally be negligible. Equitable liens present a more difficult question: their purpose of achieving justice in certain cases despite the parties' noncompliance with statutory formalities would remain applicable under the new statutes as it is under the present ones. See *supra* Part I.C.1.

²⁵² See *supra* Part II.A. If the secured party's interest were banished altogether, rather than subordinated, this discussion would be unnecessary. See *supra* note 159; *infra* Part III.A.

²⁵³ See *supra* Part I.A.1.

violated: it would no longer be true that negative pledgees and other unsecured creditors have equal rights to assert property rights upon executing on a judgment. This particular vulnerability of negative pledgees to others who execute first should be preserved because it lies at the core of negative pledgee status, distinguishing negative pledgees from secured parties even more strongly than the presence or absence of self-help remedies does. Reducing this vulnerability would eviscerate the vitality and fascination inherent in the mezzanine type of debt that the proposal would establish, midway between secured and unsecured.

To escape between the horns of this dilemma, I suggest that the secured party be subordinated to the executing creditor, but only to the extent of the negative pledgee's debt.²⁵⁴ This rule would preserve the *pari passu* principle (and thus the vitality of mezzanine debt) while also, to the extent possible, preserving the perfection principle. The suggested rule is also defensible on grounds of notice and fairness: the secured party who perfects after a negative pledgee is on constructive notice of its vulnerability to one creditor holding debt of a given size, and the identity of the creditor that benefits from that vulnerability should not make any difference.²⁵⁵

The relationship between a secured party and a subsequently executing creditor would thus work just as it does under current law: the executing creditor can levy on the debtor's "interest in property," that

²⁵⁴ A numerical example may help to clarify this suggestion. Assume that the debtor has assets of 100; a perfected negative pledgee is owed 20; a secured party perfecting after the negative pledgee is owed 75; and another creditor has a judgment for 40. Under the proposal, if the judgment creditor executes after the secured party perfects, it will recover only 25, that is, the 5 that are claimed by no prior creditor plus the cushion of 20 being held available by the negative pledgee. (Part II.C.2, *infra*, addresses a variation on this example: if the secured party were owed more than 80, an additional rule should probably apply, calling for the executing creditor to compensate the negative pledgee for part of its take.)

The limited nature of the executing creditor's rights, discussed *infra* in Part II.C, makes "subordinate" a potentially confusing way to describe the secured party in this context. The secured party is not being hurt by the executing creditor any more than it is already hurt by the perfected negative pledgee; the executing creditor is simply appropriating the benefits that the negative pledgee has extracted from the secured party.

²⁵⁵ As is implicit in the foregoing, the secured creditor's vulnerability to any creditor shrinks, dollar for dollar, as the executing creditor benefits. That is, to the extent the secured party loses to the executing creditor, it is no longer vulnerable to the negative pledgee or others.

The statement in the text does not necessarily imply a position on broader questions about a secured party selling its place in line. See Steven Walt, *The Case for Laundered Security Interests*, 63 TENN. L.REV. 369 (1996); Spencer Neth, *The First to File Priority in Article 9: Can You Sell Your Place in Line?*, 31 UCC L.J. 64 (1998); Morris Shanker, *A Response to The First to File Priority in Article 9: Can You Sell Your Place in Line?*, 31 UCC L.J. 82 (1998); Steven Walt, *Revisiting Neth's The First to File Priority in Article 9: Can You Sell Your Place in Line? and Shanker's Response*, 31 UCC L.J. 217 (1998).

is, on the portion of debtor's property that is unencumbered.²⁵⁶ The proposal's internal logic and its conservative approach are both vindicated. As discussed in Part II.A, however, one must carefully watch the use of terms like "property" and "encumbrance." The perfected security interest should of course be considered an encumbrance for this purpose, as under current law. But the perfected negative pledge covenant should not be so considered, notwithstanding Parts II.A.1 and 2, because the negative pledgee remains vulnerable to prior judgment creditors.

C. Executing Creditor Versus Negative Pledgee

1. *In General: A Conservative Result*

The last of the three bilateral relationships completes the circle: it concerns the executing creditor without a negative pledge covenant and the negative pledgee with which the story started. Current law treats this relationship as simply a conflict between two unsecured creditors and, as a result, the *pari passu* principle governs; the first creditor to execute on its judgment has priority.²⁵⁷ Thus, if the unsecured creditor without a negative pledge covenant wins the race through the judicial and execution processes, it has priority over the negative pledgee.

The proposal would generally produce the same result. Aside from the principal rule presented in Part II.A and the single narrow circumstance described below, the proposal does not treat perfected negative pledgees any differently from other unsecured creditors. In other words, as seen in Part II.B, the proposal's conservatism includes preserving the *pari passu* principle, just as it includes preserving the perfection principle to the maximum extent possible. The borrower and the lender have chosen to make the debt unsecured with a negative pledge covenant rather than secured, and I do not wish to disturb the outcome of that delicate negotiation.²⁵⁸ Thus, as a general matter, perfected negative pledgees should have rights only against subsequent secured parties, not against other unsecured creditors,²⁵⁹ and

²⁵⁶ See, e.g., N.Y. C.P.L.R. 5233(a) (McKinney 1997).

²⁵⁷ See *supra* Part I.A.

²⁵⁸ See *supra* Part I.E; *supra* text accompanying note 177.

²⁵⁹ Nor could one practicably alter the proposal to give the negative pledgee rights against other unsecured creditors, at least while remaining consistent with the principles of Article 9. With a little work one can imagine a public registry of all unsecured debt, in which all lenders would be required to record their loans on pain of subordination to later lenders who did record. See, e.g., Schwartz, *supra* note 10, at 218-22. Part III.C *infra* discusses other aspects of the Schwartz article. The volume and rapidity with which our economy expects unsecured debt to be extended makes it impossible, however, to imagine such a regime being implemented; it is not simply a question of expense, but also one of radically dampening the volume of commerce, with correspondingly radical effects on the

should accordingly lose to creditors that execute earlier than they do, in keeping with current law.

2. *A Narrow Exception*

This first-to-levy rule should, however, be modified in one narrow circumstance: when (1) the debtor's assets are subject to claims not only of a negative pledgee and an executing creditor, but also of a secured party subordinate to the negative pledgee and senior to the executing creditor and (2) the presence of the negative pledgee causes the secured party to be undersecured. A numerical example may help to explain the need for this exception. Assume that the debtor has assets of 100; a perfected negative pledgee is owed 20; a subsequently perfected secured party is owed 85 (but, because of the perfected negative pledgee's presence, the secured party has access to collateral equalling only 80); and a subsequently executing creditor has a judgment for 40.²⁶⁰ If one simply applied the rules of Parts II.A and B, then the executing creditor would collect 20—the full amount of the cushion being protected by the negative pledgee. This result seems clearly unjust, not because it makes the negative pledgee vulnerable (negative pledgees have always been vulnerable to executing creditors), but because if the perfected negative pledgee were not present, then the executing creditor would collect only 15. By causing the secured party to be undersecured, the negative pledgee has benefitted the executing creditor in a direct and measurable manner.

Were it not for the negative pledgee's efforts to keep a cushion of assets unencumbered, the secured party would have insulated more of the debtor's assets for itself, reducing the assets available to the subsequently executing creditor. Accordingly, if any of the three parties in this context can justifiably be called upon to make a sacrifice, it is the executing creditor, and I suggest that, in these narrow circumstances, the first-to-execute aspect of the *pari passu* rule should be limited. Not only should the executing creditor be prevented from taking the secured party's collateral,²⁶¹ it should also be prevented from taking the negative pledgee's entire interest. Instead, the executing creditor should pay over to the negative pledgee the portion of its recovery that is directly attributable to the negative pledgee's presence.

fabric of daily life. (Whether this would nonetheless be desirable is a rich but different subject.)

As Baird and others have noted, unsecured creditors rarely consult Article 9's filing system. See Baird, *supra* note 112, at 55. It would be grossly anomalous to require them to check for perfected negative pledge covenants but not for perfected security interests.

²⁶⁰ This example is the same one used *supra* in note 254, with the exception that the secured party's debt is now larger than the collateral available to it.

²⁶¹ See *supra* Part II.B.

This approach, which we may call a "compensation rule," serves intuitive notions of justice, because without it the negative pledgee's own efforts would harm it and unfairly enrich the executing creditor. The *pari passu* rule yields, but only to the extent that the *pari passu* rule itself would otherwise allow the executing creditor to free ride, to a more severe degree than usual,²⁶² on the negative pledgee's perfection. The judgment creditor who is required to pay compensation has no grounds for complaint: if the negative pledgee had instead held the interest of a secured party, then the executing creditor would not have been able to reach the collateral at all, rather than merely required to pay compensation in order to gain access to it.

