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# ADDING ANOTHER PIECE TO THE FINANCING PUZZLE: THE ROLE OF REAL PROPERTY SECURED DEBT

*Alex M. Johnson, Jr.\**

## I. INTRODUCTION

At first blush, a secured debt system appears to be inequitable.<sup>1</sup> Secured debt permits the debtor to grant its secured creditors priority over other unsecured creditors.<sup>2</sup> Thus, in the event of debtor insolvency, the secured creditors have the right to take as much of the collateral or "security" as necessary to satisfy their claims before the unsecured creditors can take anything.<sup>3</sup> A system disallowing secured debt would require all creditors to share pro rata in the debtor's assets in the event of debtor insolvency.<sup>4</sup>

Realizing the facial inequity of secured debt, scholars have advanced numerous theories to justify its existence and widespread use.<sup>5</sup> While many theories purport to explain the role of secured financing, none attempts to explain the role of *real property* secured financing.<sup>6</sup> The secured debt puzzle cannot, however, be pieced together successfully unless the role that real property secured debt plays in financing transactions is factored into the analysis of secured debt.

This Article briefly describes the secured debt puzzle, the debate that has developed concerning its existence, and the theories legal schol-

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1. Jackson & Kronman, *Secured Financing and Priority Among Creditors*, 88 YALE L.J. 1143, 1147 (1979).

2. *Id.*

3. *Id.*

4. *Id.*

5. See, e.g., D. BAIRD & T. JACKSON, *CASES, PROBLEMS, AND MATERIALS ON SECURITY INTERESTS IN PERSONAL PROPERTY* 361-67 (1984); Jackson & Kronman, *supra* note 1; Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 YALE L.J. 49 (1982); Schwartz, *Security Interests and Bankruptcy Priorities: A Review of Current Theories*, 10 J. LEGAL STUD. 1 (1981); Scott, *A Relational Theory of Secured Financing*, 86 COLUM. L. REV. 901 (1986).

6. See Scott, *supra* note 5, at 902. Real property secured financing differs from personal property secured financing in that the collateral or "security" is real property, as opposed to personal property.

ars have developed to explain the existence and use of secured financing. It then explores the role that real property secured debt plays in solving the secured credit puzzle by raising and answering the question of how, if at all, real property secured debt impacts personal property secured debt. By examining the role that monitoring<sup>7</sup> plays in real property security interests, as opposed to personal property security interests, another piece is added to the puzzle.

Finally, this Article explains the need for and use of secured debt in light of the existence and widespread use of real property security interests. By drawing upon examples provided by real property secured debt, the Article concludes that secured debt serves an important signaling function.<sup>8</sup> Contrary to previously considered approaches, however, this Article shows that the signal provided by real property secured debt is not solely or primarily for the benefit of the creditors; real property secured debt also provides an important signal to creditors' investors.

## II. SUMMARY OF RELEVANT THEORIES OF SECURED DEBT

The role of secured debt in financing transactions is puzzling. Many commentators have asked, "What purposes, whether benign or malignant, does security serve?"<sup>9</sup> Specifically, scholars have questioned the preference given to some creditors over others for personal property security.<sup>10</sup> In the intellectual pursuit to justify and explain the function of secured debt, legal scholars have advanced many theories.<sup>11</sup>

Proponents of the conventional theory<sup>12</sup> justify the preferential treatment lenders give to secured creditors by arguing that a secured credit system benefits debtors because it increases the amount of credit available to the debtor.<sup>13</sup> Under this theory, if lenders did not demand security, high-risk debtors would be forced to pay prohibitive interest rates or would be denied credit altogether.<sup>14</sup> Under a secured credit system, creditors can reduce the unacceptably high risks of default by demanding adequate security. Thus, creditors can extend credit to debtors

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7. "Monitoring" is a strategy used by creditors to police the debtor's conduct after the loan has been made. Jackson & Kronman, *supra* note 1, at 1150. Creditors monitor the debtor to minimize the risk of misbehavior. *Id.*

8. "Signaling" is a mechanism used by debtors to ensure creditors of their credit-worthiness as debtors. Scott, *supra* note 5, at 906.

9. Scott, *supra* note 5, at 901; *see supra* note 5 and accompanying text.

10. *See* Scott, *supra* note 5, at 901. Secured financing is discriminatory in the sense that it gives preference to secured creditors over unsecured in the event of the debtor's insolvency. *Id.*

11. *Id.*

12. *See, e.g.*, J. VAN HORNE, FINANCIAL MANAGEMENT AND POLICY 536 (3d ed. 1974).

13. *Id.*

14. *Id.*

who may otherwise be denied access to the credit market.<sup>15</sup>

The "zero-sum game" analysis<sup>16</sup> discredits the conventional justification by showing that secured credit is a zero-sum game in which any benefits accruing to the secured creditors as a result of their security interest are offset by the increased costs to unsecured creditors.<sup>17</sup> Similarly, any cost-savings debtors realize by incurring secured debt are offset by the higher interest rates debtors pay for unsecured debt. Moreover, zero-sum game analysts allege that the high transaction costs debtors incur to create a security interest may cause the debtor's aggregate cost of financing to be higher in a world that allows secured credit, than in one that prohibits secured credit.<sup>18</sup>

A third theory explaining the role of secured debt in financing transactions is put forth by "monitorists." Professors Thomas Jackson and Anthony Kronman, the most prominent proponents of monitoring, use an efficiency argument to explain the role of secured financing. They argue that able monitors extend unsecured credit because they are effectively able to monitor the debtor for misbehavior, while less efficient monitors require a security interest to compensate them for their inability to monitor the debtor effectively.<sup>19</sup> Jackson and Kronman's theory has been criticized because it fails to explain the empirical facts that many unsecured creditors are inadequate monitorists and that the most able monitors frequently require security.<sup>20</sup>

Finally, Professor Robert Scott, one of the most prominent "relationalists," advances a theory of secured financing based on relational contract theory.<sup>21</sup> The relational model of secured financing relies on the

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15. *Id.*

16. The term "zero-sum game" was used by Scott, *supra* note 5, at 902 (citing Schwartz, *Security Interests and Bankruptcy Priorities: A Review of Current Theories*, 10 J. LEGAL STUD. 1, 10-11, 18-21 (1981)).

17. See A. SCHWARTZ & R. SCOTT, *COMMERCIAL TRANSACTIONS: PRINCIPLES AND POLICIES* 556-59 (1982); Schwartz, *supra* note 5, at 7-11, 18-21.

18. Scott, *supra* note 5, at 902.

19. See Jackson & Kronman, *supra* note 1, at 1158-61.

20. Levmore, *supra* note 5, at 53.

21. Scott, *supra* note 5. A relational contract is defined as:

A contract is relational to the extent that the parties are incapable of reducing important terms of the arrangement to well-defined obligations. Such definitive obligations may be impractical because of inability to identify uncertain future conditions or because of inability to characterize complex adaptations adequately even when the contingencies themselves can be identified in advance.

Goetz & Scott, *Principles of Relational Contracts*, 67 VA. L. REV. 1089, 1091 (1981). Long-term contracts are more likely than short-term agreements to fit this conceptualization, but temporal extension per se is not the defining characteristic. *Id.* Relational contracts differ from complete contingent contracts in that the complete contingent contract assumes complete risk allocation *ex ante*; in other words, performance standards are reduced to specific obliga-

creditor's use of a blanket or floating lien<sup>22</sup> pursuant to Article 9 of the Uniform Commercial Code.<sup>23</sup> The floating lien gives the creditor exclusive control over the debtor's financing needs because it grants the creditor priority in all the debtor's assets including after acquired assets.<sup>24</sup> The exclusive control given to the creditor, and the resultant cooperative behavior that must take place between the debtor and creditor establishes the relational financing device by which each party seeks to maximize the joint return from the venture.<sup>25</sup> Because both the debtor and the secured creditor are committed to the success of the venture, all creditors, including the unsecured creditors, benefit.

Interestingly enough, none of the above theories considers the role of real property secured financing. Although the relational model cannot be faulted for ignoring real property secured debt because conventional mortgages are not relational contracts,<sup>26</sup> the other theories purport to

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tions. *Id.* at 1092. In the complete contingent contract, parties are assumed to be able to allocate all the risks *ex ante*, because they are presumed to have access to complete information about all the future contingencies and the relevant legal rules that could affect their relationship. See Goetz & Scott, *The Mitigation Principle: Toward a General Theory of Contractual Obligation*, 69 VA. L. REV. 967, 971 n.11 (1983).

22. A floating lien "floats from one bit of collateral to another, and may first secure one debt and then another." Coogan, *Article 9 of the Uniform Commercial Code: Priorities Among Secured Creditors and the "Floating Lien,"* 72 HARV. L. REV. 838, 839 (1959).

