

# Articles

## The First Shall Be Last: A Contextual Argument for Abandoning Temporal Rules of Lien Priority

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Within the academic circles of commercial law, secured credit is about as hot as a topic can get. For a good fifteen years, leading scholars have argued contentiously about the most fundamental questions concerning secured credit: not just about the policies that might justify the law's protection of secured creditors, but more fundamentally about the seemingly obvious question of why businesses and their creditors choose to grant collateral to secure their payment obligations.<sup>1</sup> The extensive and inconclusive debate in the academic literature has not, however, undermined the confidence in secured credit exhibited by the law-reform institutions of the profession. Rather, The American Law Institute and the National Conference of Commissioners on Uniform State Laws are pressing ahead with a project that has as one of its avowed goals a significant

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1. The debate started with Tom Jackson and Tony Kronman's provocative 1979 *Yale Law Journal* article, Thomas H. Jackson & Anthony T. Kronman, *Secured Financing and Priorities Among Creditors*, 88 *YALE L.J.* 1143 (1979), and went into full steam with Alan Schwartz's 1981 *Journal of Legal Studies* article, Alan Schwartz, *Security Interests and Bankruptcy Priorities: A Review of Current Theories*, 10 *J. LEGAL STUD.* 1 (1981), which challenged scholars to offer a credible explanation for secured credit. The most recent substantial contribution to the debate is a 1994 conference at the University of Virginia, which resulted in a lengthy symposium issue of the *Virginia Law Review*, *Symposium on the Revision of Article 9 of the Uniform Commercial Code*, 80 *VA. L. REV.* 1783 (1994). I have argued at length that the existing literature is deeply flawed by its failure to attend to contextual differences and empirical evidence that are necessary to make any sense out of the actual pattern of secured credit in the economy. See Ronald J. Mann, *Explaining the Pattern of Secured Credit*, 110 *HARV. L. REV.* (forthcoming 1997).

broadening of the scope of secured credit and the rights of secured creditors.<sup>2</sup> That approach has broad support from many of the most prominent scholars in the field. Jim White, for example, recently published a clarion call for a broad-ranging extension of the priority rights accorded to creditors that file under Article 9.<sup>3</sup>

Although the use of collateral in the real-estate context is even more important to the economy than its use in the personal-property context,<sup>4</sup> the academic real-estate community has not entered into the debate about the value of the institution of secured credit. The lack of engagement with that debate is particularly surprising because the secured-credit debate has coincided with the ambitious undertaking by The American Law Institute to produce its first Restatement of Mortgages.<sup>5</sup> In any event, the end result has been the same as in the secured-credit context. The proposed *Restatement of Mortgages* reflects the same approach as the revisions to Article 9 of the Uniform Commercial Code: a general confirmation and broadening of the priority of first-in-time consensual secured creditors.<sup>6</sup>

Without taking issue with the specific provisions of the revised Article 9 and the *Restatement*, I do believe that the general approach those revi-

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2. See UNIFORM COMMERCIAL CODE REVISED ARTICLE 9: SECURED TRANSACTIONS; SALES OF ACCOUNTS, CHATTEL PAPER, AND PAYMENT INTANGIBLES; CONSIGNMENTS xv, xxxii-xxxiii (Discussion Draft Apr. 16, 1996) (discussion by Reporters and ALI Chairman of provisions extending Article 9's provisions to payment intangibles and deposit accounts).

3. James J. White, *Reforming Article 9 Priorities in Light of Old Ignorance and New Filing Rules*, 79 MINN. L. REV. 529, 535-36 (1995) (advocating a principle that White calls "First to File, the King").

4. It is difficult to obtain reliable evidence about the total amount of secured lending, but the statistics for federally insured financial institutions suggest that those institutions hold more than four times as much debt secured by real property as they do debt secured by personal property. Specifically, Federal Deposit Insurance Corporation statistics indicate that as of the end of 1995, the institutions that it insures (banks and savings associations) held more than half of their portfolios (about 1.7 trillion dollars) in loans secured by real estate; the remaining amount of commercial and industrial loans was less than 700 billion dollars, and much of that probably was unsecured. DIVISION OF RESEARCH AND STATISTICS, FEDERAL DEPOSIT INSURANCE CORPORATION, STATISTICS ON BANKING C-6 tbl.RC-4, E-6 tbl.RC-14 (1995); see BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, ANNUAL STATISTICAL DIGEST: 1994, at 133 tbl.63 (1995) (reporting a survey of commercial and industrial lending by banks indicating that banks took collateral for 27% of their short-term loans and 63% of their long-term loans).

5. The first installment appeared in 1991, RESTATEMENT (THIRD) OF PROPERTY-SEC. (MORTGAGES) (Tentative Draft No. 1) [hereinafter RESTATEMENT]. Subsequent installments appeared in 1992 (Tentative Draft No. 2), 1994 (Tentative Draft No. 3), 1995 (Tentative Draft No. 4), and 1996 (Tentative Draft No. 5). The final draft was approved in May of 1996. See *American Law Institute Nears Finish Line on Lawyer Ethics, Product Liability Projects*, 64 U.S.L.W. 2739, 2739, 2747-48 (May 28, 1996).