How should the amount of this compensation be determined? Considerations of efficiency and autonomy would call for fixing the compensation by rule, rather than by standard,²⁶³ and if a rule were chosen, an amount somewhere between twenty and fifty percent of the judgment creditor's recovery attributable to the negative pledgee would seem appropriate.²⁶⁴ On the other hand, the wide potential variation in fact patterns²⁶⁵ may make it appropriate to fix the compensation by standard, such as an amount that is equitable under the circumstances. This standard would concededly make it more difficult for a prospective plaintiff to determine *ex ante* whether it is worthwhile to sue and execute; on the other hand, prospective plaintiffs face similar difficulty under current law whenever a prior perfected security interest exists, and even an unencumbered defendant can thwart an executing creditor's recovery at the last minute by filing

²⁶² Free riding on negative pledge covenants in general is discussed *infra* in note 331.

²⁶³ See Douglas G. Baird & Robert Weisberg, *Rules, Standards and the Battle of the Forms: A Reassessment of § 2-207*, 68 VA. L. REV. 1217, 1227-31 (1982); Isaac Ehrlich & Richard A. Posner, *An Economic Analysis of Legal Rulemaking*, 3 J. LEGAL STUD. 257, 262-67 (1974); Duncan Kennedy, *Form and Substance in Private Law Adjudication*, 89 HARV. L. REV. 1685, 1687-1713 (1976).

²⁶⁴ If the percentage is too large, it undermines the idea that negative pledgees remain vulnerable to creditors that execute first. See *supra* Part II.C.1. If the percentage is too small, it fails to serve the compensation rule's goals of protecting the negative pledgee and preventing unfair enrichment.

²⁶⁵ For example, when the executing creditor's debt and secured party's collateral are large compared to the negative pledgee's debt and the debtor's assets, then the negative pledgee's presence in the picture will mean the difference between a healthy return to the executing creditor and no return at all, and the compensation should accordingly be some substantial portion of the recovery attributable to the negative pledgee. On the other hand, when the secured party's collateral is only a small portion of the debtor's assets, then much of the executing creditor's return will not be attributable to the negative pledgee, and the amount of the compensation should accordingly be small or nil. The unpredictability of these factors is exacerbated by the fact that the amount of debt held by either the secured party or the negative pledgee can vary up- or downwards without any need for public notice via the filing system or otherwise. See U.C.C. § 9-204 cmt. 2 (1995); *id.* § 9-312(7).

a voluntary bankruptcy petition.²⁶⁶ The pattern of trade-offs between rule and standard in this matter is familiar from other areas: a standard would enable the courts to achieve justice with greater nuance, although at a higher enforcement cost, while a rule would permit easy enforcement at the cost of unavoidable over- or underinclusiveness.

D. Trustee in Bankruptcy Versus Negative Pledgee

The third relationship discussed above, between a perfected negative pledgee and an executing creditor, is replicated (with, of course, some changes) when the negative pledgee's unsecured competitor is represented by a trustee in bankruptcy, rather than executing on its own behalf. Article 9 has heretofore treated the collective proceeding in the same way that it treats the individual proceeding,²⁶⁷ and strong policy counsels that this proposal follow suit.²⁶⁸ Fortunately, there is almost no incongruity between the norms of federal bankruptcy law and the state-law patterns proposed so far.²⁶⁹

Like state law, the Bankruptcy Code has heretofore divided all creditors into two starkly bipolar classes: secured and unsecured.²⁷⁰ The mezzanine type of debt that this Article proposes has no parallel

²⁶⁶ See 11 U.S.C. § 362(a)(2) (1994) (providing that the automatic stay prevents enforcement of judgments).

²⁶⁷ See U.C.C. § 9-301(1)(b) (subordinating security interests to a person who becomes a lien creditor before the security interest is perfected); *id.* § 9-301(3) (defining "lien creditor" to include both "a creditor who has acquired a lien on the property involved by attachment, levy or the like" and "a trustee in bankruptcy from the date of the filing of the petition").

²⁶⁸ In the words of Justice Stevens, Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding. Uniform treatment of property interests by both state and federal courts within a State serves to reduce uncertainty, to discourage forum shopping, and to prevent a party from receiving 'a windfall merely by reason of the happenstance of bankruptcy.' The justifications for application of state law are not limited to ownership interests; they apply with equal force to security interests

Butner v. United States, 440 U.S. 48, 55 (1979) (quoting *Lewis v. Manufacturers National Bank*, 364 U.S. 603, 609 (1961)) (citation and footnote omitted).

To the extent that one views even a perfected negative pledgee as not holding property, the foregoing loses much of its salience, but the concern over forum shopping remains. See, e.g., Douglas G. Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren*, 54 U. CHI. L. REV. 815, 824-28 (1987). But see LoPucki, *supra* note 9, at 1945-47 (noting that the rights of "cash-flow surfers" are not replicable in bankruptcy).

²⁶⁹ This fact further attests to the underlying conservatism of the proposal.

²⁷⁰ See, e.g., 11 U.S.C. § 506(a) (dividing claims of undersecured creditors in two, one secured and one unsecured). This bipolarity pervades the Bankruptcy Code, affecting not only priority of distribution (as under state law) but also entitlement to interest payments, adequate protection, and other issues. See 11 U.S.C. § 361 (describing adequate protection); *id.* § 363 (dealing with use of cash collateral); *id.* § 506(b) (addressing interest payments).

in the Bankruptcy Code, at least in part because it has had no parallel in the statute's state-law backdrop. Hence, current bankruptcy law would treat the perfected negative pledgee like any other unsecured creditor, and the trustee would equally represent both parties to this third relationship. What appeared under the individual-action norm of state law as a conflict between opposing interests now appears, under the Bankruptcy Code, as a convergence of interests.

Under this Article's proposal, as Part II.B notes, state law must maintain the *pari passu* principle in order to preserve the status of perfected negative pledge debt as a true mezzanine between secured and unsecured debt. Under the Bankruptcy Code, a similar principle already applies because equal treatment of unsecured creditors is such a strong norm. This principle, like state law's *pari passu* principle, should be maintained, so that in bankruptcy as under state law, the negative pledgee's cushion of assets remains vulnerable to the claims of other unsecured creditors. The only difference from vulnerability under state law would be the one that, under current law, already differentiates all bankruptcy proceedings from all individual state-law proceedings: the first-to-execute rule is abandoned in favor of a less hasty, more orderly proceeding in which, as a rule, unsecured creditors share equally.²⁷¹ The negative pledgee would be vulnerable to other unsecured creditors in the sense that its *pro rata* share of the estate would shrink as the claims of other unsecured creditors grew.

Well-established provisions of current bankruptcy law would apply in a straightforward manner to mirror the state-law results that Part II.A, B, and C.1 describe. First, even if the perfected negative pledge covenant is considered an interest in property, the trustee's strong arm power would implement the negative pledgee's state-law vulnerability to other unsecured creditors.²⁷² Second, Bankruptcy

²⁷¹ The Bankruptcy Code's most important tool for achieving this goal is the automatic stay. *See id.* § 362. The preference provisions of 11 U.S.C. § 547 serve the same goal (and these provisions should probably also apply to prevent an initially unperfected negative pledgee who perfects within the preference period from acquiring the compensation discussed *supra* in Part II.C.2.) So do 11 U.S.C. § 544 (discussed *infra* in note 272 and accompanying text), 11 U.S.C. § 548 (fraudulent transfer) and 11 U.S.C. § 549 (postpetition transfers).

²⁷² *See id.* § 544(a). This section, the strong arm power, gives the trustee the rights and powers of . . . a creditor that extends credit to the debtor at the time of the commencement of the case, and that obtains, at such time and with respect to such credit, a judicial lien on all property on which a creditor on a simple contract could have obtained such a judicial lien

Id. "Judicial lien" is defined as including, among other things, a lien obtained by levy or other legal proceeding. *Id.* § 101(36). Thus the trustee would have the power described in Part II.C of an executing creditor.

Section 544(a) allows the trustee to "avoid any transfer of property of the debtor . . . that is voidable by" such a creditor. Currently, courts typically apply this avoidance power to unperfected security interests, which under state law are subordinate to the rights of a lien creditor, including an executing creditor. *See* U.C.C. § 9-301(1)(b) (1995). This sec-

Code § 551 would allocate the negative pledgee's former cushion of assets to the estate as a whole,²⁷³ so that the negative pledgee and the other unsecured creditors would share it pro rata.