23. U.C.C. § 9-109 (1989); see Scott, *supra* note 5, at 903.

24. See U.C.C. § 9-204. Article 9 contains an exception for purchase money security interests. See U.C.C. § 9-312(3), (4); Scott, *supra* note 5, at 913.

25. Scott, *supra* note 5, at 916-19. As Professor Scott notes:

[T]he purposes behind this elaborate mechanism are revealed by evidence that secured creditors and debtors form a relational contract in order to finance growth opportunities or prospects. Secured creditors invest substantial resources in directing debtor actions toward optimal development of the financing venture. Since these services are not separately priced at the time of contracting, the parties enter into relational credit contracts in which the creditor gains the exclusive option over the financing venture in exchange for the obligation to aid in its full development. The creditor's interest in cooperating *ex post* is maintained by the single fact that the loans cannot feasibly be repaid except out of the proceeds of the venture itself. The debtors [sic] commitment to the joint interest of the venture is itself enforced through the elaborate security mechanisms generated by this specialized industry.

*Id.* at 951.

One significant mechanism for achieving the debtor's commitment is that the debtor offers its assets as a "hostage" to the creditor in order to grant the creditor leverage over the debtor's assets. As noted by Professor Scott, "The hostage imagery was introduced into bargaining analyses by Schelling, *An Essay on Bargaining*, 46 AM. ECON. REV. 281, 300 n.17 (1956)." Scott, *supra* note 5, at 928 n.91; accord Williamson, *Credible Commitments: Using Hostages to Support Exchange*, 73 AM. ECON. REV. 519, 522-26 (1983) (discussing use of hostages in contemporary contracting).

26. For a discussion of the conventional, non-relational nature of the typical mortgage transaction and the relational nature of certain new financing devices, see A. Johnson, *The Recent Development and Limited Use of Relational Contracts in Real Estate Financing: The*

deal with secured debt, but specifically limit their analyses to personal property security.

Real property secured debt must be analyzed in order to evaluate fully the role of security in debtor-creditor relationships. The land upon which a business is built may be: (1) the one asset for which monitoring plays little or no role because land is immobile;<sup>27</sup> (2) the one asset that may appreciate in value to reflect the capitalization provided by the financing;<sup>28</sup> and, (3) the one significant asset that is tied up or secured by a mortgage which gives the mortgagee priority over all secured and unsecured creditors in the mortgaged property.<sup>29</sup> This super security interest may motivate, in some fashion, creditors' efforts to obtain security in other assets held by the debtor.<sup>30</sup> At the very least, the existence of the mortgage, or the option of taking a mortgage on real property if no priority mortgages<sup>31</sup> exist, affects a subsequent creditor's use of secured debt. It may be nothing more than the absence of the creditor's ability to take a super security interest in real property that motivates him or her to accept a floating lien or other collateral for the debt.

Yet, a priority mortgage or super security interest in the property must be a choice available to the creditor at the time the debtor-creditor relationship is established. This Article establishes that the use or the inability to use real property secured debt impacts the creditor's choices regarding the type of security interest taken by the creditor in the debtor's assets.<sup>32</sup> Thus, it is impossible to discuss the role of secured debt without an analysis of the role of real property secured debt and its interaction with personal property secured debt. No game can take place, including a zero-sum game, without understanding all of the tools of the

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Creation of Exotic Financing Devices (Oct. 1, 1990) (unpublished manuscript on file at Loyola of Los Angeles Law Review).

27. See *infra* notes 39-51 and accompanying text.

28. See *infra* notes 79-81 and accompanying text.

29. See *infra* notes 82-92 and accompanying text. A mortgage is a written instrument creating an interest in real property to secure repayment of a debt. BLACK'S LAW DICTIONARY 911 (5th ed. 1979).

30. See *infra* notes 76-97 and accompanying text.

31. A priority mortgage is one that is validly recorded and given priority in a foreclosure action over subsequent debt interests or later recorded mortgages, thus giving to the priority mortgagee the first or superior interest in the security, the land. See G. NELSON & D. WHITMAN, REAL ESTATE FINANCE LAW §§ 9.1-7 (2d ed. 1985) (discussing creditors' priorities in bankruptcy and foreclosure). For further discussion of foreclosure and its impact on the rights and remedies of the other creditors, see *infra* notes 89-92 and accompanying text.

32. See *infra* notes 76-97 and accompanying text. The issue of why lenders take collateral or perfect a security interest in assets, real or personal, however, is beyond the scope of this Article. For a discussion of that issue, see Scott, *supra* note 5, at 945.

game available to the players.<sup>33</sup>

### III. REAL PROPERTY SECURED DEBT: ANOTHER PIECE OF THE PUZZLE

#### A. *Real Property Security Interests Are More Efficient Security Interests Than Their Personal Property Correlatives*

Debtors have many choices with respect to financing options and frequently use real property secured financing rather than personal property secured financing because real property secured financing is more advantageous to both the debtor and the creditor.<sup>34</sup> Real property security is easy to monitor. Therefore, the cost of this type of financing is usually less than the cost of the debtors' other options.<sup>35</sup> Further, creditors who take security interests in real property are primarily interested in the value of the debtors' land, as opposed to debtors' businesses.<sup>36</sup> As a result, real property secured creditors are less likely to involve themselves in debtors' businesses.<sup>37</sup> Thus, debtors who have accrued significant equity in their real property, should attempt to finance the growth of their businesses by mortgaging their real property. In this way, debtors can preserve their businesses while securing their debts with real property. It is only when the equity in their real property is either insufficient or nonexistent that debtors should turn to other financing alternatives, such as a relational financing arrangement, to finance the growth and development of their businesses.<sup>38</sup>

#### 1. The monitoring advantages of real property secured debt

The creditor's ability to monitor debtor behavior and thereby avoid the consequences of debtor misbehavior is an important factor in establishing the price of credit to the debtor.<sup>39</sup> The most efficient and practical security device from a monitoring perspective, and hence the cheapest and most advantageous to the debtor,<sup>40</sup> is generally the real property

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33. For a discussion of the zero-sum game approach to secured debt, see *supra* notes 16-18 and accompanying text.

34. The use of real property secured debt should not be taken lightly, however, because the initial use of real property secured debt has the practical disadvantage of preventing the later use of real property secured debt in potentially advantageous situations. See *infra* notes 82-87 and accompanying text.

35. See *infra* notes 39-51 and accompanying text.

36. See *infra* notes 63-73 and accompanying text.

37. See *infra* notes 63-73 and accompanying text.

38. See *infra* notes 82-97 and accompanying text.

39. See Levmore, *supra* note 5, at 50.

40. *Id.* at 51.

mortgage.<sup>41</sup> Unlike other forms of security, the real property mortgage has one overwhelming monitoring advantage: the land securing the debt is immobile. It is, therefore, relatively easy to monitor visually the asset for debtor misbehavior that affects the physical characteristics of the asset.<sup>42</sup>

The two most important types of debtor misbehavior that the creditor must monitor for and guard against are conversion and risk alteration.<sup>43</sup> Real property secured debt provides monitoring advantages in these areas as well. For example, if the creditor utilizes real property secured debt, it is very difficult for the debtor to convert the security interest, the land, for the benefit of the debtor. This is because the operation and relative efficiency of the land title recording system,<sup>44</sup> and the immobility of the asset itself affords the creditor significant protection. By properly using the recording system in the state in which the land is located, creditors can achieve priority over any subsequent creditors with respect to their interest in the property and, more importantly, prevent the sale or conversion of the property to a bona fide purchaser for value without their consent.<sup>45</sup>

Similarly, creditors using a conventional mortgage with a due-on clause,<sup>46</sup> can prevent risk alteration, such as a reduction of the loan-to-

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41. From a pure monitoring perspective, perhaps the most efficient security device for creditors is physical receipt and control of the asset; in other words, creditors literally hold the security hostage. See W. WALSH, A TREATISE ON MORTGAGES § 1, at 1 (1934). However, this arrangement is often impractical. If the asset that serves as security, such as equipment or inventory, must be used by the debtor in his business, giving the creditor possession of the asset as security defeats the purpose of the loan. See A. SCHWARTZ & R. SCOTT, *supra* note 17, at 716-17. In almost all conceivable commercial arrangements, delivering assets to the secured creditor to be held hostage as security for the debt will be impracticable, if not impossible. *Id.* In addition, certain assets that may be used to secure the debt, like land or the goodwill of the business, may be incapable of reduction to corporeal possession by the creditor. *Id.*

42. In rare circumstances involving waterfront land, through the use of the property doctrines of accretion and avulsion, such property's boundaries can be affected, resulting in a larger or smaller parcel of property. See J. DUKEMINIER & J. KRIER, PROPERTY 564 (2d ed. 1988). But even this rare and limited change in the nature of the security should not be characterized as moving the real property, or at least not voluntary movement controlled by the debtor.