6. See, e.g., RESTATEMENT, *supra* note 5, § 2.2 (Tentative Draft No. 1, 1991) (enhancing the priority granted to a first-in-time lienor for future advances and especially for advances made to protect collateral); *id.* § 4.2 (Tentative Draft No. 2, 1992) (enhancing the ability of a first-in-time lienor to obtain a perfected interest in subsequently accruing rents); *id.* § 7.3 (Tentative Draft No. 4, 1995) (enhancing the ability of a first-in-time lienor to retain priority after modifications of the terms of its debt).

sions reflect is wrong: wrong because it simplistically fails to acknowledge the limited benefits of first-in-time priority rules, and wrong because it ignores contextual factors that can make alternate priority systems superior.<sup>7</sup> The purpose of this Article is to offer a new conception of lien priority rules designed to structure analysis of the propriety of first-in-time priority.

I start in Part I with the basic and traditional approach to the economics of priority. I explain the two benefits of first-in-time priority: simplicity that reduces transaction costs, and notice that allows subordinate creditors to adjust their transactions to take account of the priority of superior creditors. Although those benefits are important, previous scholars have glossed over the fundamental limitations on the reach of that explanation: because the explanation relies heavily on the ability of subordinate creditors to adjust, first-in-time priority is difficult to justify when the creditors who are to be subordinate do not adjust to account for their lack of priority. A system that subordinates without adjustment raises concerns much more significant than a simple transfer of wealth from the subordinate creditor to the prior creditor. When subordinate creditors do not adjust to account for their lack of priority, the credit extended to the debtor is mispriced in a way that subsidizes unduly risky enterprises and thus undermines the efficiency of the credit market as a whole.

In Part II, I take the general analysis of Part I and use it to examine a single common priority dispute: a contest between construction lenders and the contractors that provide labor and materials to the project the construction lenders finance. I argue that the multiplicity of contractors limits the incentives of the contractors in two significant ways: it limits their incentive to adjust the terms of their transactions to take account of the risks of priority, and it limits their incentive to implement monitoring and administrative mechanisms to reduce the risk of financial defalcation by the owner or other parties involved in the transaction.

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7. My criticism of the *Restatement* and Article 9 projects should not be taken as criticism of the drafters of those projects. The institutions that organize those projects must accommodate constraints on enactability that limit their ability to stray beyond conventional frameworks. In particular, the *Restatement* is limited for the most part to rules that courts could adopt without statutory enactments. The reforms that I advocate could not plausibly be adopted by judicial interpretation of existing rules, but would require statutory enactments. Furthermore, with respect to the *Restatement of Mortgages* in particular, my sense is that the *Restatement of Mortgages* in fact goes much further than most such projects in its willingness to update conventional rules to accommodate modern commercial practice. See, e.g., RESTATEMENT, *supra* note 5, § 1.6 (Tentative Draft No. 5, 1996) (requiring the lender to provide a statement of the nature of the debt owed to it); *id.* § 5.5 (Tentative Draft No. 5, 1996) (stating that payments made to a previous holder of a note are effective unless the payor has received notice of the assignment); *id.* § 6.4(b) (Tentative Draft No. 5, 1996) (requiring the lender to provide a satisfaction of indebtedness); *id.* § 8.5 (Tentative Draft No. 5, 1996) (abandoning the merger doctrine).

Because my analysis hinges on my factual conclusions about the relative intensity of the assessment and monitoring practices of lenders and contractors, I undertook a series of interviews of borrowers, contractors, and lenders of various types with a view to assessing the accuracy of my analysis.<sup>8</sup> As part of those interviews, I tried to get a sense for the practicality of adopting my proposal to give contractors priority over construction lenders. To evaluate that problem, I took advantage of the existence of a legal system in Missouri that closely resembles my proposal, by including a number of interviews with individuals that have experience both under Missouri's unusual contractor-first rule and under the traditional first-in-time rule generally followed in other states. Using the evidence from those interviews, I argue that the legal system should grant the contractors priority over the construction lenders because a system in which the contractors have priority produces a more appropriate incentive to assess and control the risk of financially unsound construction projects.

Because the analysis in Part II develops a proposal designed to minimize the problem of nonadjusting creditors, Part III of the Article addresses the possibility that other considerations make that proposal less than optimal. Subpart III(A) addresses the tradeoff between certainty and adjustment, with a focus on the limited reforms proposed by the *Restatement* to enhance the priority of construction lenders. Although that proposal might solve some of the difficulties of the current system, it would not solve the problems related to risk assessment and control that are the focus of this Article. Subpart III(B) addresses a variety of other efficiency-related concerns posed by the partial-priority proposal Lucian Bebchuk and Jesse Fried advanced in their recent *Yale Law Journal* article.<sup>9</sup> I argue that their proposal to limit the priority of first-in-time lenders by granting partial priority for the second-in-time creditors provides only a partial solution. The best approach in this context is a complete abandonment of temporal priority, giving contractors complete priority over the construction lenders, even if the construction lenders are first in time.