Finally, in order to adhere as closely as possible to the proposal's state-law scheme, when the perfected negative pledgee's presence causes the secured party to be undersecured, the perfected negative pledgee should retain some benefit analogous to Part II.C.2's compensation rule. One can achieve this goal by giving the negative pledgee an administrative claim (which, by its nature, takes priority over secured claims and normal unsecured claims²⁷⁴) in the amount it would have been entitled to under the compensation rule. Rewarding the negative pledgee with the device of an administrative claim is quite appropriate, for current law generally allows such claims for those who have benefitted the estate as a whole,²⁷⁵ and as Part II.C.2 discusses, a perfected negative pledgee who causes a secured party to be undersecured does indeed benefit the debtor's creditors (that is, the estate) as a whole.

III

THE PROPOSAL COMPARED TO STRUCTURAL ALTERNATIVES

The proposal set forth in Part II is not the only means to accomplish the goal of protecting negative pledgees. In addition to possible variations within the proposal itself,²⁷⁶ entirely different structural approaches are possible. This Part briefly considers three of the latter.

A. Voiding of Subsequent Security Interests

Rather than subordinating security interests to prior perfected negative pledge covenants, one could provide that security interests

tion could also, however, apply to perfected negative pledge covenants because, as discussed in Part II.B, the negative pledgee's interest would, under state law, be subordinate to executing creditors. Conceptualizing the strong-arm power as an avoidance in this way is useful for the light it sheds on 11 U.S.C. § 551.

²⁷³ "Any transfer avoided under section . . . 544 . . . of this title . . . is preserved for the benefit of the estate . . ." 11 U.S.C. § 551. This section prevents junior property interests (in this case, a security interest) from moving into a higher position when a senior property interest (in this case, the perfected negative pledgee's interest) is avoided. See 5 LAWRENCE P. KING ET AL., COLLIER ON BANKRUPTCY ¶¶ 551.01-551.02 (15th ed. rev. 1998).

²⁷⁴ See 11 U.S.C. § 503 (allowing administrative claims); *id.* § 507(a)(1) (granting them priority); *id.* § 1129(a)(9)(A) (requiring payment of them for Chapter 11 plan to be confirmed); *id.* § 1322(a)(2) (requiring the same for a Chapter 13 plan).

²⁷⁵ See *id.* §§ 330, 503(b)(2) (allowing compensation for trustees, examiners or professionals); *id.* § 364(a) (allowing claims of those extending unsecured credit to the estate); *id.* § 503(b)(1)(A) (allowing the actual and necessary costs and expenses of preserving the estate, including compensation for services rendered after the commencement of the case); *id.* § 503(b)(3)(B) (allowing the expenses of a creditor who recovers property of a debtor).

²⁷⁶ Some of these are discussed *supra* in note 172 and Part IIA.3.

granted in violation of a perfected negative pledge covenant are void.²⁷⁷ The most obvious virtue of this alternative is its relative simplicity: it renders moot many of the nuances that the proposal's subordination-based approach entails,²⁷⁸ while also protecting negative pledgees in the same property-like manner as the proposal does.²⁷⁹ Moreover, to the extent one is interested in enabling debtors to opt out of Article 9,²⁸⁰ this alternative provides a truer, more complete means of doing so than the proposal itself.

The alternative also has the virtue of being consonant with the outcome that, as a practical matter, some negative pledgees are able to obtain under current law. As Lynn LoPucki details, large debtors that are subject to negative pledge covenants currently give up not only the right to issue security but also, in many cases, the practical ability to do so.²⁸¹ Such debtors' recurrent need for access to the credit market, their negative pledgees' monitoring efforts, their creditors' power to commence involuntary bankruptcy proceedings, and the trustee's power to avoid preferential security interests all combine, in many cases, to keep later lenders from taking security.²⁸² Many commercial actors might prefer a change in law that facilitated and extended such a prohibition on security interests, rather than a change in law that merely subordinated later security interests.²⁸³ In addition, such an alternative's consonance with some current outcomes might lead commercial actors more readily to adopt it.

Such an alternative would run counter to at least one of Article 9's central principles. Under current law, the grant or perfection of a security interest does not deprive the debtor of a remaining interest in the property that the debtor can voluntarily transfer, including by the grant of a second security interest.²⁸⁴ Because the perfection of one

²⁷⁷ This and related alternatives are also briefly discussed above. See *supra* note 159 and the cross-references appearing there.

²⁷⁸ The relationship between secured party and executing judgment creditor, see *supra* Part II.B, would cease to be an issue, and the relationship between executing judgment creditor or bankruptcy trustee and negative pledgee, see *supra* Part II.C and D, would become vastly more simple. In addition, there would be little need for concern over the particular contours of enforcement, see *supra* Part II.A.3. Additional nuances not addressed in this Article would also be rendered moot—for example, questions about a perfected negative pledgee's ability to require a subsequent secured party to marshal.

²⁷⁹ None of the discussion *supra* in Part II.A.1 and 2 depends on the subsequently perfecting secured party's interest being subordinated as opposed to void.

²⁸⁰ See *infra* note 309 and accompanying text; Part IV.C, D; Conclusion.

²⁸¹ See LoPucki, *supra* note 9, at 1924-31 (discussing "asset-based unsecured lending").

²⁸² See *id.*

²⁸³ Lenders' preferences would, of course, depend at least in part on their borrowers' preferences, and these, in turn, would depend at least in part on those of their unsecured creditors. The whole matter rapidly reduces to a question of one's view of the desirability of secured credit as an institution. See *infra* note 285 and accompanying text.

²⁸⁴ See U.C.C. § 9-311 & cmt. 1 (1995) ("The debtor's rights in collateral may be voluntarily or involuntarily transferred (by way of sale, creation of a security interest, attachment,

security interest does not prevent the creation or perfection of another, it would be novel (and, for some observers and commercial actors, startling or undesirable) for the perfection of a negative pledge covenant to do so.

However, nothing places beyond question this principle of current law. Ultimately, the extent to which one is willing to embrace the outright voiding of offending security interests is an ideological matter, one tied closely to the larger controversies over the desirability of secured credit as a whole.²⁸⁵ All things being equal, those who favor the relatively free availability of secured credit would probably tend to prefer the proposal as detailed in Part II (with all its attendant complexities), rather than the simpler and more radical alternative discussed here. By the same token, those who view the institution of secured credit as more of a social problem than a benefit would probably tend to have the contrary preference.

B. Contractual Waiver and Subordination

Without modifying the current provisions of Article 9 at all, one might use simple contract to replicate most or all of the provisions of this Article's proposal. For example, a debtor could bargain for the lender to take a security interest but also to (1) waive its rights to self-help remedies²⁸⁶ and (2) sign a subordination agreement. This agreement would subordinate the secured party's interest in the collateral to the claims of any unsecured creditors who might execute on judgments before the secured party executes on one of its own and would also subordinate its interest to the claims of the debtor's bankruptcy trustee.²⁸⁷

This approach presents severe transaction costs. Not only would there be high out-of-pocket costs relating to negotiation and drafting, but there also would be substantial uncertainty costs. For example, the contracting parties may overlook a matter that they consciously intended to bargain over or may fail to realize the worth of bargaining

levy, garnishment or other judicial process) notwithstanding a provision in the security agreement prohibiting any transfer or making the transfer constitute a default.").

Gilmore observes that this section "may not have been drafted with the particular problems of the negative pledge clause in mind—indeed it is the author's memory that it was not so drafted. . . . Nevertheless, by accident if not by design, § 9-311 takes care of the negative covenant very nicely." 2 GILMORE, *supra* note 31, § 38.5, at 1017.

²⁸⁵ See *supra* note 141 and accompanying text; Carlson, *Zero-Sum Game*, *supra* note 141, at 1738 (characterizing questions about the desirability of the institution of secured credit as ultimately moral).

²⁸⁶ See Adler, *supra* note 127, at 86.

²⁸⁷ See 2 GILMORE, *supra* note 31, § 38.1, at 999 ("Subordination agreements and negative pledge covenants are in a sense mirror images of each other: both aim at the result of giving the favored creditor priority over other claims without resort to a formal security transaction.").

over a certain matter.²⁸⁸ In addition, the parties may not know with certainty the legal or factual effect of the contract that they write. For example, if a *soi-disant* secured party relinquishes both self-help remedies and protection from unsecured creditors, does it lose the property interest that is at the core of a security interest²⁸⁹ and, thus, fall out of Article 9 altogether?²⁹⁰ Moreover, the lender's waiver would introduce an unusual reversal of the relationship between debtor and creditor: the debtor would have to trust the creditor to abide by the waiver.²⁹¹ These difficulties, rather than any intrinsic lack of appeal of

²⁸⁸ See, e.g., Oliver E. Williamson, *Transaction Cost Economics*, in 1 HANDBOOK OF INDUSTRIAL ORGANIZATION 135, 139 (Richard Schmalensee & Robert D. Willig eds., 1989) ("Although it is instructive and a great analytical convenience to assume that agents have the capacity to engage in comprehensive ex ante contracting (with or without private information), the condition of bounded rationality precludes this. All contracts within the feasible set are incomplete.").