43. Levmore, *supra* note 5, at 51-52. Conversion occurs when people involved in management of a firm take company assets and use them for their own benefit. *Id.* at 52. Risk alteration occurs when debtors switch to riskier business strategies after the loans are finalized. *Id.*

44. For a discussion of the land title recording system, see J. DUKEMINIER & J. KRIER, *supra* note 42, at 690-96.

45. *Id.* at 589-601.

46. A due-on-sale clause, or more appropriately a due-on clause (because it includes a due-on-encumbrance as well as a due-on-sale clause), "is a device commonly used in real property security transactions to provide, at the option of the lender, for acceleration of the maturity of the loan upon the sale, alienation or further encumbering of the real property security." Wel-



value ratio<sup>47</sup> or the equity-to-value ratio<sup>48</sup> on the premises. Thus, it is extremely unlikely that a debtor will be able to switch to a riskier business strategy that will impact the value of the security interest.<sup>49</sup> Real property, therefore, provides a security interest that requires little, if any, monitoring, yet grants the secured creditor all the advantages that the most active and efficient monitoring can provide. These advantages enable the creditor to charge a lower interest rate on the debt.

A creditor cannot achieve comparable advantages with a perfected security interest<sup>50</sup> in the debtor's accounts receivables. This is true even though the creditor can record its perfected security interest giving notice to the world of its interest and, as a result, prevent a subsequent purchaser of the secured account receivables from acquiring bona fide purchaser status.<sup>51</sup> The primary advantage of acquiring a perfected security interest in real property secured debt is the static nature of the underlying security which acts to stabilize the value of the security interest. With personal property secured debt, a subsequent purchaser may not be interested in acquiring the benefits of a bona fide purchaser and may acquire the secured assets notwithstanding the perfected and re-

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lenkamp v. Bank of Am., 21 Cal. 3d 943, 946 n.1, 582 P.2d 970, 971 n.1, 148 Cal. Rptr. 379, 380 n.1 (1978); see also G. NELSON & D. WHITMAN, *supra* note 31, § 5.21 (discussing due-on-sale clauses).

47. Loan-to-value is the percentage which expresses the amount of the loan when compared to the appraised or accepted value of the property. See BLACK'S LAW DICTIONARY 845 (5th ed. 1979). Thus, if a conventional mortgage of \$75,000 is made on property appraised at \$100,000, the loan-to-value ratio is 75%.

48. Equity-to-value ratio is the flip side of the loan-to-value ratio; it is merely one way to express the debtor's equity in the premises as a percentage of the appraised or agreed upon value of the mortgaged premises. See BLACK'S LAW DICTIONARY 484 (5th ed. 1979). Thus, if the total amount of the debt secured by mortgages on property appraised at \$100,000 is \$75,000, the equity-to-value ratio is 25%.

49. It is possible that some business debtors will take firm-specific risks with the property that potentially have the effect of reducing the real property's value. This might occur if the debtor is allowed to use the borrowed assets to alter its business in a manner which has potential for increasing the value of the property only if that particular debtor remains in business or is successful. If the assets are used for reasons that are indigenous and unique to the debtor, the value of the real property security may not be increased and may, in fact, decline. The creditor can, however, control his firm-specific risk by drafting certain clauses in the mortgage or by using a method of disbursement similar to that used in construction contracts. See G. OSBORNE, G. NELSON & D. WHITMAN, REAL ESTATE FINANCE LAW § 12.10 (1979). Moreover, a loan which has no positive impact on the value of the secured premises is, from a risk perspective, more like a personal property security interest than a conventional real property security interest. See *infra* notes 80-81 and accompanying text.

50. A security interest is perfected when it has attached and all the steps required for perfection have been taken. U.C.C. § 9-303 (1989); see also §§ 9-302, 9-304, 9-305, 9-306 (steps required for perfection).

51. Bona fide purchaser status is limited to persons who purchase for value, in good faith, and without notice of any adverse claim. *Id.* § 8-302.

corded security interest. When the debtor and subsequent purchaser deal in such illegal transactions, the value of the security interest becomes *de minimis* if it cannot be located. A personal property security interest cannot be located if the person who acquired the property has moved it and the debtor either cannot or will not reveal the identity or location of the assets.

2. Additional advantages of real property secured debt as contrasted with other financing devices

If available, creditors may prefer to secure the debt with real property irrespective of the monitoring advantages or the type of activity being financed. For example, assume that the creditor extends debt for the purchase of personal items that in no way improve the value of the realty.<sup>52</sup> The creditor can choose from a number of financing options. First, the creditor can remain unsecured. Clearly this is an untenable position in the world of secured credit because a subsequent creditor, or an earlier creditor using a floating lien<sup>53</sup> may take a security interest in the debtor's assets, including the assets purchased with funds provided by the unsecured creditor. In the event of debtor insolvency, the secured creditors would have priority over the unsecured creditor. Thus, the creditor should take a security interest in the personal or real property of the debtor.

Assuming the availability of real property secured debt, the following section examines and compares various financing arrangements to determine whether real property secured debt is a viable substitute for personal property secured debt.<sup>54</sup>

a. a real property security interest versus a purchase money security interest

One way in which the creditor can secure the debt is by taking a purchase money security interest<sup>55</sup> in personal property. The creditor can obtain a security interest in the assets being purchased and can attempt to perfect a purchase money security interest in those assets.<sup>56</sup> In so doing, the creditor obtains an interest in the assets superior to any

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52. For a discussion of real property loans that increase the value of the property to reflect the capitalization provided by the loan, see *infra* notes 79-81 and accompanying text.

53. See *supra* note 22.

54. If the creditor has enough leverage to obtain a real property secured debt, it is assumed that the creditor will be able to extract a security interest in the debtor's personal property assets.

55. See U.C.C. § 9-107.

56. See *id.* § 9-312(3), (4).

other lienor,<sup>57</sup> including a lienor who has the benefit of a floating lien.<sup>58</sup>

Secured creditors collateralize the loans they make in order to obtain a psychological and actual advantage over the debtor (leverage)<sup>59</sup> and to ensure that the debtor does not engage in misbehavior (monitoring).<sup>60</sup> However, both the monitoring role served by secured credit and the psychological advantage achieved by the creditor over the debtor would be greatly enhanced by the use of a real property security interest. By taking an interest in their debtors' equity in real property, creditors increase their negotiating position vis-a-vis their debtors.<sup>61</sup> Similarly, by using a conventional mortgage, creditors can ensure that debtors will not engage in any subsequent real property financing that could potentially jeopardize the value of their security interest.<sup>62</sup> In addition, the monitoring function most creditors perform would be increased by supervision of the debtors' real property. Hence, shrewd creditors should be interested in obtaining a real property security interest in their debtors' property in order to maintain greater monitoring presence over the relevant activities of the debtors.

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57. *See id.* § 9-312(3), (5).

58. The traditional rationale for the grant of this "super-priority" status to a lienor who perfects a purchase money security interest in personal property, is that the purchase money creditor brings new money into a faltering business. *See Scott, supra* note 5, at 961-64. Professor Scott illustrates that this rationale may not be correct in light of relational financing theory. *See id.* Scott argues that there are two reasons why the Uniform Commercial Code may grant this super-priority status to the purchase money creditor: First, due to the innate conservatism of an original creditor holding a floating lien and the fixed rate of return it receives on the investment, the original creditor has no incentive to finance new and risky ventures. *Id.* at 962-63. Purchase money financing offers an "escape hatch" to the debtor to finance prospects that may have a positive value to the firm without negatively impacting the original creditor's security interest in preexisting secured assets. Second, the purchase money creditor brings his unique and complementary skills to the venture, which benefits all concerned parties. *Id.* at 963-64. Theoretically, the general financier secured by the floating lien would agree *ex ante* to subordinate his interest to bring the purchase money creditor's unique skills to the venture. *Id.* Presumably, the parties are unable to reach this agreement *ex post* due to strategic bargaining (bluffing) so the Uniform Commercial Code provides the parties with the efficient mechanism of trumping. *Id.*

59. Scott, *supra* note 5, at 945.

60. *Id.* at 946-47.

61. The creditor's leverage increases because the debtor presumably has more equity in the real property which secures the debt than in the personal property which would otherwise secure the debt. Thus, the debtor has more incentive to comply with the terms of the financing agreement.

62. Most personal property secured creditors, by failing to insure that the debtor will not engage in a subsequent real estate secured financing venture with another creditor, imperil perhaps the most valuable asset owned by the debtor—the land.

b. *a real property security interest versus an Article 9 floating lien*

A creditor considering extending credit to a debtor who has no significant preexisting secured debts has the option of seeking a floating lien.<sup>63</sup> An Article 9 floating lien permits the creditor to take a security interest in all of the debtor's currently held or after-acquired assets.<sup>64</sup> A floating lien, however, establishes a complex and costly arrangement between the debtor and the creditor.