## I. The Economics of Priority

In American law, the central principle for determining priority between competing lienholders is the simple notion that first in time is first

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8. I recorded and transcribed the interviews to improve the accuracy and verifiability of the conclusions that I draw from the interviews. Copies of the transcripts are available upon request, as are redacted copies of the relevant loan documents from a construction-loan transaction on which I worked during 1995. For a more detailed justification of my interview methodology, see Mann, *supra* note 1 (manuscript at 6-8).

9. Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857 (1996).

in right. Notwithstanding the foundational role of that principle, scholars have done surprisingly little to justify it; for the most part it is taken for granted without any substantial examination. A full-scale treatment could examine priority rules from such perspectives as the autonomy of the party granting the lien,<sup>10</sup> the fairness to competing claimants,<sup>11</sup> or the effects on the overall distribution of wealth.<sup>12</sup> In this Article, however, I focus on a single justification: maximization of wealth.<sup>13</sup> Thus, I examine the extent to which a first-in-time priority system can be justified as the system that produces the greatest wealth for the parties affected by the transactions that it governs, with a view to showing how departures from the first-in-time rule can increase the net wealth of the affected parties. This Part

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10. Under the autonomy-based argument, the same principles that call for protection of the right of individuals to sell property also require protection of the lesser-included right to grant a lien in that property. See David Gray Carlson, *Rationality, Accident, and Priority Under Article 9 of the Uniform Commercial Code*, 71 MINN. L. REV. 207, 212 (1986) ("The idea that one may only transfer what he has leads to the priority rule 'first in time is first in right.'"); Steven L. Harris & Charles W. Mooney, Jr., *A Property-Based Theory of Security Interests: Taking Debtors' Choices Seriously*, 80 VA. L. REV. 2021, 2047-66 (1994) (discussing autonomy-related arguments for a first-in-time rule of priority). See generally Ronald J. Mann, *Bankruptcy and the Entitlements of the Government: Whose Money Is It Anyway?*, 70 N.Y.U. L. REV. 993, 1022-53 (1995) (analyzing the implications of an autonomy-based perspective for bankruptcy law). My sense, however (based largely on the reaction to my work in the area), is that few commercial-law scholars would conclude that autonomy-based principles require any particular set of rules for lien priority. Rather, I think that most of those scholars would agree that the government should be free (subject to distributional and fairness concerns) to adopt (or allow private parties to adopt) rules that maximize the wealth of society. See, e.g., Beבחuk & Fried, *supra* note 9, at 932-34 (deprecating the significance of freedom of contract concerns in the allocation of lien priority). On that point, I do not understand Harris and Mooney to argue that principles of autonomy require a first-in-time priority rule. Instead, they seem to argue for a presumption in favor of free transfer that could be rebutted if those opposing the first-in-time rule could demonstrate serious distributional concerns. Harris & Mooney, *supra*, at 2053 (contending that opponents of the Article 9 priority system "must . . . explain why, based on distributional concerns, the law should treat security interests differently from other transfers of property interests"). In any event, this Article does not examine the extent to which principles of autonomy might require recognition of a first-in-time rule of priority, but instead proceeds on the premise that our commercial-law system should adopt rules of lien priority designed to maximize the wealth of society as a whole.

11. For writings in that genre, see Beבחuk & Fried, *supra* note 9, at 931-32 (suggesting that fairness and bargain considerations provide a "normative principle" that cuts against full first-in-time priority for secured creditors) and Carlson, *supra* note 10, at 253 (arguing that commercial law has an "ineluctable" interest "in preserving the weak from the wicked"); see also White, *supra* note 3, at 532 (arguing that "most of us would agree that the legal consequences that attach to the first filing should be fair and efficient" and defining "a rule as fair if it meets legitimate expectations of a reasonable business person who is not necessarily familiar with the rule").

12. See, e.g., Lynn M. LoPucki, *The Unsecured Creditor's Bargain*, 80 VA. L. REV. 1887, 1916 (1994) (criticizing the institution of security as unjustifiably redistributing wealth from unsecured creditors to secured creditors).

13. My choice of a wealth-maximization perspective is not based on any deep-seated conviction that it is the "correct" perspective. Indeed, I have argued elsewhere that a perspective that limits its attention to questions of wealth maximization is seriously flawed. Mann, *supra* note 10, at 1020-22. Rather, I choose that perspective based on an intuition that it is the perspective most likely to be useful as a starting ground for analysis by most scholars in the community.

offers a relatively abstract model of priority that summarizes the general effects a priority system is likely to have on the production of wealth.