To highlight the bargaining difficulties in this context, note that executing creditors, who would be among the direct beneficiaries of the subordination agreement, would not be at the bargaining table. They may never materialize, but even if they do, their identities may remain unknown at the time of the subordination agreement. To some extent, they may be vicariously represented by the debtor, due to its stake in keeping interest rates on its unsecured debt to a minimum. But this is an indirect, weak, and contingent substitute; the debtor's far stronger motivation at the time will be striking a deal with the lender, and it can accordingly be expected to accept a less than rigorous subordination agreement.

²⁸⁹ See U.C.C. § 1-201(37) (defining a security interest, in part, as "an interest in . . . property" that "secures payment or performance of an obligation").

²⁹⁰ In a similar situation involving the waiver of self-help rights (and without the exacerbating factor of a subordination agreement), one prominent New York law firm declined to opine that the waiving creditor was secured. This choice was understandable; courts cannot be counted on to indulge in the same amount of fancy about property interests that Part II.A does. The view of security interests as property often holds self-help remedies, in particular, to be the core of the property interest. See *supra* notes 178-79 and accompanying text.

An additional certainty problem with the contract approach hampers the parties' presumed desire to maintain flexibility. If the borrower and the contractually dismembered secured party decide, after executing their contract, that they wish to rescind the subordination or reinstate the secured party's rights to self-help remedies, may they do so? The answer depends on whether the rights of the other creditors, who will be intended third party beneficiaries of the agreement, have vested: once they vest, it becomes necessary to bargain with them for modification of the contract, a difficult or impossible project when more than a few parties are involved. Some legal uncertainty besets the vesting question. Compare *Tweeddale v. Tweeddale*, 93 N.W. 440, 443 (Wis. 1903) (holding that a creditor third-party beneficiary's rights vest immediately upon the execution of a contract, even if the beneficiary is unaware of contract), and *Estate of Cochrane v. Kurz*, 108 N.W.2d 529 (Wis. 1961) (same), with *Olson v. Etheridge*, 686 N.E.2d 563, 567 (Ill. 1997) (adopting the prevailing modern view that such rights vest only when the beneficiary relies on the contract, brings suit, or manifests assent to it at the request of a party). Even when it is clear that the modern rule prevails, factual uncertainty may remain because parties often cannot be certain which of many unsecured creditors have relied on the contract at any given moment.

²⁹¹ Dean Robert Scott has identified a similar problem of "creditor misbehavior" in the context of exclusive financing arrangements. See Scott, *supra* note 14, at 929-30. He notes that outright "cheating . . . is not a serious problem," but that the divergence of interests between debtor and creditor generates conflicts. *Id.* at 929. The same would be true in

a mezzanine between secured and unsecured debt,²⁹² presumably explain why no pattern such as this has yet emerged in the marketplace.

Making a secured party behave like a negative pledgee in this way is comparable to making a corporation behave like a general partnership.²⁹³ With enough careful modification of the default rules, almost any off-the-rack suit can be made to fit almost any situation, but it is far simpler, safer and cheaper to pull the right size suit off of the rack in the first place. This Article's proposal would provide an intermediate size suit, much as limited liability companies serve as an intermediate accommodation between corporations and general partnerships.

C. Automatic Priority for Lead Financiers

A third structural alternative is the priorities regime sketched by Alan Schwartz in an important *Journal of Legal Studies* piece.²⁹⁴ Schwartz approaches questions of priority between creditors as an optimal contracting problem, positing that the law should enact the priority rules that the debtor and its creditors would select voluntarily, so long as third parties are not thereby harmed. He then observes that certain lenders ("financiers"²⁹⁵) often bargain for covenants from their

the waiver context, and the tremendous attractiveness of Article 9 self-help compared to suing on the debt exacerbates the problem.

²⁹² See *supra* notes 151-54 and accompanying text.

²⁹³ In order to achieve this result (tax considerations aside), one could, for example, provide in the charter that the shareholders have unlimited personal liability for the corporation's debts. See, e.g., DEL. CODE ANN. tit. 8, § 102(b)(6) (1991). The charter could also grant full management power to the shareholders rather than a Board of Directors. See, e.g., *id.* §§ 351, 102(b)(1). The transfer of shares might also be restricted. See, e.g., *id.* § 202. Finally, the charter might provide that corporate existence terminates upon the first sale of shares by any shareholders. See, e.g., *id.* § 102(b)(5); see also *id.* § 354 (providing that charter provisions are not invalid on the grounds that they mimic partnership relations).

Jack Nicholson's film *FIVE EASY PIECES* (Columbia Pictures Corp. 1970) provides another example of unnecessarily radical modification of pre-existing patterns. In a justly famous scene, Nicholson's character tries to order an omelette with a side of whole wheat toast in a diner. The waitress tells him that they don't serve toast.

Nicholson: "OK, I'll make it as easy for you as I can. I'd like an omelette, plain, and a chicken salad sandwich on wheat toast. No mayonnaise, no butter, no lettuce. And a cup of coffee."

Waitress: "A number two. Chicken sal. sand. Hold the butter, the lettuce, the mayonnaise. Anything else?"

Nicholson: "Yeah, now all you have to do is hold the chicken, bring me the toast, give me a check for the chicken salad sandwich, and you haven't broken any rules."

²⁹⁴ See Schwartz, *supra* note 10, at 209. He raises kindred ideas in Schwartz, *Priority Contracts*, *supra* note 141, at 1398, 1418; see *infra* note 302 (discussing the latter piece).

²⁹⁵ Schwartz describes financiers as "initial lenders that hold substantial amounts of a borrower's debt when the debt is expected to be outstanding for a considerable time," Schwartz, *supra* note 10, at 212, as "the first creditor that made a substantial loan that would be outstanding for a nontrivial time period," *id.* at 247, and as lenders "who face a realistic prospect that their borrowers will incur substantial debt to pursue new projects

debtors, including covenants restricting future unsecured debt as well as negative pledge covenants. Schwartz frames this pattern as an attempt to contract around Article 9's basic framework: both lender and debtor wish to provide that no later debt, whether secured or unsecured, will take priority over that of the covenantee. Rather than expanding the perfection principle to make these contracts more effective (as my proposal does for negative pledge covenants²⁹⁶), he proposes changing the perfection and *pari passu* principles themselves, so that commercial actors will no longer need to incur the costs of contracting around them.²⁹⁷

In brief, Schwartz would give financiers priority over later creditors, secured and unsecured, without requiring them to make an Article 9 filing,²⁹⁸ take other steps for perfection or, apparently, even write a negative pledge covenant into their loan agreements.²⁹⁹ By giving financiers priority over subsequent secured creditors, Schwartz rejects the perfection principle, and by giving financiers priority over

during the term of the loan," *id.* at 248. Trade creditors, whose loans are outstanding for 30 or 45 days, are specifically mentioned as falling outside this class. *See id.* at 247-48.

²⁹⁶ The proposal does not feasibly lend itself to covenants restricting future debt. *See supra* note 259.

²⁹⁷ The grounds for such a change is that it would be Pareto superior: it would save the parties the trouble of contracting around a rule that they do not want, while also not making other creditors worse off because they "will exact compensation for their worsened status in the interest rates they charge." Schwartz, *supra* note 10, at 210; *see also id.* at 218-26 (setting out his proposal). Certain claimants who can be expected not to adjust would be accommodated in Bankruptcy Code provisions. *See id.* at 254-59.

²⁹⁸ Schwartz recognizes that filing is one way to make other creditors aware of interests having priority, but argues that an unregulated market for information is equally effective and cheaper. *See id.* at 211, 218-26. That subject is beyond the scope of this Article.

At least some of Schwartz's aversion to filing stems from (or is at least consonant with) his goal of protecting financiers from unsecured lenders as well as secured lenders. As observed above, filing systems seem simply unworkable for protecting creditors against prior unsecured debt. *See supra* note 259. In contrast, Schwartz seems to entertain filing as feasible for that purpose, although here too he concludes that it seems intuitively more expensive than the market for information. *See Schwartz, supra* note 10, at 219-22, 248. Moreover, part of the expense of filing, in his view, rests on there being "considerable litigation until the exact contours of the new [filing] scheme are established." *Id.* at 222. By contrast, under this Article's proposal, there would be no filing to protect against unsecured debt, and the familiar Article 9 system itself would apply, with virtually no need to establish new contours.