From the debtor's perspective, the primary disadvantage of an Article 9 floating lien is the loss of control. By granting a creditor a floating lien, the debtor grants the creditor exclusive control over the financing of the debtor's business venture.<sup>65</sup> More fundamentally, however, the debtor gives up a certain degree of control over basic business decisions by granting a creditor a floating lien. A floating lien permits the creditor to in effect hold the debtor's assets hostage. This gives the creditor the power to force its business judgment on the debtor.<sup>66</sup>

Similarly, the floating lien has many disadvantages for the creditor. For example, many creditors lack the expertise or desire to engage in relational financing. More importantly, many creditors may not wish to engage in operational control over the debtor's business operation<sup>67</sup> because of the possibility of legal liabilities that such a creditor may incur.<sup>68</sup> For example, legal liability may be incurred under federal bankruptcy law, securities law and under common law tort theories.<sup>69</sup> Thus, Article 9 floating liens are only effective and efficient in those situations involving long-term financing arrangements requiring the creditor to maintain exclusive control of the debtor's business in order to optimally finance

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63. See Coogan, *supra* note 22, at 839-50.

64. See U.C.C. § 9-204(1).

65. Scott, *supra* note 5, at 956-57.

66. Professor Scott illustrates this point:

By taking an interest that wraps around the debtor's business, the [creditor] gains important influence over the debtor's strategic planning and operational decision making. The creditor's power comes from the ability to veto any proposed actions by withdrawing either financing or assets from the enterprise. A floating lien . . . gives the creditor the power both to seize the debtor's assets . . . and to terminate the financing necessary for the operation of the business. This power to "turn off the spigot" permits quick, decisive responses to the threat of disfavored behavior. As with any lever, the power to prevent a disfavored action generates the power to compel a second, desired action.

*Id.* at 926-27.

67. Although the holder of a floating lien may not wish to engage in operational control of the debtor's business, it must do so to protect its security interest. The creditor must monitor the debtor's day-to-day business operations to ensure that the assets, for example accounts receivables, are sufficient to cover the debt.

68. Scott, *supra* note 5, at 934.

69. *Id.*

growth opportunities.<sup>70</sup>

A loan secured by real property avoids the disadvantages of the floating lien. From the debtor's perspective, real property secured debt is more advantageous because the creditor is interested in the value of the land, rather than the debtor's business. Thus, the creditor is less likely to become involved in the debtor's business.<sup>71</sup>

A real property security interest is also more advantageous from the creditor's perspective. As long as the creditor engages in the typical mortgage transaction—real property secured debt—the creditor exhibits no control over the operation of the debtor's business. Therefore, the debtor and the creditor would not be in a joint venture relationship, and the creditor would run little risk of being characterized as an insider and exposing itself to the ensuing potential liabilities.<sup>72</sup>

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70. Advantages exist for a small firm that engages in relational financing. Professor Scott uses the following hypothetical to illustrate that certain relational secured financing devices provide the optimal method to finance growth prospects in a small firm: Dunning Cabinet Company, a company that manufactures television cabinets, needs \$500,000 to finance a new addition to the company's single-story plant in order to double its production capacity. The proposed expansion by Dunning Cabinet Company is defined as "a firm specific opportunity"; that is, if the opportunity is not developed the firm cannot "sell" any rights in the prospect to third parties. Yet the firm can, in effect, sell the development rights to prospective lenders. Scott, *supra* note 5, at 917.

In the relational model it is more advantageous for the debtor to grant exclusive control over financing the investment to one single creditor for the optimal development of the growth opportunity. *Id.* at 918. In exchange for financing the growth opportunity, the creditor receives a premium above the competitive rate of return on all loans committed to the project. *Id.* The debtor company agrees to pay this premium in exchange for the financier's exclusive financial management "and other inputs necessary for optimal development of the prospect." *Id.* As a result of this relational arrangement, both parties act as though they own all of the property rights in the venture. *Id.* By utilizing an Article 9 floating lien to secure the bank's debt, see U.C.C. § 9-204, the debtor and the creditor have entered into a relational contract that maximizes the potential for optimal development of any potential growth opportunity. Scott, *supra* note 5, at 919.

71. This is logical because the value of the creditor's security interest lies in the value of the land, not in the value of the business. Consequently, the creditor has no interest in the financial success of the business and, therefore, has little incentive to provide financial or other managerial assistance. However, the debtor would lose the benefit of the creditor's expertise.

72. For a discussion of situations in which the mortgagee has exceeded the boundaries of a normal mortgagor-mortgagee relationship and is deemed to be involved in something akin to a joint venture relationship with the mortgagor, see *Connor v. Great W. Sav. & Loan Ass'n*, 69 Cal. 2d 850, 447 P.2d 609, 73 Cal. Rptr. 369 (1968) (lender intimately involved in every stage of development of construction project of residential dwellings held to be "active participant" in project and, as a result, liable to plaintiff-home buyers for defects in construction of dwellings). *But see* CAL. CIV. CODE § 3434 (West 1970) (limiting *Connor's* applicability to certain defined activity); *cf.* *Rice v. First Fed. Sav. & Loan Ass'n of Lake County*, 207 So. 2d 22 (Fla. Dist. Ct. App. 1968) (rejecting plaintiff's claim that construction lender had implied contractual duty to inspect premises on behalf of plaintiff because lender charged a fee to plaintiff for "inspection and supervision"). See generally Gutierrez, *Liability of a Construction Lender*

Even a relational creditor who already holds a floating lien on the debtor's assets should establish a security interest in the debtor's realty. The relational creditor desires exclusive control over the debtor and seeks to monitor the debtor's activities in order to thwart debtor misbehavior.<sup>73</sup> By holding both the debtor's real property and the personal property hostage, the relational creditor can maintain exclusive control over the debtor's business.

*c. a final advantage of real property secured debt*

Finally, the most persuasive argument that the real property security interest represents an optimal form of security in certain situations is the fact that even after it has been created, it has no detrimental impact on the creation of a relational secured financing device. If a relational contract is desired for later financing opportunities, the floating lien and other devices are still available to the exclusive financier. This raises the issue of whether the financier is exclusive if a conventional real estate mortgage on land already exists. The answer is yes, as long as exclusivity is measured by the type of security interest created. The creditor can still achieve exclusivity over the *personal property* of the debtor through the use of the floating lien or some other appropriate vehicle.<sup>74</sup> Although exclusivity is unavailable with real property security financing, it is also unnecessary because of the unique nature of real estate and the devices the secured mortgagee of real property can utilize to ensure exclusivity with respect to the real property security interest.<sup>75</sup>

*B. Real Property Secured Debt Impacts the Financing Arrangements Analysis*

In an optimal setting, both debtor and creditor prefer real property secured debt to personal property secured debt, and it is the unavailability of this alternative that compels the parties to engage in a relational financing device. In other words, only when real property secured debt is

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*Under Civil Code § 3434: An Amorphous Epitaph to Connor v. Great Western Savings & Loan Ass'n*, 8 PAC. L.J. 1 (1977) (analyzing *Connor*, the legislative response of passing § 3434, and subsequent case law).

73. Scott, *supra* note 5, at 916-17.

74. Of course, this exclusivity is subject to a limited number of exceptions including purchase money security interests. U.C.C. § 9-312(3), (4).

75. By using a conventional mortgage, mortgagees can ensure that they maintain their priority not only as the first mortgagees but as the only mortgagees through the utilization of due-on clauses which allow mortgagees to accelerate the debt if a mortgagor places a subsequent mortgage on the premises without the consent of the original mortgagee. For a discussion of due-on clauses, see *supra* notes 46-49 and accompanying text.

considered and rejected will the parties turn to such devices as the floating lien.

To test this theory, consider Professor Scott's hypothetical: Dunning Cabinet Company, a company that manufactures television cabinets, needs \$500,000 to finance a new addition to the company's single-story plant in order to double its production capacity.<sup>76</sup> There are three situations in which it may be inappropriate for the creditor to take a real property security interest. The first situation exists when the debtor owns no land by which to secure the debt. This situation is highly unlikely given the nature of most small businesses. A manufacturing company like Dunning Cabinet Company presumably owns the land on which the cabinets are manufactured.<sup>77</sup> If the debtor owns no land, clearly the use of a real property security interest is inappropriate. Moreover, securing a \$500,000 line of credit with a floating lien is inadvisable because the manufacturer has no permanent base of operations.<sup>78</sup>

More than likely, the problem will not be that the debtor owns no real estate, but that the debtor does not own enough real property to support the amount of debt needed to expand the premises. This objection, however, also seems somewhat chimerical. Even if the land is worth a nominal amount prior to constructing the expansion—for example, \$10,000—that fact is irrelevant to the mortgagee because, theoretically, there should be a dollar-for-dollar increase in the value of the premises once the addition to the plant is built. It would be a very poor investment indeed, and one that should not be made, if the value of the premises after \$500,000 is poured into the improvements is less than \$510,000.<sup>79</sup>

The second situation in which it may be inappropriate to take a real

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76. See *supra* note 70.