### A. *The Benefits of First-in-Time Priority*

Although the main thrust of this Article is to illustrate the limited range within which first-in-time priority is appropriate, I do not mean to suggest that we should abandon first-in-time priority entirely. Rather, as I explain in this subpart, I believe that first-in-time priority provides important wealth benefits in many contexts. My criticism is the more modest point that the rule should be excluded from the contexts in which it does not in fact provide those benefits. To make that criticism, I start by outlining the benefits of first-in-time priority, which I divide into two<sup>14</sup> separate categories: simplicity and adjustment.<sup>15</sup>

1. *Simplicity*.—The most obvious benefits of a first-in-time priority rule come under the heading of simplicity. A first-in-time priority rule facilitates use of a filing system for determining priority, which parties can use to give notice of their priority to other parties.<sup>16</sup> A first-in-time filing

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14. My analysis does not discuss a further benefit noted by Hideki Kanda, Saul Levmore, and George Triantis. Those scholars argued in paired submissions to the 1994 *Virginia Law Review* symposium that first-in-time priority aids the parties by preventing the debtor from increasing the risk of a lending transaction by subsequent issuance of debt. See Hideki Kanda & Saul Levmore, *Explaining Creditor Priorities*, 80 VA. L. REV. 2103, 2108-14 (1994) (arguing that the first-in-time priority rule prevents a debtor from altering the lender's risk by issuing later debt that decreases the likelihood that the first lender will be repaid); George G. Triantis, *A Free-Cash-Flow Theory of Secured Debt and Creditor Priorities*, 80 VA. L. REV. 2155, 2155-56 (1994) (explaining that a "first-in-time priority rule is justified as an impediment to subsequent debt financing arrangements that harm earlier creditors"); see also George G. Triantis, *A Theory of the Regulation of Debtor-in-Possession Financing*, 46 VAND. L. REV. 901, 911-12 (1993) (earlier consideration of that point). Although that argument may identify one of the factors that motivates parties choosing between secured and unsecured debt (an issue I discuss at length in Mann, *supra* note 1 (manuscript at 25-35)), it seems to me to have less relevance to the topic at issue in this Article, in which the question is who will prevail in a contest between two types of secured lenders.

15. Tom Jackson, Tony Kronman, and Alan Schwartz have argued that the first-in-time rule should be adopted because it reflects the contract that sophisticated parties would select. Jackson & Kronman, *supra* note 1, at 1149-58; Alan Schwartz, *A Theory of Loan Priorities*, 18 J. LEGAL STUD. 209, 235-41 (1989). That aspect of their analysis is not directly relevant here because the point of my analysis is to examine the underlying operational effects of the rule. If we can determine that the economic effects of the rule are negative, then I do not think that we should adopt the rule even if sophisticated parties bearing all of the costs would select it. (Of course, it is unlikely that sophisticated parties bearing all of the costs would select the rule if its effects in fact were negative; the fact that some parties select it now is not particularly significant given that the parties subordinated by the rule frequently are not parties to the contracts selecting the rule.) My sense is that Jackson, Kronman, and Schwartz would agree with my general focus on wealth maximization, even if they did not accept the arguments regarding the effects of the rule that I present here.

16. See LYNN M. LOPUCKI & ELIZABETH WARREN, *SECURED CREDIT: A SYSTEMS APPROACH* 326-27 (1995). Absent some special contextual factors (like the ones discussed in this Article), a filing system is not as effective in a priority system in which timing is not relevant because the party with

system, in turn, can provide a simple way both to acquire priority and to determine who has it. On the first point, the only costs necessary to acquire priority under a first-in-time filing system are the costs of determining the appropriate place to file and of making filings in the appropriate locations. Although those costs will not always be insignificant,<sup>17</sup> they can be considerably less than the analogous costs under alternative systems of allocating priority. Consider, for example, the most common alternative system: requiring the lender to retain possession of the collateral. Obtaining priority in that system requires the borrower to forgo all of the value that the borrower obtains from having possession of the collateral: if the lender takes possession of the borrower's manufacturing equipment, the borrower cannot continue its manufacturing business.<sup>18</sup> The costs of possession to maintain priority will be minimal in cases in which making valuable use of collateral does not require physical possession (as with a corporate bond), and those costs also can be mitigated by devices that limit the lender's interference with the borrower's use of the collateral.<sup>19</sup> In many contexts, though, the costs are likely to be far greater than those under a simple first-in-time filing system, which readily allows the borrower relatively unhindered use of the collateral.

Similarly, the only facts necessary to determine who has priority under a first-in-time filing system are the dates of the relevant filings and whatever facts are necessary to determine whether the filings are valid. In the great run of cases, the costs of determining those facts are minimal.<sup>20</sup>

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priority may come into existence after the subordinated party advances its loan. The fact that the superior party can come along after the extension of credit by the subordinated party thus makes it difficult for the subordinated party in a nontemporal system to determine whether it will have priority by investigation at the time that it extends credit.