Interestingly, Schwartz would retain the filing system after all, in part because creditors other than financiers may take security interests and filing "has been considered a necessary condition" to perfection. *Id.* at 223-24. He does not here address the merits of the market for information in the non-financier as opposed to the financier context. *Cf. Bjerre, supra* note 158, at 758-67 (proposing partial abolition of the filing system, supplemented by market mechanisms); James W. Bowers, *Of Bureaucrats' Brothers-in-Law and Bankruptcy Taxes: Article 9 Filing Systems and the Market for Information*, 79 MINN. L. REV. 721, 725-33 (1995) (proposing outright abolition of the filing system and replacement with market mechanisms).

²⁹⁹ Financiers could, however, waive this priority. *See Schwartz, supra* note 10, at 249. Thus, this portion of Schwartz's rule is a default rule. *See id.* at 251 n.58.

unsecured creditors, he also rejects the *pari passu* principle.³⁰⁰ In contrast, this Article's proposal adheres to both the perfection principle and the *pari passu* principle, modifying them slightly—but only in order fully to vindicate the perfection principle's own animating concerns.

Schwartz's proposal and my own share the goal of improving the enforceability of protections that lenders seem to want,³⁰¹ but the two proposals differ in numerous, important respects. The most important difference is that Schwartz's financiers are prior to both secured and unsecured creditors, while my perfected negative pledgees are prior only to secured creditors and remain vulnerable to unsecured creditors as under current law. A second difference is that Schwartz's financiers obtain their protection automatically, while my perfected negative pledgees obtain theirs only by providing the notice to third parties on which Article 9 depends.³⁰²

These two differences between our approaches are related, and the reasons behind them illuminate methodological and philosophical differences between our respective proposals. I preserve the current vulnerability of negative pledgees to unsecured creditors principally because I seek a true mezzanine type of debt between secured and unsecured, in order both to enrich the spectrum of possible outcomes of bargaining between borrowers and lenders³⁰³ and to

³⁰⁰ Schwartz would also "substantially" modify the priority principle. *Id.* at 211. He would strengthen its ordinary first-in-time rule by, among other things, limiting PMSI superpriority over a financier to a level specified in the debtor's contract with the financier, abolishing PMSI superpriority in inventory, and preventing PMSI superpriority in other collateral from trumping secured parties who do not have blanket liens. *See id.* at 250-54. By contrast, my proposal would keep Article 9's present priority principles unchanged, including those relating to PMSIs. *See supra* note 173.

³⁰¹ As a means to this end, Schwartz favors strengthening the first-in-time priority principle, whereas I call, instead, for strengthening both *nemo dat* and its exception for cases in which public notice is not provided.

³⁰² A third practical difference is that Schwartz's protections would be available only to financiers, while mine would be available to all comers. (This facet of my proposal, too, comports with fidelity to current law.)

Schwartz's more recent thoughts in this area would apparently make protections available to all lenders as well. Schwartz, *Priority Contracts*, *supra* note 141, at 1417-18. This piece concludes with a brief proposal to make financial covenants enforceable against third parties. *See id.* at 1398, 1418. Schwartz's few remarks on the subject suggest a number of differences as well as similarities with my own proposal. For example, Schwartz treats several other covenants identically to negative pledge covenants, and relies on debtor disclosure rather than perfection to protect those lending later in time than a protected covenantee. *See id.* at 1404-07. Accordingly, he does not discuss any consonance or dissonance between his approach and that of Article 9. Schwartz and I are both interested in the efficiency effects of our proposals, *see id.* at 1406-07; *infra* Part IV.C, but my proposal stresses other values as well, as detailed elsewhere in Part IV.

³⁰³ *See supra* notes 155-57 and accompanying text. Schwartz's proposal can also be viewed as serving this goal, but the relatively close resemblance between today's secured parties and Schwartz's financiers muffles that aspect of his piece.

expose the falsity of the secured/unsecured dichotomy.³⁰⁴ My proposal is, in a word, conservative, curing the vulnerability of negative pledgees only to the extent possible within the principles of current law, and I attribute this conservatism to two impulses. One is skepticism about all human wisdom (particularly my own), which leads me to prefer proceeding incrementally with reform. The other, more important, is a simple desire to wrest as much understanding from current law as possible: quite apart from the merits of any reform, an incrementalist inquiry is inherently valuable because it helps to shed fresh and subtle light on the world that we live in today.

By contrast, Schwartz readily embraces principles on which current law is not based, readily discards longstanding principles on which it is,³⁰⁵ and does not question current law's black-and-white division between secured and unsecured debt.³⁰⁶ Both of our proposals grant commercial actors the power to adopt or reject them, but the baseline of my proposal is Article 9, whereas the baseline of Schwartz's proposal is a regime of his own devising.³⁰⁷ In eighteenth-century political terms, Schwartz's proposal reflects the rationalists' boldness in implementing revolutionary changes, while mine reflects the empiricists' preference for building on tried and true foundations.³⁰⁸

In this case, the more conservative method yields the more startling result. Schwartz's proposal constructs a new default rule for certain lenders, while my proposal converts Article 9 as a whole from a mandatory rule to a default rule. It enables all debtors to, in effect,

³⁰⁴ See *supra* Part II.A.1 and 2.

³⁰⁵ Schwartz does, of course, sound notes of caution. See Schwartz, *supra* note 10, at 214 (noting that the article's principal goal is to persuade scholars that the issues again deserve serious study); *id.* at 260 (noting that "the question remains" whether his proposal or current law is more just).

³⁰⁶ Lynn LoPucki writes that Schwartz's financier is "a secured creditor in sheep's clothing." LoPucki, *supra* note 9, at 1890 n.8; see also Carlson, *Zero-Sum Game*, *supra* note 141, at 1734 n.272 (characterizing Schwartz's financiers as secured, "at least in the sense of having a bankruptcy priority and the right to repossess collateral"). Schwartz's insulation of financiers from both secured and unsecured later creditors does support likening financiers to secured creditors, while my preservation of vulnerability to unsecureds keeps perfected negative pledgees at a more intermediate point.

Financiers would apparently not have self-help remedies under Schwartz's proposal unless they were actually secured in the traditional sense of the word, but Schwartz suggests that these remedies are not of substantial value. See Schwartz, *supra* note 10, at 243-44.

³⁰⁷ My proposal simply neutralizes the heretofore mandatory nature of Article 9's rules, out of agnosticism about the best choice in a given context. Schwartz, more gnostic, preserves Article 9's priority rules only as an ancillary option of interest to some who, for unspecified reasons, might not embrace the new world that he prescribes. See Schwartz, *supra* note 10, at 260.

³⁰⁸ See, e.g., EDMUND BURKE, REFLECTIONS ON THE REVOLUTION IN FRANCE (L.G. Mitchell ed., Oxford Univ. Press 1993) (1790); Peter J. Stanlis, *Burke, Rousseau, and the French Revolution*, in BURKE AND THE FRENCH REVOLUTION (Steven Blakemore ed., 1992).

opt out of the regime that forces onto their unsecured creditors the risk that other creditors will obtain security.³⁰⁹

IV

RAMIFICATIONS: THE WORLD IN A GRAIN OF SAND

Details aside, this Article's proposal as a whole resonates with much of the rest of commercial law, including a number of important theoretical questions. The issue of negative pledge covenants is a grain of sand in which to see the world.³¹⁰

A. Traditional Principles at the Heart of a Radical Proposal

The effect of this Article's proposal is surprising, radical, and admittedly even outlandish. Who would dream of using Article 9, of all statutes, to protect unsecured creditors: isn't its very *raison d'être* to do the opposite—protect secured creditors against unsecureds? Perhaps not: we can now see that this conception is too narrow and that the real purpose of Article 9 is arguably less result oriented. Part of the beauty of my proposal is that, in addition to achieving an instrumentalist goal that historically has been foreign to Article 9, it does so with precisely the tools that Article 9 has always used. It thus invites us to look afresh at the statute's foundations, which we tend to take for granted. By turning Article 9 inside out, the proposal more clearly reveals the statute's inner workings.

In addition to carrying forward Article 9's foundational principles of *nemo dat* and public notice, the proposal carries forward Article 9's even more fundamental techniques. It allocates and prioritizes property interests in an automatic, self-executing way, as the result of a simple act that confers constructive notice, and without the need for fact-intensive litigation that the equitable lien, injunction, and tort doctrines entail.³¹¹ The proposal accordingly alleviates the pressure that courts, using those inadequate tools, have felt to reach just results at the cost of commercial unpredictability. Moreover, by enhancing predictability and clearing out an antiquated and confusing under-

³⁰⁹ See *infra* Part IV.C, D; Conclusion. The choice to opt out would be reversible. Its effect lasts only as long as the perfected negative pledgee's debt is outstanding (or, if perfection is accomplished by filing, until that filing lapses).