77. However, there are situations where it may be advantageous to a company like Dunning to use a functional equivalent like a long-term lease. For a discussion of long-term leases and their functional equivalency to mortgages, see Johnson, *Correctly Interpreting Long-Term Leases Pursuant to Modern Contract Law: Toward a Theory of Relational Leases*, 74 VA. L. REV. 751, 774-77 (1988).

78. If a long-term lease is used by the debtor, a mortgage can be executed on that interest as well. See G. NELSON & D. WHITMAN, *supra* note 31, §§ 15.12-.13. Hence, if a mortgage is unavailable, it is presumably due to the fact that the debtor has no mortgageable assets in real estate.

79. The term "value" is used loosely in this context. This is not to say that the value of the land and the improvement itself should total in all instances \$510,000 or more. The future stream of potential income represented by the good will of the business has some positive impact on the value of the premises. But is that goodwill severable from the asset itself? Even though this is a firm specific asset, the asset itself, the firm, may be sold or captured by the creditor in the event of default. For a discussion of the rights of the mortgagee in the event of default, see J. DUKEMINIER & J. KRIER, *supra* note 42, at 590-99.

property security interest is where the manufactured product has a value or an identity which is tied to one individual's unique skill or reputation.<sup>80</sup> That, however, should have no impact on the value of the factory which is being financed with the proceeds of the debt. Presumably, the factory will be worth \$510,000 to some manufacturer. If, for some reason, the value of the endeavor is tied to other intangible assets, such as the intelligence or skill of the individual, then no amount of security may be adequate to totally protect the creditor.<sup>81</sup> In this type of situation, the creditor is relying on the individual efforts of the debtor, like a painter using his best efforts to produce a masterpiece, and is engaging in a true relational contract.

The third situation occurs when the property is already secured by a creditor who is in a priority position and unwilling to relinquish that position. In many situations, an earlier creditor may have forced a new and struggling business to execute a mortgage to purchase the premises. The first mortgagee, whose funds typically provide the majority of the purchase price for the property, may be unwilling to relinquish that lofty appellation. Nevertheless, for the same reasons that the creditor is willing to make a \$500,000 loan on property worth \$10,000, the first mortgagee should be willing to subordinate his interest to the new loan of \$500,000.<sup>82</sup> In a world with no transaction costs and perfect information, theoretically, the development of the property should cause the value of the property to increase, and the first mortgagee's security as a second mortgagee should be worth more as a result.<sup>83</sup> Therefore, a pre-existing mortgage which has priority should not impede the use of real

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80. For example, the products of a famous fashion designer are worth more because of the identification with that designer's name or style. See *E.T.F. Enterprises, Inc. v. Nina Ricci, S.A.R.L.* 523 F. Supp. 1147 (S.D.N.Y. 1981); *Wood v. Duff-Gordon*, 222 N.Y. 643, 118 N.E. 214 (1917).

81. All endeavors, to some degree, are based on the acumen and skill of the parties involved. However, it is important to distinguish the skills that are easily transferable and for which there is a market from those that are not easily transferable and for which there is no market. It may be difficult, if not impossible, to predict a designer's future designs in advance notwithstanding the number and value of security interests used to secure the creditor's position. If a designer refuses to develop new designs, the creditor will lose its investment.

82. Subordination occurs when a secured creditor expressly agrees to subordinate its interest in the security, which is given priority because it was recorded earlier in time, to an inferior interest for the purpose of giving to the later recorded security interest priority with respect to that security interest. Subordination agreements are frequently used with construction loans and other loans by which real property is developed. See *G. OSBORNE, G. NELSON & D. WHITMAN*, *supra* note 49, § 12.9.

83. While this type of subordination agreement is commonly used, the theoretical increase in the value of the security does not always provide sufficient protection to the subordinated mortgagee. The insufficient protection is caused by this country's inadequate foreclosure system. *Id.* § 7.21.



property secured debt because the mortgagee should consent to the subordination of the mortgage.

In light of the above, what stops *any* creditor, relational or otherwise, from taking security in the debtor's real property assets? The advantages seem to outweigh any negative transaction costs associated with documenting the mortgage.<sup>84</sup> The problem is generally that there is a preexisting mortgage when the debtor requests the later creditor to extend funds to the business, and we do not live in a perfect world of no or even low transaction costs with access to perfect information. The preexisting mortgagee has a priority with respect to the security interest<sup>85</sup> that the mortgagee is not going to relinquish easily. The first mortgagee will likely have a provision in the mortgage prohibiting the debtor from placing a subsequent mortgage on the premises without the permission of the first mortgagee.<sup>86</sup> That permission may be costly. The prior mortgagee may engage in strategic bluffing to extract an exorbitant fee to subordinate its interest to a subsequent creditor.<sup>87</sup>

More importantly, although the use of a second mortgage should increase the value of the property in excess of the amount of secured debt, the debtor must demonstrate the value increase in order to obtain the first mortgagee's assent to the use of a junior security interest. The only realistic way in which the initial mortgagee can ensure the safety of its investment is by monitoring the investment of the junior lienor. If the senior or first mortgagee is forced to monitor the later investment to protect his earlier investment, he loses the "monitoring advantages" gained by using a mortgage. The absence of the use of real property secured debt indicates that the real property is unattainable as a security interest. The most logical explanation for it being unattainable is that a real property security interest is already held by some other advantageous creditor. Thus, in certain situations, the creditor may be unable to get a security interest in the debtor's real property.

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84. The mortgage is a rather standard transaction requiring no significant transaction costs. See White, *Efficiency Justifications for Personal Property Security*, 37 VAND. L. REV. 473, 490 (1984) (costs of standardized security clauses in loan agreements are *de minimis*). The form or off-the-rack provisions can be used by almost all parties. The ease and low cost by which one can place a mortgage on another's real property supports the notion that such devices, in the absence of other factors, should be used more often by creditors.

85. This is assuming that the preexisting mortgagee recorded its security interest. See J. DUKEMINIER & J. KRIER, *supra* note 42, at 705-08.

86. See *supra* note 46 and accompanying text.

87. The incremental value of the security provided by a second mortgage may be less than the cost incurred by the creditor in attempting to obtain the agreement of the first mortgagee either to consent to the placement of a second mortgage on the property or to subordinate the first to a second position.

In sum, the only situation in which a creditor would not take a real property security interest is when that opportunity is unavailable. Thus, the fact that mortgages are not used by secured creditors to finance the expansion of the debtor's business does not indicate that real property secured debt plays no role in solving the financing puzzle. Rather, real property security interests have a tremendous impact and influence on the way personal property secured debt is structured because the presence of the secured real property creditor motivates totally, or in part, the subsequent personal property creditor to obtain an exclusive financing arrangement with respect to the debtor's personal property.

In situations where real property secured debt is unavailable because a real property security interest is held by another creditor, the financing creditor should obtain an exclusive financing arrangement not only to control the actions of the debtor,<sup>88</sup> but also to protect itself from the real property secured creditor. If financing the creditor fails to protect its interest in other assets of the debtor, it has allowed those assets to remain subject to the prior control of the real property secured creditor in the event of the debtor's default. Often overlooked in discussions of the real property secured creditor's rights upon foreclosure is the fact that the creditor has two methods of collecting the debt which the real property secures. The real property secured creditor may foreclose upon the real property.<sup>89</sup> Alternatively, the real property secured creditor, like any other creditor, may sue and get a judgment at law on the obligation and enforce this judgment by levy upon any property, including personalty, owned by the debtor.<sup>90</sup> More importantly, in most jurisdictions, the creditor may pursue these remedies consecutively or concurrently.<sup>91</sup>

To protect its position, the financing creditor must protect itself from the real property secured creditor's security interest, which in the event of the debtor's default, has the potential of absorbing the personal assets of the debtor to the detriment of the financing creditor. If a subsequent creditor does not take any security, the real property secured creditor may be the largest unsecured creditor at the time of a debtor's default or bankruptcy and, as a result, is entitled to the majority of the debtor's unsecured assets.<sup>92</sup>

This raises the interesting question of why the first creditor, the real

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88. See *supra* notes 39-51 and accompanying text.

89. See G. NELSON & D. WHITMAN, *supra* note 31, § 8.1.

90. See *id.*

91. See *id.*

92. As the creditor to whom the largest amount is owed, the real property creditor will be entitled to unsecured assets proportionate to his claim.

property secured creditor, would allow the debtor the freedom to pledge other assets to subsequent creditors. Would the wise creditor obtain the real property security interest and a floating lien on the personal assets? It likely has something to do with cost and the role that monitoring plays in secured transactions.<sup>93</sup> By holding the debtor's real property as security, with all the attendant monitoring advantages that accrue,<sup>94</sup> it may be inefficient for the creditor to engage in monitoring the debtor's subsequently acquired personal property assets.<sup>95</sup> In addition, it may not be cost-effective given the possibility of purchase money security interests which trump the prior security interest of the real property secured creditor.<sup>96</sup> Finally, the cost of obtaining the security interest in personal property assets may outweigh any benefits. The real property security interest, along with the creditor's right to stand in line as an unsecured creditor with respect to the debtor's personal property, may be enough security to satisfy even the most risk-averse creditor.