17. Peter Alces and Lynn LoPucki recently have argued that those costs are relatively large. See Peter A. Alces, *Abolish the Article 9 Filing System*, 79 MINN. L. REV. 679, 689-93 (1995) (reporting the results of an empirical study of lender's attorney fees in more than 100 loan transactions secured by personal property); Lynn M. LoPucki, *Why the Debtor's State of Incorporation Should Be the Proper Place for Article 9 Filing: A Systems Analysis*, 79 MINN. L. REV. 577, 597-98, 630-32 (discussing the costs of filing and the taxes associated with filing). I have argued that those costs rarely are significant, but I do agree that they can be significant in some cases. Mann, *supra* note 1 (manuscript at 40-41).

18. See, e.g., Douglas G. Baird, *Notice Filing and the Problem of Ostensible Ownership*, 12 J. LEGAL STUD. 53, 56 (1983) (emphasizing the costs of a rule requiring possession to perfect security interests). For a thoughtful discussion of the costs and benefits of giving possession to the lender during the term of the loan, see Robert C. Ellickson & Charles DiA. Thorland, *Ancient Land Law: Mesopotamia, Egypt, Israel*, 71 CHI.-KENT L. REV. 321, 394-99 (1995) (discussing "antichretic" mortgages used in the ancient Near East).

19. For example, the lender could allow the borrower to retain physical possession, with the lender maintaining only a stylized form of possession such as field warehousing. See, e.g., LOPUCKI & WARREN, *supra* note 16, at 165-66 (discussing the motivations for field warehousing).

20. See Baird, *supra* note 18, at 64 (arguing that using benchmarks other than time would complicate determinations of priority); 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

First, the dates of the filings can be determined by a simple search of the relevant records. Second, at least in a well-designed filing system, the facts relevant to determining the validity of the filings will be simple and objective matters that would not ordinarily be subject to serious dispute.<sup>21</sup> Accordingly, in most cases the parties need not incur significant expenses to determine who has priority under a first-in-time filing system.<sup>22</sup> Most alternative systems for determining who has priority—those based on types of claims, for example—will impose much greater costs in most cases, because of the difficulty a creditor normally will face in determining whether it will have priority over competing claimants.

2. *Adjustment.*—The second significant benefit of first-in-time priority is that it enhances the ability of parties to adjust the terms of their transactions to react to the priority of competing claimants. Because first-in-time priority protects each claimant from claimants that arrive later, the first-in-time priority system allows new claimants to adjust the terms of their transaction to account for the likelihood that the claims of competing claimants will diminish the new claimant's likelihood of repayment. In a first-in-time system, adjustment is simple: if a preexisting claimant has priority, the new claimant can charge a higher price to compensate for the risk of nonpayment; conversely, if there are no preexisting claimants, the new claimant can set the terms of its transaction safe in the knowledge that it will have priority over all subsequent claimants.<sup>23</sup>

Although some scholars have criticized the subordination of creditors that do not have an opportunity to adjust as unfair,<sup>24</sup> my analysis in this

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ALA. L. REV. 683, 749-51 (1988) (discussing how a filing system can lower the costs of determining who has priority in a particular asset).

21. "Certainty promotes efficiency because it allows the parties who do not wish to be governed by the rule to know what and how to negotiate to avoid the rule. Certainty minimizes litigation and the cost of litigation because outcomes are predictable." White, *supra* note 3, at 533; see Richard A. Epstein, *Past and Future: The Temporal Dimension in the Law of Property*, 64 WASH. U. L.Q. 667, 670-71 (1986) ("[M]aking a clear decision one way or the other is of enormous importance. The relatively automatic quality of [a temporal priority] rule helps private parties organize their affairs without resorting to litigation."); Mooney, *supra* note 20, at 751 (arguing that "[f]iling provides definite, irrefutable evidence of the baseline time on which the first-in-time priority rule will be applied" and that "[d]etermining priorities based on the time of public filing reduces evidentiary costs and disputes in connection with secured transactions"); White, *supra* note 3, at 535-36 (arguing that the extension of first-to-file priority would enhance efficiency); cf. Menachem Mautner, *"The Eternal Triangles of the Law": Toward a Theory of Priorities in Conflicts Involving Remote Parties*, 90 MICH. L. REV. 95, 139-40 (1991) (arguing that the first-in-time rule favors parties that are likely to have greater reliance interests at stake).

22. See also Bebchuk & Fried, *supra* note 9, at 872 (criticizing the "existing erosion of full priority in the United States [because it] is ad hoc, creating unnecessary uncertainty for creditors").

23. See, e.g., Mooney, *supra* note 20, at 745 ("A secured creditor will charge a lower interest rate on account of receiving collateral only if it can rely with relative safety on the priority of its claim.").