The proposal's effectiveness as an opt-out mechanism is, of course, dependent upon the right incentives being crafted. See *supra* Part II.A.2.

³¹⁰ To see a World in a Grain of Sand
And a Heaven in a Wild Flower,
Hold Infinity in the palm of your hand
And Eternity in an hour.

WILLIAM BLAKE, *Auguries of Innocence*, in *SELECTED POETRY AND PROSE OF WILLIAM BLAKE* 90 (Northrop Frye ed., 1953).

³¹¹ Part I.C, *supra*, examines these doctrines. Dean Baird's metaphor for Article 9's allocative process is "staking a claim." See Baird, *supra* note 112, at 62-63; *supra* note 223.

brush of case law, the proposal helps to achieve the UCC's overall goals "to simplify, clarify and modernize the law governing commercial transactions."³¹²

The proposal also advances Article 9's precept that debtors have freedom of alienation. Under the common understanding of current law, debtors who grant security interests dispose of property, while debtors who agree to negative pledge covenants give up the right to dispose of property. The proposal would enhance the latter's freedom of alienation: debtors who grant perfected negative pledge covenants would not only dispose of property;³¹³ they would also be able to dispose of the power to dispose of property.

Traditional wisdom is that more bargains are struck when property rights are clear,³¹⁴ and by taming the specter of today's judge-made doctrines,³¹⁵ the proposal would make parties surer of their rights and of the limits thereon. They should accordingly be more prepared to enter into secured or negative pledge transactions in appropriate cases. This result, incidentally, is consonant with another of the UCC's overall goals: "to permit the continued expansion of commercial practices through . . . agreement of the parties."³¹⁶

In short, although the proposal subverts certain outcomes that Article 9 has always taken for granted, it also, on a deeper level, remains beautifully consistent with Article 9. In this age of debate over the merits of secured credit,³¹⁷ the proposal highlights the idea that Article 9 is just a tool, and that as such it is inherently neither good nor bad; a tool's worth depends on how it is used.

B. Further Leveling of the Playing Field

The proposal tends to level the playing field between lenders of differing abilities. Under current law, negative pledge lenders who better select their debtors *ab initio* or who are better able to monitor them after the loan closes fare better than other negative pledge lenders. Under the proposal, however, less well-equipped negative pledge lenders can fare equally well, simply by taking advantage of Article 9's perfection mechanisms.³¹⁸

³¹² U.C.C. § 1-102(2)(a) (1995).

³¹³ See *supra* Part II.A.1 and 2 (discussing the flexible nature of the concept of property).

³¹⁴ See ROBERT COOTER & THOMAS ULEN, *LAW AND ECONOMICS* 100 (1988) ("One well-confirmed result in the literature on bargaining is that bargainers are more likely to cooperate when their rights are clear, and less likely to agree when their rights are ambiguous.").

³¹⁵ See *supra* Part I.C; text following note 251.

³¹⁶ U.C.C. § 1-102(2)(b).

³¹⁷ See *supra* note 141 and accompanying text; *infra* Part IV.C.

³¹⁸ In this respect, rendering negative pledge covenants perfectible extends yet another of Article 9's existing principles. See *supra* Part IV.A. "The filing system purportedly

This promotion of competition would also have regrettable aspects. By nullifying a comparative advantage that currently belongs to certain lenders, it would cause a loss of biodiversity in the lending kingdom, rendering the world of commerce slightly more homogenized than it already is. It would concomitantly allow even greater distance between commercial actors than today's system does, exacerbating the mutual estrangement that characterizes modern society.³¹⁹ On the other hand, these aspects of the proposal, like the others identified above,³²⁰ simply extend principles that Article 9 already embraces. The statute's nature enables lenders to rely more heavily on borrowers' assets and less heavily on knowledge of either their characters or business plans.

C. Efficiency and Reduced Debtor Cross-Subsidization

Considerations of both efficiency and autonomy call for freeing debtors from paying for rights that they neither use nor desire. Some debtors may view their rights under current law as a "white elephant"—costly, troublesome, and unwanted.³²¹ Debtors have the power, by issuing secured debt, to enable a later creditor to take priority over an existing unsecured creditor, but the debtor's power is its own unsecured creditors' risk, and the latter naturally compensate by raising interest rates or fees.³²² The problem here is that some debt-

serves as a seal of good faith, signaling less informed or occasional creditors that they may engage in asset-based lending on a level playing field with more experienced lenders." Robert E. Scott, *The Politics of Article 9*, 80 VA. L. REV. 1783, 1829 (1994); see also 2 GILMORE, *supra* note 31, § 41.1, at 1079 (noting that pre-Code law was "a sort of paradise for specialists," and that under Article 9, specialists may be left behind with amateurs taking over). Lenders who are relatively advantaged under current law can perhaps accordingly be expected to oppose adoption of the proposal. The political economy of the proposal would be an interesting sidelight to explore.

³¹⁹ One of the fathers of Article 9 reports how, in an epoch that now seems long gone, lenders relied on first-hand judgment of credit and moral risk rather than on filing records. Indeed, "[o]ne banker thought the questions [about sources of debtor information] 'silly' because his bank did not make a loan unless the borrower 'was properly introduced,' and therefore a fraudulent borrower was an impossibility." Allison Dunham, *Inventory and Accounts Receivable Financing*, 62 HARV. L. REV. 588, 611 & n.48 (1949). This anecdote illustrates, of course, that the pendulum can swing too far in the other direction, as well: no one wishes society to revert to the stifling closure in which status, rather than contractual self-definition, shapes individuals' prospects. See generally SIR HENRY SUMNER MAINE, *ANCIENT LAW* 163-65 (1906) (idealizing "the movement of progressive societies" as being "from status to contract"). A dilemma arises: we don't want to declare some persons insiders and others outsiders, but in levelling the playing field too assiduously, in a sense we tend to make everyone an outsider to everyone else.

³²⁰ See *supra* Part IV.A.

³²¹ Brewer reports that the King of Siam made a present of a white elephant to those among his courtiers whom he wished to ruin. See E. COBHAM BREWER, *THE DICTIONARY OF PHRASE AND FABLE* 1296 (Wordsworth Editions 1993) (1894).

³²² At issue here is unsecured creditors' adjustment to the threat of future issuances of security, rather than to the fact of past issuances. See Adler, *supra* note 127, at 83-84; Bebchuk & Fried, *supra* note 7, at 890 ("For purposes of our analysis, we are willing to

ors, though settled in their plans not to issue secured debt, cannot credibly assure unsecured creditors that they will suffer no loss of priority. In other words, debtors that do not value the power to give security are nonetheless forced to pay for it, in effect cross-subsidizing debtors who do value it.³²³

Scholars have explored whether this dynamic explains the existence of security interests: perhaps debtors issue security because they know they will be charged for it even if they do not. This theory, which Alan Schwartz labels the "defensive distributional explanation," is agreed not to represent a complete explanation of all security.³²⁴

assume that prior creditors anticipate the risk that subsequent security interests will subordinate their claims in bankruptcy and charge [all firms an overall compensating amount] accordingly."); Jackson & Kronman, *supra* note 101, at 1147-48 ("It is a fair assumption . . . that . . . creditors will be aware of this risk and will insist on a premium for lending on an unsecured basis" or adjust in other ways); James H. Scott, Jr., *Bankruptcy, Secured Debt, and Optimal Capital Structure: Reply*, 34 J. FIN. 253, 258 (1979) ("If the unprotected creditors are rational and if they believe firms act in stockholders' best interests, they will expect an issue of secured debt with probability one, and will price the credit they extend accordingly.").

³²³ The cross-subsidization problem arises from a dynamic similar to that described by Bebchuk and Fried. Even voluntary creditors may find it rational not to adjust their interest rates for the presence of prior perfected security interests, because the transaction costs of determining the presence and size of the prior encumbrances would outweigh the benefits. See Bebchuk & Fried, *supra* note 7, at 885-87. Debtors that have not issued security thus, in effect, subsidize debtors that have. See LoPucki, *supra* note 9, at 1957 & n.255. Similarly, current law makes prohibitive the transaction costs of preventing future issuances of security; hence, debtors that will not in the future issue security subsidize debtors that will.

The cross-subsidization problem is also the converse of the conventional Modigliani-Miller analysis of secured debt. See *infra* note 329. Whereas that analysis views debtors as exploiting unsecured creditors by issuing security, the cross-subsidization problem views debtors as, in a sense, being exploited by unsecured creditors when they do not issue security. Cf. Scott, *supra* note 322, at 258 ("Indeed, if stockholders behave suboptimally and fail to issue secured debt, stockholders exploit themselves, while creditors receive a windfall gain."). Schwartz associates the conventional Modigliani-Miller analysis with "the offensive distributional explanation," Schwartz, *supra* note 8, at 30-31, in contrast to the "defensive distributional explanation" discussed in the text below.