Thus, one piece of the secured debt puzzle may, in large part, be reactive. Personal property secured debt may exist to counteract real property secured debt. The conventional mortgage, by which the creditor takes a security interest in the land purchased by the debtor, is ingrained in our society.<sup>97</sup> As a reaction to this scenario, subsequent creditors protect their positions by taking security in other assets of the debtor.

Perhaps it is only when real property secured debt is eliminated that other forms of secured financing, including personal property secured debt, likewise will be eliminated. In examining the present secured debt puzzle, however, the puzzle must be expanded to include real property secured debt. Without considering real property secured debt, the puzzle is incomplete and impossible to solve.

#### IV. REAL ESTATE FINANCING ILLUMINATES THE BENEFITS OF ALL SECURITY INTERESTS

##### A. *The Social and Economic Costs of Security*

Scholars researching the role and function of secured debt make much of the fact that the creation of a security interest, real or personal,

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93. See *supra* notes 39-51 and accompanying text for a discussion of the role monitoring plays in secured transactions.

94. See *supra* notes 39-51 and accompanying text.

95. See *supra* notes 39-51 and accompanying text.

96. The purchase money security interest has priority over the prior-in-time floating lien. See U.C.C. § 9-312(3), (4).

97. See G. NELSON & D. WHITMAN, *supra* note 31, § 1.1.

is not costless. Although there is some dispute regarding whether that cost is *de minimis*,<sup>98</sup> there is unanimity that creating a security interest imposes some cost on the debtor.<sup>99</sup> The cost of security, coupled with the conclusion that secured credit is a zero-sum game<sup>100</sup> have led some analysts to conclude that “[s]ince setting up security arrangements is costly, the debtor’s total credit bill—consisting of *both* secured and unsecured credit charges—may be greater under a regime of secured credit than in a world where security is prohibited.”<sup>101</sup> In other words, is a system disallowing secured debt that would require that all creditors share pro rata in the debtor’s assets in the event of insolvency better than one in which secured and unsecured debt are allowed to exist simultaneously?<sup>102</sup>

This question has led to a plethora of articles analyzing the role of secured credit and the law’s preference for secured debt within and without bankruptcy.<sup>103</sup> Thus, conventional efficiency theorists explained that high risk debtors grant creditors security because it increased the amount of debt available to them at lower interest rates than would otherwise be available. Creditors took security because it enabled them to issue credit while minimizing their risks.<sup>104</sup>

Professor Schwartz exposed a flaw in the conventional efficiency theory. Professor Schwartz argued that secured debt was actually a zero-sum game by which the costs incurred by unsecured creditors offset the benefits which accrued to secured creditors.<sup>105</sup> Similarly, Professor Schwartz argued that the higher interest rates debtors had to pay for their unsecured debt<sup>106</sup> offset the savings debtors realized from the lower secured debt interest rates.<sup>107</sup> Professor Scott expanded on Professor Schwartz’ zero-sum hypothesis by noting that debtors’ total credit bill could actually increase in a secured debt system due to the transaction

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98. White, *supra* note 84, at 489-91.

99. Schwartz, *supra* note 5, at 7.

100. Gains to those creditors who accept security are created only by inflicting losses on those creditors who do not take security. *Id.* at 10-11, 18-21 (monitoring costs and security interests are inversely related).

101. Scott, *supra* note 5, at 902.

102. Jackson & Kronman, *supra* note 1, at 1147.

103. *See supra* note 5.

104. *See, e.g.,* J. VAN HORNE, *supra* note 12, at 536.

105. Schwartz, *supra* note 5, at 7-11, 18-21.

106. Unsecured creditors charge higher rates not only to compensate for the risks of debtor default, but also to compensate for the inferior positions in bankruptcy of unsecured creditors vis-a-vis secured creditors. Schwartz, *supra* note 5, at 7.

107. Schwartz, *supra* note 5, at 7-11, 18-21.

costs of creating security interests.<sup>108</sup>

These conclusions led monitorists<sup>109</sup> and relationalists<sup>110</sup> to attempt to alter the sum of the zero-sum game by introducing a previously ignored piece of the puzzle.<sup>111</sup> These theorists attempted to demonstrate that security and secured debt were efficient because they provided a benefit that outweighed the costs of establishing a security interest.<sup>112</sup>

Prior attempts to justify secured debt in light of Schwartz' conclusions may have been too narrow. By focusing on the costs of credit and the alleged offsetting benefits created in the debtor-creditor relationship,<sup>113</sup> analysts have failed to consider the exogenous benefits gained by secured credit arrangements. These benefits, to a limited degree, explain the puzzle of secured debt.

### B. Exogenous Benefits Created by Secured Debt

By limiting their analyses to the debtor-creditor relationships, scholars have lost sight of important facts that may explain, in part, the function of secured debt. Creditors and debtors take many shapes and forms. The creditor may be one individual or may represent a corporation or a joint venture.<sup>114</sup> Analysts have ignored the different types of creditors or, more accurately, the composition of the creditor and how that composition impacts the role of secured debt.

The composition of the creditor is important because of the transaction costs involved in imparting information to large numbers of the creditor's investors. Secured debt is efficient because it serves as a vehicle to impart information while minimizing transaction costs.<sup>115</sup> Examining the identity of the debtor and the identity of the creditor, as opposed to treating the debtor-creditor relationship as uniform and stagnant, is beneficial in resolving the secured debt puzzle.<sup>116</sup>

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108. Scott, *supra* note 5, at 902. *But see* White, *supra* note 84, at 489-91 (arguing that the cost of creating security interest was *de minimis* in many cases).

109. *See supra* notes 19-20 and accompanying text.

110. *See supra* notes 21-25 and accompanying text.

111. *See, e.g.*, Jackson & Kronman, *supra* note 1 (monitorist theory); Scott, *supra* note 5 (relationalist theory).

112. *See supra* notes 19-25 and accompanying text. Whether these efforts have been successful is the subject of some dispute and is beyond the scope of this Article.

113. *See supra* notes 19-25 and accompanying text.

114. *See* Goldstein, *Loan Structures and Third Party Problems*, in *ASSET-BASED LENDING INCLUDING COMMERCIAL FINANCE AND ACQUISITION FINANCING* 333, 335-57 (Practicing Law Institute Commercial Law & Practice Course Handbook No. 483, 1989).

115. *See infra* notes 130-34 and accompanying text.

116. Schwartz, *The Continuing Puzzle of Secured Debt*, 37 *VAND. L. REV.* 1051, 1067-68 (1984).

The identity of the creditor may partially determine whether security is needed and efficient given the signaling role that security may play.<sup>117</sup> As the increasing securitization of real property security interests proves, security serves as an important and efficient vehicle for pooling assets and reducing transaction costs in certain commonplace situations. Certainly there are short-term costs to the creation of security interests, but are these costs not outweighed by the long-term benefits?

Consider the Dunning Cabinet Company hypothetical<sup>118</sup> to illustrate the efficiency of secured real property debt and the importance of the composition of the creditor. Assume Dunning needs \$500,000 to expand its plant in order to increase its production of television cabinets. Further, assume an economic system that prohibits the use of security interests. In this system, Dunning should prefer to obtain the entire amount of its present financing needs from one creditor because the transaction costs incurred by dealing with one creditor are less than those incurred by dealing with several creditors.<sup>119</sup> If that individual creditor has \$500,000 and is willing to lend it to Dunning, Dunning will be satisfied. If the credit extended is owned in full by the creditor, the creditor can evaluate the risk adequately to protect its interest. If, however, a percentage of the creditor's investment were owned by someone else, problems would arise and transaction costs would increase. If we assume that the \$500,000 to be extended to Dunning represented five equal shares of \$100,000, five separate approvals would be needed before the transaction could be completed.

First, the lead creditor,<sup>120</sup> acting as broker, would have to deal with Dunning and learn enough about Dunning's business venture to determine whether Dunning and the venture were worth the risk of extending credit. Second, the lead creditor or the debtor would have to convince each investor of the credit-worthiness of the arrangement. In a "no security" system, the only way to assure investors of the safety of their investment would be to explain fully to each investor Dunning's history and its present proposed venture.<sup>121</sup> The transaction costs involved in

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117. For a discussion of signaling, see Schwartz, *supra* note 5, at 14-21.