24. See, e.g., Bebchuk & Fried, *supra* note 9, at 868-70 (discussing the bankruptcy principle that bars nonconsensual subordination).



Article emphasizes a different facet of the adjustment issue: the relation between adjustment and the proper allocation of resources through the credit market. I start from the obvious dependency of adjustment on timely access to information necessary to determine priority. When each party that extends credit to a borrower has full information about the likelihood of nonpayment, each party can adjust the terms of its transaction so that the net price that it charges for the extension of credit reflects the likelihood that it will not be repaid.<sup>25</sup> Conversely, when a party does not have full information about the likelihood of repayment because it does not know whether it will have priority over competing claimants, it is unable to calculate a price that accurately reflects the likelihood that it will be repaid.

For example, assume that two borrowers of apparently similar financial strength (Borrower One and Borrower Two) each approach a lender (New Lender) seeking a loan for a term of one year. The only difference between the two is that Borrower Two already has encumbered its assets in connection with a prior loan from another lender (Old Lender). Assume also that New Lender is willing to make loans to the borrowers at an interest rate of 10% per year if it is sure that it will have a prior right to payment, but will insist on an interest rate of 12% per year if it will not have priority, to take account of the increased risk of loaning money in a subordinate position. Under a first-in-time system, New Lender will know that it will have priority against Borrower One and thus will lend to Borrower One at 10%. Similarly, it will know that it will not have priority with respect to Borrower Two and thus will lend to Borrower Two at 12%. By facilitating the lender's ability to evaluate the risks of its borrowers, the first-in-time system enhances the lender's ability to discriminate in its pricing based on the riskiness of each of its borrowers.<sup>26</sup> Because that

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25. The examples that follow rely for ease of explication on adjustments limited to increases in interest rates. As the empirical evidence in Part II of this Article suggests, the most common reactions to perceptions of risk take other forms (see *infra* notes 107-09 and accompanying text), but using interest rates allows me to present a numerical example that is simpler and easier to follow than any alternative that is obvious to me. Lynn LoPucki has argued with vigor that it is impracticable for unsecured creditors to adjust the terms of their loans to take account of the relative riskiness of different transactions. LoPucki, *supra* note 12, at 1935-36 & nn.181-82; see also Paul M. Shupack, *Solving the Puzzle of Secured Transactions*, 41 RUTGERS L. REV. 1067, 1095-98 (1989) (arguing that achieving full risk neutrality by "offering either collateral or a sufficient risk premium" is implausible). As I have explained elsewhere, his argument ignores the manifold devices that creditors use to compensate for risk. See Mann, *supra* note 1 (manuscript at 60 n.193) (arguing that inventory suppliers compensate for credit risk by insisting on cash payment rather than offering credit to purchasers of doubtful financial strength, by charging steep interest rates for deferred payment that disproportionately burden weaker purchasers, and by taking security interests). Furthermore, the evidence presented in Part II of this Article demonstrates that his argument cannot be reconciled with the actual practices of lenders in the construction industry. To be sure, they may account for that risk by mechanisms other than increasing interest rates (such as increasing expenditures on procedures for controlling risk), but they account for it nonetheless.

26. See Schwartz, *supra* note 15, at 220 (arguing that "the loan market would segment" if borrowers could make credible disclosures of priority debt, with the result that "[t]he good types would

price discrimination tends to match the cost of the loan to the risk of default, enhancement of the lender's ability to set accurate prices enhances the efficiency of the credit market.<sup>27</sup>

When creditors are unable to determine their priority, their inability to adjust necessarily will result in mispricing of credit. That mispricing, however, is not likely to be random. On the contrary, it will tend to subsidize the risky borrowers, as a simple example will show. Take the hypothetical discussed above, but assume that it would cost New Lender 5% of the loan amount to determine that it has acquired priority. In that case, the parties rationally could conclude that it would not be worthwhile for New Lender to spend the money to make sure that it had priority<sup>28</sup> because the costs of acquiring and determining priority would exceed the benefits of having priority.<sup>29</sup>

In that event, the likely reaction would be for New Lender to charge a premium to all borrowers to account for the risk that it would not in fact have priority.<sup>30</sup> Thus, if New Lender believed that it would have priority in only one-tenth of the cases, it could charge a priority-risk premium on each loan of 1.8% per year, which would give it a total fund to account for priority losses equal to 2% per year on the 90% share of the loans in which it would not have priority. The effect of that system would be that each borrower would pay the same, whether or not New Lender would have priority with respect to that borrower's loan. Thus, Borrower Two would get money at the same price as Borrower One, even though Borrower Two presented New Lender with a riskier investment. To put it another way, the uncertainty of priority would result in Borrower One

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receive the low interest rate that reflected their debt-free status, and the bad types . . . would be charged the highest interest rate").

27. See *id.* at 220 ("Each borrower would be charged the interest rate that reflects the social costs of lending to it, and the creditors would be compensated accurately for the risks they bear.").