³²⁴ Schwartz, *supra* note 8, at 31-33; see also Baird, *supra* note 189, § 1.04[2], at 1-19 to 1-21. Schwartz finds two difficulties with the theory. The first, that not all debtors issue as much as possible of their debt on a secured basis, see Schwartz, *supra* note 8, at 32, relates in part to the relative costs, benefits, and other dynamics briefly discussed *supra* in Part I.E. The second, that explanations are lacking of why security is a cheaper means of protection than negative pledge covenants, see *id.* at 32-33, is partially addressed *supra* in Part I: under current doctrine, negative pledge covenants are not reliably binding on third parties, and to the extent that they are, the circumstances and consequences are unpredictable. Cf. Bebchuk & Fried, *supra* note 7, at 888 ("[A]n unsecured lender might not be willing to offer a lower interest rate in exchange for a negative pledge covenant from a borrower if the transactions of that borrower may be difficult to monitor.").

As an example of the monitoring problem, Bebchuk and Fried discuss a small- or medium-sized, monitoring-evasive debtor with an "informal" secured creditor who might remain unperfected until just before a competing creditor obtains a judgment lien, and yet still have priority under U.C.C. § 9-301(1)(b) if the debtor cooperates by giving it late perfection. *Id.* This late perfection problem (to the extent that it persists despite the

However, this conclusion does not make cross-subsidization any less troubling. On the contrary, the more one finds that debtors fail to issue security in reaction to cross-subsidization, the more troubling the dynamic becomes.³²⁵

This Article's proposal provides debtors with a means to avoid paying for the unwanted power to issue secured credit. One component of debtors' unsecured borrowing costs is currently attributable to the unenforceability of negative pledge covenants against subsequent secured parties,³²⁶ and in a competitive lending market, removing that limitation upon enforceability will eliminate that component of the cost. Debtors can remove the enforceability limitation by letting creditors who are concerned with the problem perfect their negative pledge covenants as Part II.A describes.³²⁷ Those creditors will be as-

Bankruptcy Code's preference provisions) is actually even broader than Bebchuk and Fried's scenario; even an arm's-length creditor might create it, if the creditor obviates the need to trust the debtor late in the game by means of a power of attorney. (Further assurances clauses are devices with similar, though weaker, potential.) Moreover, even if perfection is immediate, most feasible monitoring will detect it only after the fact, and by that point it is too late to the extent that the proceeds of the secured loan are dissipated. *See* Part I.A.2.

By contrast, under this Article's proposal, a perfected negative pledgee would be relieved of virtually all monitoring concerns *vis-à-vis* subsequently perfecting secured parties. Even if it discovers a security interest after it is perfected and the proceeds of the secured loan have been dissipated (a problem that grows more unlikely if the proposal is adopted, *see supra* notes 236-37 and accompanying text), the negative pledgee can assert its constructive trust or other rights against the secured party. *See supra* Part II.A.3. The only monitoring concerns would be those relating to other unsecured debt and those relating to changes in jurisdiction, debtor name, and the like that Article 9 has always imposed on secured creditors.

³²⁵ The cross-subsidization model presents an interesting echo of David Carlson's argument against the view that security is not efficient. Carlson points out that unsecured lenders will not necessarily ever materialize to absorb the risks exported by security and that in those cases, secured credit is not merely redistributive. *See* Carlson, *Efficiency*, *supra* note 141, at 2182, 2192-95, 2199. The cross-subsidization model shows, conversely, that in cases in which secured lenders never materialize to fulfill the risks that unsecured lenders charge for, a portion of the unsecured lenders' compensation is merely redistributive.

³²⁶ *See* Adler, *supra* note 127, at 83-84. Adler notes that:

[A] firm must pay the higher interest rate on an unsecured loan even if it possesses unencumbered property and covenants not to encumber or dispose of that property. This is because an unsecured creditor faces the risk—despite any covenant—that the firm will subsequently offer unencumbered property as collateral for another's loan [U]ntil a firm pledges all possible property as security for its loans, that firm pays more than it must in total interest if it borrows on an unsecured basis.

Id.; *see also* Bebchuk & Fried, *supra* note 7, at 889 ("If an unsecured creditor believes a negative pledge covenant is not enforceable, it will simply set its interest rate to reflect the fact that the firm may later create security interests, thereby subordinating its claim . . .").

³²⁷ There will, of course, be expenses associated with this procedure. *See supra* note 151. The proposal will generate private gains in cases in which the expenses associated with perfection of a negative pledge covenant are less than the debtor's net subsidization costs, that is, less than the amount by which the debtor supports others' borrowings exceeds the amount by which others' borrowings support that of the debtor. It will also generate social gains in cases in which the aggregate expenses associated with perfection of

sured of suffering no loss of priority under the perfection principle by, in effect, using an extension of that same principle themselves.³²⁸ Thus, debtors need not give security interests for purely defensive reasons: debt can remain unsecured except for those cases when the dynamics of bargaining described in Part I.E genuinely dictate that the loan be secured, for reasons undistorted by a needlessly perceived threat. The result is efficient: lenders and borrowers can exchange more precisely what they wish, and third parties are harmed no more than they would have been had security been used instead.

D. A Fresh View of the Debate over Secured Transactions

For nearly two decades, scholars have debated whether the institution of secured credit is efficient or merely redistributive,³²⁹ and whether security is otherwise socially desirable.³³⁰ Without attempting directly to advance these debates,³³¹ this Article's proposal places them in a fresh light. In effect, the proposal steps back from them to ask an anterior question—not whether security is desirable, but who should decide whether security is desirable. Thus far, scholars have

the negative pledge covenant are less than those entailed by measures such as excessive monitoring, forcing a loan that should be unsecured to be secured, or forgoing the transaction.

³²⁸ They could similarly assure themselves by taking security interests, but by hypothesis, the dynamics of bargaining described in Part I.E have led these creditors not to take security.

³²⁹ The debate arose through the application to secured lending of the Modigliani and Miller Irrelevance Theorem. See Franco Modigliani & Merton H. Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 AM. ECON. REV. 261 (1958). The theorem holds that under idealized conditions, a firm's capital structure is irrelevant to its aggregate cost of capital. A firm's mixture of secured and unsecured debt can be viewed as one application of this proposition. See, e.g., Jackson & Kronman, *supra* note 101, at 1154 & n.46.

³³⁰ See *supra* note 141 and accompanying text.

³³¹ In particular, the proposal has little to say about the aggregate utility of security, although enacting the proposal and studying who does and does not take advantage of it would generate a useful fund of empirical evidence bearing indirectly on this question.

The proposal would not ensure that only efficient security interests are issued. Indeed, unless parties using the proposal tailor their negative pledge covenants properly, the proposal could even result in the blockage of security interests that would be efficient. See Bebchuk & Fried, *supra* note 7, at 879 (noting that overinclusive covenants generate opportunity costs); Triantis, *supra* note 14, at 239-40. However, as discussed in Part IV.C, the proposal would eliminate some inefficient security interests.

Nor would the proposal ensure that parties use negative pledge covenants whenever they are efficient. Creditors other than the negative pledgee can free ride on a negative pledge covenant, see Bebchuk & Fried, *supra* note 7, at 889, 900, 923, and making the covenants perfectible would not alleviate this problem. (The compensation rule described in Part II.C.2 prevents only a new, exacerbated kind of free riding that the proposal itself would otherwise have introduced.) This fact, combined with the fact that perfecting a negative pledge covenant would entail noticeable costs, see *supra* note 151, means that creditors may not have the incentive to use the device even in cases in which it does represent an improvement over other available arrangements. See Bebchuk & Fried, *supra* note 7, at 889.

uniformly cast the debate as one that has only a single answer for society as a whole.³³² By contrast, my proposal recasts the question as one that each debtor can answer for itself.

Even if proponents definitively establish that security is, in the aggregate, a socially desirable institution, this would not establish that it is a desirable option for any particular debtor. To think otherwise is to commit the fallacy of division, presuming that what is true of the collective is also true of the individuals comprising the collective.³³³ For some debtors, the possibility of issuing security is not desirable, and simply to tell these debtors not to issue it is an inadequate answer. For as Part IV.C discusses, the present system forces even debtors who are confident in their plans not to use security to pay for the risk that it presents to their lenders. My proposal would eliminate this burden.