118. See *supra* note 70.

119. In addition, Professor Scott illustrates that Dunning, in certain situations, should try to provide not only for its current needs, but also for its future needs through relational financing. See Scott, *supra* note 5, at 928.

120. This assumes some mechanism by which one creditor emerges as the lead creditor. In the absence of such a mechanism, the creditors would have no incentive to pool their assets because they would all have to act as individual lead creditors and transaction costs would increase.

121. The more discretion each investor grants the lead creditor to make decisions to invest funds unilaterally in speculative ventures, the more risk the individual investor takes with

such an effort would be substantial.

Obtaining adequate security would resolve these coordination problems and reduce transaction costs. Security, such as secured real property, serves as a signal, not only to creditors but also to investors of the creditors, of the credit-worthiness of the debtor and the safety of the investment.<sup>122</sup> Thus, by using security, investors gain the ability to pool their resources efficiently.<sup>123</sup> Security solves some of the problems created in the real world by reducing externalities, solving imperfections in information, and resolving coordination problems.<sup>124</sup> This is achieved because security, such as secured real property, serves as a signaling device, not only to creditors, but also to investors of lead creditor.

The fact that security serves as a signal is not new. In his seminal article which motivated many to attempt to unravel the secured debt puzzle, Professor Schwartz noted that one explanation for the existence of security is the so-called signaling function by which the debtor signals the creditor that the debtor is a worthwhile risk.<sup>125</sup> The signaling theory has been attacked, however, as being counter-intuitive<sup>126</sup>—once creditors possess all information necessary to convince them of the worth of the security, they no longer need the security to convince them of the credit-worthiness of the debtor.<sup>127</sup>

Traditional signaling theory is counter-intuitive because it misidentifies the recipient of the signal. By focusing instead on the investors of the lead creditor as the recipients of the signal, coordination, information

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respect to the security of the investment. While economic efficiency can be gained by relying on the expertise of the lead creditor, problems arise in determining how to verify the lead creditor's expertise. One way to establish the expertise of the lead creditor would be to focus on past successes. Competition among lead creditors should weed out poor and inept lead creditors and reward efficient lead creditors. This theory, however, would require that all investors have access to all relevant information about the lead creditor in a timely fashion. This theory would not sufficiently account for information imperfections, coordination problems or other costly externalities.

For a discussion of efficiency rationales for inalienability rules based on market failures that arise because of the presence of externalities, imperfections in information or problems of coordination (along with definitions of these terms) see Rose-Ackerman, *Inalienability and the Theory of Property Rights*, 85 COLUM. L. REV. 931, 938, 942, 950 (1985).

122. See *infra* notes 130-34 and accompanying text.

123. See *infra* notes 130-34 and accompanying text.

124. For a further discussion of the difficulties caused by externalities, imperfections in information and coordination problems, see Rose-Ackerman, *supra* note 121.

125. Schwartz, *supra* note 5, at 14.

126. White, *supra* note 84, at 477.

127. *Id.* Of course, there are other reasons to take security, such as to hold the debtor's assets hostage to force repayment. See *supra* note 25. Alternatively, security may be taken to monitor the activity of the debtor to ensure that there is no subsequent debtor misbehavior that impacts the investment. See *supra* notes 19-20, 39-51 and accompanying text.

and externality problems are resolved because the lead creditor uses the security not to determine the credit-worthiness of the debtor, but as a signal to inform and placate investors of the lead creditor that their investments are worth the risk. First, the investors of the lead creditor use the signal as an efficient way to ensure that the debtor is worth the risk of the investment.<sup>128</sup> Second, investors of the lead creditor use the security signal as an efficient way to monitor the lead creditor.<sup>129</sup>

1. The efficiency of security as a signal to investors of the credit worthiness of the debtor and the safety of the investment

In determining whether to extend credit, the lead creditor negotiates with the debtor and acquires all relevant information to determine the credit-worthiness of both the debtor and the debtor's proposed venture.<sup>130</sup> If that same information had to be imparted to one hundred investors who also had to be convinced of the credit-worthiness of the debtor, significant transaction costs would be incurred.

In a secured debt system, the lead creditor determines the value of the security and uses the security to signal the investors, who have pooled their assets, regarding the credit worthiness of the venture.<sup>131</sup> To avoid higher transaction costs—the costs incurred by the lead creditor in explaining in great detail the basis for the lead creditor's determination of the credit-worthiness of the debtor—the security interest serves as a short-hand method of signaling the investors of the worth of their investment. By using this signal, creditors avoid coordination problems and their ensuing transaction costs.

Creditors also avoid informational problems by relying on the secured debt signal. If the investors and the lead creditor agree on the nature of the investment and the security to be received *ex ante*, the receipt of the security interest may serve to impart correct and timely information to the investors.<sup>132</sup> Similarly, if each investor must approve the activities of the lead creditor *ex post*, the security may serve as a signal of the credit-worthiness of the debtor, thereby allowing the investors quick and easy access to relevant information about the decision of the lead creditor.

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128. See *infra* notes 130-34 and accompanying text.

129. See *infra* notes 135-44 and accompanying text.

130. D. EPSTEIN, DEBTOR-CREDITOR LAW 82-83 (1985).

131. Goldstein, *supra* note 114, at 342-44.

132. This information ensures that the loan is "safe." Of course, subsequent events may reduce the value of security. Presumably, however, the lead creditor has taken precautions against this.



Hence, security serves as a signaling device to investors of the lead creditor and as an efficacious way of reducing transaction costs by imparting relevant information efficiently to investors of the lead creditor. Through this signaling process, investors with different levels of risk averseness are able to pool their assets and minimize transaction costs for the purpose of making investments that match the level of the risk they are willing to assume. Security serves as a short-hand symbol by which transaction costs are reduced because opportunity-specific information about the credit arrangement does not have to be conveyed from the lead creditor to investors.

To be effective, however, the cost of obtaining and using the signal must not exceed the incremental benefit attributable to the security in its signaling function.<sup>133</sup> Thus, requiring the lead creditor to explain and validate the accuracy or strength of the signal, lessens the value of the signal. Any saving that accrues to the lead creditor by using security as a signal to its investors would be lost if the lead creditor had to explain the worth of the investment. The lead creditor and the investors should agree *ex ante* to the type of security which will be accepted in exchange for the amount of risk to be taken by investors.

*Ex ante* agreement between the lead creditor and the individual investor as to the type of security resolves this problem, particularly if the signal is readily receivable by the investors of the lead creditor. Security that cannot be verified, or that can be verified only by the individual investor's independent investigation may be worth no more than having no signal. If the parties to a transaction have to take action to verify the worth of the security, the cost of obtaining it has increased. This may be why more credit-worthy debtors give more and better security than their less able counterparts. The strength and easy recognition of the signal allows debtors a comparative advantage in the marketplace which they should exploit to obtain cheaper credit.

Thus, even though lead creditors "(i) can learn of and react to the existence of security; (ii) can calculate risks of default reasonably precisely; (iii) are risk-neutral; and (iv) have homogenous expectations respecting default probabilities,"<sup>134</sup> the costs of conveying all of this information to the investors may outweigh the advantages of the signal-

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133. If security serves a risk reduction function, the interest rate of secured debt should be less than the interest rate of unsecured debt. But if there is another function, that fact should also be reflected in the cost of security. There should be some correlation between the strength of the signal and the reduction of the risk. In addition, there should be some correlation between the ease of verification of the strength of the signal and the lower transaction costs that result from the strength of the signal.

134. Schwartz, *supra* note 5, at 7.

ing function of secured debt. By creating secured debt, the lead creditor may be imparting this same information to its investors at a lower cost than actually transmitting the information to the investors of the creditors, thus providing part of the missing link in the secured debt puzzle.

## 2. Security as a Signal Used by Investors To Monitor the Behavior of Lead Creditors

Coordination problems may develop if individual investors are not able to monitor adequately the actions of the lead creditor. In the absence of signaling, investors who would benefit from the coordinated action of pooling their resources, may be dissuaded from doing so because they fear lead creditor misbehavior. Security may be required by investors of the lead creditor and used as a device to monitor and limit the misbehavior on the part of the lead creditor vis-a-vis the investors.<sup>135</sup> The lead creditor occupies a very advantageous position in dealing with the debtor. The investors must rely on the lead creditor's efforts in placing their investment in a beneficial manner given the parameters established by the relationship.<sup>136</sup> That reliance on the lead creditor's efforts could lead to numerous problems given the nature of the relationship.<sup>137</sup>

First, the lead creditor could engage in opportunistic behavior and deprive the investors of an attractive investment opportunity.<sup>138</sup> There

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135. Security's function of monitoring the lead creditor may explain why security is sometimes required of even the most credit-worthy debtors. Thus, while taking a security interest in the assets of a "super-solvent" and well-known debtor may appear inefficient because the investors are virtually assured of repayment; the security fulfills a function quite apart from ensuring repayment—the security serves as a signal to monitor the lead creditor for misbehavior.