28. The analysis in the text assumes that the parties will act jointly to minimize the costs of the loan. I defend that approach to analyzing borrowing decisions in Mann, *supra* note 1 (manuscript at 9-10).

29. Because the loan in the hypothetical has a term of one year, the parties probably would not view it as prudent to expend 5% of the loan amount to assure the lender of priority if the benefit to the lender of having priority was an increased likelihood of payment valued at 2% of the loan amount per year.

30. See Jackson & Kronman, *supra* note 1, at 1148-49 ("[I]f secret liens . . . were legally enforceable, creditors would either refuse to lend at much below the unsecured rate or would have to incur substantial costs in policing their loans . . ."); Schwartz, *supra* note 15, at 220. Describing the approach taken by some lenders, Schwartz observes:

The sensibly conservative strategy for a lender operating in [a] legal environment [in which lenders cannot determine whether they will have priority] is to assume that each borrower it faces is bad with a high probability . . . [and to] charg[e] an interest rate that is almost as high as the rate that would be exacted by a lender that believed with certainty that it was dealing with a bad debtor.

*Id.*

paying an extra charge to subsidize the loan to Borrower Two (1.8% per year in the example).<sup>31</sup>

To generalize, the end result of a system in which it is not practical for parties to acquire priority is a distortion of the economy to support excessive investment in enterprises with questionable financial strength. That suggests that first-in-time priority is preferable when it furthers adjustment, but offers no reason to adopt first-in-time priority when it hinders adjustment.

### B. *The Limits of First-in-Time Priority*

The most obvious thing about the economic justification for first-in-time priority is its limited scope. The linchpin on which the justification rests is the ability of the later creditor (who will be subordinate) to react to the priority of the earlier creditor.<sup>32</sup> To put it in the terms of my hypothetical, the first-in-time priority system leads to accurate pricing only when it is practical (and cost effective) for New Lender to determine whether Old Lender exists and to adjust the terms of its loan to account for the additional risk presented by Old Lender's priority.<sup>33</sup>

Thus, although the first-in-time system might be useful for thinking about the high-finance world of large transactions among informed, sophisticated parties, its unrealistic assumptions necessarily limit its general probative value. As several scholars have noted, the concept of first-in-time priority has at best limited validity in the context of involuntary creditors.<sup>34</sup> Because involuntary creditors by definition did not engage in a consensual lending transaction with their debtors, they cannot have had an opportunity to adjust the terms of their transaction to account for the

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31. See Schwartz, *supra* note 15, at 220 ("[G]ood' debtor types, rather than the lenders, would bear the costs of any uncertainty concerning property rights . . .").

32. The text at this point ignores the simplicity-related benefits of the first-in-time rule. I argue in subpart III(A) that my proposed rule is not significantly worse on that score than the first-in-time rule.

33. See, e.g., Bebchuk & Fried, *supra* note 9, at 881-82 (explaining that the easy case for full priority for secured creditors is limited to a world with perfectly adjusting creditors).

34. See, e.g., Bebchuk & Fried, *supra* note 9, at 882-83 (characterizing as "a familiar point" the notion that giving full priority to secured claims permits a firm to divert value from its tort creditors); David W. Leebron, *Limited Liability, Tort Victims, and Creditors*, 91 COLUM. L. REV. 1565, 1649, 1646-49 (1991) ("Subordinating all lenders to tort claimants would eliminate the advantage of leverage, and would remove the ability of corporate organizers to unilaterally determine an artificial level of exposure to tort judgments."); LoPucki, *supra* note 12, at 1893, 1897-98 (discussing how the priority of secured creditors allows firms to externalize tort risk); Robert K. Rasmussen, *An Essay on Optimal Bankruptcy Rules and Social Justice*, 1994 U. ILL. L. REV. 1, 31-35 (cataloguing the "ills of the current regime" of according secured creditors priority over tort creditors); Robert K. Rasmussen & David A. Skeel, Jr., *The Economic Analysis of Corporate Bankruptcy Law*, 3 AM. BANKR. INST. L. REV. 85, 87 (1995) ("[C]ompensating tort claimants injured by the firm ahead of contractual creditors . . . forces corporations to take into account the injuries their behavior imposes on third parties.").

risk that their claims would not be paid because of the priority of other creditors. Accordingly, subordinating their claims to the claims of priority creditors inevitably results in underpayment of their claims. To the extent that the claims of involuntary creditors sound in tort (as they generally do), their subordination results in an improper diminution of the tort system's incentives to avoid conduct that causes compensable harms.