Under this proposal, any debtor concluding that security, with the threat that it presents to its unsecured creditors, is not a desirable institution could, in effect, opt out of the regime that imposes the threat, simply by allowing its unsecured creditors to perfect negative pledge covenants against it (or, in the alternative, opt out on a less global basis by letting only selected negative pledgees perfect).³³⁴ Assuming that the right incentive structures were in place,³³⁵ negative pledgees could be entirely confident that if any later security interest were perfected, it would not meaningfully affect them. This is not technically the same as being confident that the debtor will not issue later security at all, but it is the practical equivalent.³³⁶ In short, the proposal would give each debtor the power to effectively abolish security for its own unsecured creditors, regardless of what scholars and policy makers may ultimately decide to do for commercial actors at large.

The result is to enhance the autonomy of private actors more drastically and surprisingly than was discussed in Part IV.A: debtors

³³² If this orientation has not been explicit in the literature, it is no doubt because until now no one has questioned it. The orientation is, however, clear from the global, absolutist terms in which the discussions tend to be conducted. *See, e.g.*, Bechuk & Fried, *supra* note 7, at 863 ("We will show that a rule according full priority to secured claims in bankruptcy tends to reduce the efficiency of the loan arrangement negotiated between a commercial borrower and a potentially secured creditor"); LoPucki, *supra* note 9, at 1963-65 (concluding that Article 9 "artificially and unjustifiably advantages the institution of security over unsecurity"); Schwartz, *supra* note 8, at 33 ("[I]t is not known with assurance whether security is efficient . . . or inefficient . . .").

³³³ *See* BLACKBURN, *supra* note 21, at 71.

³³⁴ The decision to opt out would also be reversible. *See supra* note 309.

³³⁵ *See* text following note 248 (noting that the goal of the enforcement mechanism should be to free perfected negative pledgees from concern over junior secured parties as much as senior secured parties have always been free of such concern).

³³⁶ Even if precisely the right incentives cannot be constructed, so that some modest concern persists on the part of unsecured creditors, the opt-out remains virtually complete, and the current law's burden on debtors and unsecureds remains vastly alleviated.

who do not desire security can effectively abolish it, while debtors who do desire it can continue to enjoy its availability. Article 9 itself thus becomes a default rule rather than a mandatory rule.³³⁷ Even those who are convinced of the overall desirability of secured credit should favor this result: ever since Bentham, a tenet of mainstream economic analysis has been that individuals rather than policy makers are the best judges of their own self-interest.³³⁸ Thus, although this Article's proposal does not address the debate over secured credit on its own terms, it does show that the debate can be converted from a social question to a much less intractable, private actor-based question.

CONCLUSION

Anything becomes profound when examined closely enough, but negative pledge covenants offer a unique window onto much of commercial law. If we realize that they are grounded in the same principles as security interests, and if we accordingly make Article 9 available like a fulcrum to negative pledgees, fascinating things happen.³³⁹ The flexible nature of property rights becomes clear.³⁴⁰ Borrowers and lenders gain access to a distinct new kind of debt, located midway between secured and unsecured, with which to accommodate their complex preferences.³⁴¹ The expansion of Article 9 also enhances debtors' freedom of alienation,³⁴² increases transactional efficiency, and reduces debtor cross-subsidization.³⁴³ Finally, the change throws the debates about secured credit into new perspective, as Article 9 stands revealed as a structure that can be optional rather than mandatory.³⁴⁴

Commercial law has remained relatively free of the debate over mandatory versus enabling rules that has long embroiled corporate law,³⁴⁵ but commercial law presents a fertile field for similar ideas. To be sure, certain areas of commercial law have long included default

³³⁷ See *supra* note 309 and accompanying text; *infra* notes 345-52 and accompanying text.

³³⁸ See, e.g., LEWIS H. HANEY, *HISTORY OF ECONOMIC THOUGHT* 250 (4th ed. 1949).

³³⁹ The primary purpose of this Article is not, however, to call for adoption of such a measure. See *supra* note 3.

³⁴⁰ See *supra* Part II.A.

³⁴¹ See *supra* Part I.E.

³⁴² See *supra* Part IV.A.

³⁴³ See *supra* Part IV.C.

³⁴⁴ See *supra* Part IV.D.

³⁴⁵ See, e.g., Symposium, *Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395 (1989). In brief, mandatory rules cannot be varied by agreement, enabling rules give legal effect to rules agreed upon by parties, and default rules govern situations in which parties have not used their power under an enabling rule to specify a different result. See, e.g., Melvin A. Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1461 (1989).

rules: examples abound in Article 2³⁴⁶ and can be found in parts of Article 9³⁴⁷ and elsewhere.³⁴⁸ These instances tend, however, to be fairly small-scale: they are modest, localized choices available to parties acting within larger, mandatory frameworks.

By contrast, this Article's proposal enables parties to take a more drastic step, in effect opting out of Article 9 altogether.³⁴⁹ It is unusual for a body of commercial law to permit itself to be so radically rejected. Recently, however, these ideas have increasingly found legitimacy. In addition to recent enactments,³⁵⁰ an opt-out approach for the sale of payment intangibles was seriously considered as a part of the recently completed revisions to Article 9 itself.³⁵¹

These moves toward radically enabling rules are a bracing breath of fresh air. Although commercial law exists largely in order to further consensual transactions,³⁵² it remains pervaded by crucial legisla-

³⁴⁶ See Randy E. Barnett, *The Sound of Silence: Default Rules and Contractual Consent*, 78 VA. L. REV. 821, 825 (1992).

³⁴⁷ See, e.g., U.C.C. § 9-203(3) (1995) (providing that a right to proceeds is implied in a security agreement unless otherwise agreed). Article 9's priority rules are also default rules. See *id.* § 9-316 (recognizing secured parties' power to alter priority through subordination agreements); *supra* Part III.A. However, Article 9 as a whole remains mandatory in the sense that no debtor is able to assure its unsecured lenders that they will not lose priority to a later secured lender. See *supra* Part IV.C; see also Margit Livingston, *Certainty, Efficiency, and Realism: Rights in Collateral Under Article 9 of the Uniform Commercial Code*, 73 N.C. L. REV. 115, 181 (1994) (Article 9 has "less room for . . . private parties to maneuver" and "fewer chances for the parties to opt out of the Code scheme" than Article 2 does).

³⁴⁸ For example, Article 3 permits parties to negate the negotiability of some notes and drafts, but this permission does not extend to checks. See U.C.C. § 3-104(d). Article 8 permits parties to opt into its coverage for securities under fairly narrow circumstances. See *id.* §§ 8-102(a)(15)(iii)(B), 8-103(c); ROCKS & BJERRE, *supra* note 109, at 6-7.

³⁴⁹ See *supra* Part IV.D.

³⁵⁰ The Article 3 provision discussed above was adopted by the UCC's sponsoring organizations in 1990, and the Article 8 provision in 1995. 2 U.L.A. 5 (1992); 2C U.L.A. 41 (1991 and Supp. 1998).

³⁵¹ Article 9 has heretofore applied to sales of accounts and chattel paper, but not to sales of general intangibles, see U.C.C. § 9-102(1), and this exclusion has proved to be an impediment to the securitization industry. The simplest solution, repeal of the exclusion as applied to general intangibles principally consisting of rights to payment (now known as "payment intangibles"), was not feasible because Article 9's perfection requirements would impose a large and needless burden on the loan participation market. Accordingly, a task force on which I served proposed permitting parties to payment intangibles simply to opt out of Article 9; thus, banks could provide in their loan documentation that sales of the payment rights would not be subject to Article 9. See Memorandum from Securitized Asset Financing Task Force to Article 9 Drafters 15-17 (Sept. 13, 1994) (on file with author). Ultimately, however, the Article 9 Drafting Committee settled upon an automatic perfection rather than an opt-out approach. See Revised U.C.C. § 9-309(3) (1998); Carl S. Bjerre, *International Project Finance Transactions: Selected Issues Under UCC Article 9*, 73 AM. BANKR. L.J. (forthcoming 1999); Paul M. Shupack, *Securitization Under Revised Article 9*, 73 AM. BANKR. L.J. (forthcoming 1999).

³⁵² See U.C.C. § 1-102(2)(b) (providing that one purpose and policy of the UCC is "to permit the continued expansion of commercial practices through . . . agreement of the parties"); *id.* § 1-102(3) (providing that, with certain limitations, effect of provisions of this Act "may be varied by agreement"). A complementary goal at work in portions of the

tive choices made on a global, system-wide basis that permits individuals no opportunity to demur. Even if these legislative choices are, in fact, in the best interest of all, the decision-making structure itself sacrifices something central and highly important to the spirit of commercial law. Perhaps this Article's proposal will point the way toward other enabling ideas, equally startling but equally reinvigorating.