136. Goldstein, *supra* note 114, at 338-41.

137. In fact, the lead creditor-investor relationship arguably is a relational contract. As such, there may be a need for security between the parties to that relationship, although it does not rise to the level of a floating lien. See Scott, *supra* note 5, at 919.

138. See Muris, *Opportunistic Behavior and the Law of Contracts*, 65 MINN. L. REV. 521, 521-26 (1981). In an exceptional article, Professor Muris demonstrates that certain legal principles, particularly implied terms in contracts such as the implied covenant of good faith and fair dealing, are low-cost methods of deterring costly opportunistic behavior. *Id.* at 522. Opportunistic behavior is defined as behavior of a performing party to an agreement that is "contrary to the other party's understanding of their contract, but not necessarily contrary to the agreement's explicit terms, leading to a transfer of wealth from the other party to the performer." *Id.* at 521. More importantly, such behavior is often costly to detect and, as a result, costly to deter. *Id.* at 522. Hence, the focus in Muris' article is on the methods used to control opportunistic behavior which is ambiguous in character and exceedingly difficult to detect. *Id.* Opportunistic behavior is behavior which is not prohibited by the contract and which results in a wealth-transfer from one party to another which was not bargained for. *Id.* at 523-24. In one sense, it represents a party's strategic response to a situation that was not contemplated or anticipated by the parties and which was therefore not addressed in the agreement between the parties. *Id.* at 524. Thus, no express breach of the contract necessarily

are two guards against this: one is the public nature of security, and the other is the size of the investment opportunity. Perfection of the security interest will normally involve the filing of some public document.<sup>139</sup> If the lead creditor takes security while engaging in opportunistic behavior to the detriment of the investors, the filing of its security interest will impart notice to concerned investors.

If the lead creditor does not perfect a security interest in a public manner, the creditor's opportunistic behavior may not be discoverable. Here, however, the pooling-of-assets mechanism may protect the investors' interests from acts of misfeasance. The parties normally pool their assets to obtain a favorable arrangement with the debtor.<sup>140</sup> The sheer size of the investment opportunity sought by investors in such a relationship may prevent odious behavior on the part of the lead creditor because the lead creditor may have insufficient assets to compete for the same opportunities as the investment syndicate.<sup>141</sup>

Another type of behavior that the investors must guard against has nothing to do with the lead creditor's misappropriation of opportunity; rather it involves the creditor's misappropriation of the investment. Here, security plays a crucial role. Through agreements, investors may condition the release of investor assets upon simultaneous receipt of the security interest. The real estate mortgage, which is secured by a mortgage executed as part of the escrow process,<sup>142</sup> provides a perfect example.

Additionally, security interests are technically limited restraints on alienation.<sup>143</sup> By taking a security interest in property of the debtor, the

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occurs when a party to the contract acts opportunistically. *Id.* Yet, deterring opportunistic behavior should be a primary goal of contract law because of the multitude of costs incurred if opportunistic behavior is not prevented. *Id.* at 526. Simplistically stated, opportunistic behavior should be deterred because it is not productive and, hence, is not cost efficient. *Id.*

139. If the security is real property, the security interest must be recorded pursuant to the jurisdiction's recording act. See J. DUKEMINIER & J. KRIER, *supra* note 42, at 690-96 (describing the recording system). If the security is personal property, a financing statement must be properly executed and filed. R. HENSON, SECURED TRANSACTIONS 62-66 (1979).

140. See Goldstein, *supra* note 114, at 335.

141. Indeed, if the lead creditor has the financial resources to compete with the investment syndicate that he leads, there is no reason for the lead creditor to pool investors' funds. Additionally, as a matter of public policy, the lead creditor should drop the investment syndicate if an irrefutable conflict of interest exists between the interest of the lead creditor and the individual investors.

142. Escrow is "a system of document transfer in which a deed, bond, or funds is delivered to a third person to hold until all conditions in a contract are fulfilled . . ." BLACK'S LAW DICTIONARY 489 (5th ed. 1979).

143. See Volkmer, *The Application of the Restraints on Alienation Doctrine to Real Property Security Interests*, 58 IOWA L. REV. 747 (1973) (setting forth proper judicial approach when

creditor is restraining the ability of the debtor freely to transfer the assets.<sup>144</sup> Moreover, by taking security, the investors are in a position to ensure that the lead creditor does not engage in risk-alteration by substituting a riskier venture for the one approved by the investors.

### C. A Proposed Empirical Study

Although the traditional signaling theory has been attacked for lack of empirical underpinnings,<sup>145</sup> empirical information should support the notion that security, as a signal to the investors of lead creditors, is efficient. An empirical study which focuses on the makeup of the creditor should show that composition of the creditor is an indicator of the creditor's security requirements. The larger the number of diverse investors, the more visible security the lead creditor obtains as compared to a lead creditor acting on behalf of himself or a small number of investors.

Security is given, in part, as a signal to the lead creditor's investors that the creditor has made a sound investment. The more visible, solvent, secure and respected the debtor, the more valuable the signal. If security serves as a signal to investors of the merits of their lead creditor's investment, it stands to reason that the strongest corporate debtors would give the best and strongest signals. A company without a verifiable public track record or with a weak history of credit is in a weaker position to grant security because the debtor's signal is relatively worthless for the purpose that it is being given: to placate the "silent" investors of the lead creditor. Thus, if the debtor is risky, the odds are that the signal given to investors will be worthless. Secured debt signals the risk-averse investor that the investment taken by the lead creditor is a "good" investment.

Empirical studies should focus on the extent to which the composition of the creditor determines whether security will be required. The larger the number of diverse investors, the more security and the more visible the security the lead creditor obtains. Thus, in the Dunning Cabinet Company hypothetical,<sup>146</sup> security may be required if Dunning's lead

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restraints on alienation doctrine is asserted as defense against remedies employed by secured parties in real property secured transactions).

144. *Id.* at 753.

145. As Professor White states:

[Professor Schwartz's] "signal concept" rests upon empirical assumptions that are in direct conflict with the typical assumption, namely that debtors who are good credit risks need not give collateral, while those who are poor risks can procure loans only if they grant collateral to procure this loan could be an ambiguous signal.

White, *supra* note 84, at 477 n.10.

146. *See supra* note 70.

creditor represents one hundred investors who have invested \$1,000 each with the lead creditor; on the other hand, security may not be required from a lead creditor who represents five investors who have invested \$100,000 each in the investment.<sup>147</sup>

## V. CONCLUSION

This Article develops a theory of the secured debtor-creditor relationship that considers the overlooked function of real property secured debt in these transactions. Analysis of relational contract theory and the role that monitoring plays in secured debt demonstrates that real property secured debt must play a role in solving the secured debt puzzle. Particularly, the secured debt puzzle consists not only of personal property secured debt, but also real property secured debt.

Due to the permanence and immobility of real property, the use of real property secured debt, if available, should always be preferred over its personal property counterpart. Moreover, the same attributes that should cause debtors and creditors to prefer real property security interests to personal property security interests, should also cause subsequent creditors, to perfect their interests with subsequent real property security interests. But if that option is not available, the creditor should employ the next best alternative: a personal property security interest in the form of a floating lien, a pledge of assets, or some other security interest.

Accordingly, the use of personal property security interests, in some limited way, may be protective and reactive, protecting the later creditor from the advantages conferred upon the earlier real property secured creditor.

Finally, real property secured debt illuminates another function of the role of both real property secured debt and personal property secured debt. Secured debt may serve an important signaling function, but not between creditor and debtor. The secured debt signal may be used by a

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147. The size of the investment will obviously play a role in the degree of risk taken by the individual investor-creditor. Size of the investment alone may account for some of the investor's actions in monitoring or approving the actions of the lead creditor. A creditor would likely monitor a \$100,000 investment more closely than a \$5,000 investment. However, size of the investment alone does not determine how the investor decides to invest his money. Notwithstanding the amount of an investment, the investor must be given adequate information relative to the risk assumed. Hence, where the size of the investment is small, an investor may do something counterintuitive, such as buying blue chip stock, knowing nothing of the actual status of the company that issued the stock. *See* R. POSNER, *ECONOMIC ANALYSIS OF LAW* § 15.4 (1986) (discussing investment decisions of portfolio managers). On the other hand, a creditor may be more willing to risk a larger investment in a venture, such as a new restaurant, based on the quality of the chef and the management, which is known personally by the investor.

lead creditor and his investors as a method to pool the resources of risk-averse investors efficiently by reducing transaction costs. It also represents a way of cheaply monitoring the behavior of the lead creditor. Once it is recognized that the lead creditor is not acting in a self-interested fashion, it is relatively easy to see that a mechanism by which the lead creditor may efficiently pool and manage the assets of his investors is necessary. Security, be it personal or real, plays a very important role in this process.