What generally has gone unexamined, however, is that the problems with first-in-time priority do not stop with involuntary claimants.<sup>35</sup> For first-in-time priority to make sense, it is not enough for creditors to have, in a voluntary transaction with a borrower, an opportunity to adjust the terms of their transaction to account for the risk of other creditors' priority. For first-in-time priority to make sense, the creditors actually have to take advantage of that opportunity: they have to adjust the terms of their transaction to account for priority risks. The reason is simple. If creditors have an opportunity to adjust, but fail to adjust, three things will happen: (1) the terms of lending transactions will not account for priority risks; (2) high-risk borrowers and low-risk borrowers will obtain money at similar prices; and (3) we will be back where we started, with a system that improperly subsidizes high-risk business enterprises.

It may seem odd for me to worry about what happens when a later-in-time creditor has an opportunity to adjust to an earlier creditor's priority but chooses not to do so. That worry, however, is born from my focus in this Article on wealth maximization. The mere opportunity to adjust is relevant only from a perspective that is concerned about the fairness of subordinating later-in-time creditors. From that perspective, the existence of an opportunity to adjust is significant because a party that fails to take

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35. The only significant exceptions of which I am aware appear in Lynn LoPucki's *Virginia Law Review* article and in the recent article in the *Yale Law Journal* by Lucian Bebchuk and Jesse Fried. LoPucki argues that the law should take account of the unsecured creditors that fail to adjust because of their lack of sophistication. LoPucki, *supra* note 12, at 1956-58. As I explain below (*see infra* note 53), that concern does not play any role in my analysis because I am not willing to assume that contractors are systemically less sophisticated than construction lenders. I believe that there are sophisticated contractors, just as there are sophisticated construction lenders, and my practice in Texas during the 1980s convinces me that construction lenders can be just as unsophisticated as contractors. If those parties had the same incentives, I see no reason to doubt that their levels of sophistication would be the same in the long run.

Bebchuk and Fried extend the analysis from involuntary creditors to "voluntary creditors with small claims" and to certain types of prior voluntary creditors. Bebchuk & Fried, *supra* note 9, at 885-91. My analysis differs from theirs in two main respects. First, their analysis does not seem to me to recognize the significance of the mispricing that results from failure to adjust: an inevitable subsidy paid by the prudent for the benefit of the risky. More generally, I do not see any good reason to limit reform to a diminution of priority for the first-in-time creditor. In the contexts in which my analysis holds, the driving force is to enhance the incentives for adjustment. The partial-priority reform they advocate provides only a partial enhancement of the incentives. Although they present a variety of arguments in favor of the limited reform that they advocate, I believe (as I explain in subpart III(B)) that those arguments have little or no force in the context I examine in this Article.

advantage of the opportunity to protect itself has a diminished basis for complaining when it is subordinated to a creditor about whom it knew (or at least should have known).<sup>36</sup> From a wealth-maximizing perspective, however, the opportunity to adjust is not directly valuable. It is valuable only as a means to an end, and the end is the most precise and accurate possible pricing in the market for credit. To the extent that adjustment fosters accurate pricing, the ideal system—all other things being equal—is the system that maximizes adjustment.

I do not distinguish between the decision to adjust and the opportunity to adjust out of a desire to protect the eccentric, irrational, or unsophisticated creditor that fails to take advantage of a profitable opportunity to adjust,<sup>37</sup> or out of sympathy for a party that foolishly waives its right to priority. Rather, I make that distinction because of my belief that in a number of economically significant contexts transaction costs make it rational for second-in-time claimants that have an opportunity to adjust to refrain from adjusting to save the costs of adjustment. To defend that belief, Part II of this Article provides a contextual analysis of the effects of alternative priority rules in the construction-loan context.

## II. First-in-Time Priority in Context: Construction Contracting

In my view, there are several significant contexts in which application of the first-in-time rule is questionable at best. In some, such as inventory supply, practicalities limit the feasibility of first-to-file rules.<sup>38</sup> In others, first-in-time priority already has been abandoned, but existing rationales do not adequately explain the rules that the system applies.<sup>39</sup> The point of

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36. See *supra* note 11 (citing representative scholarship evaluating rules of lien priority based on fairness).

37. But see LoPucki, *supra* note 12, at 1956-58 (advocating reforms to benefit unsophisticated creditors).

38. The problem in the inventory-supply context is that the disproportionately high expenses that the supplier would incur if it attempted to file against all of its customers' locations can result in suppliers failing to take a security interest not because of the economics of the underlying transaction, but because of the ineffectiveness of the current filing system. See Lynn M. LoPucki, *Computerization of the Article 9 Filing System: Thoughts on Building the Electronic Highway*, LAW & CONTEMP. PROBS., Summer 1992, at 5, 26-27; Letter from R.O. Wiregard, Eveready Battery Co., Inc., to William M. Burke, Chairman, American Law Institute Drafting Committee, Revision of Article 9 of the Uniform Commercial Code 2 (July 31, 1995) (on file with the *Texas Law Review*) (discussing that problem and urging an "implicit trade lien" in favor of inventory suppliers).

39. The main situation that I have in mind here is the problem of purchase-money priority, which has attracted considerable discussion among academics. For a sampling of the literature, see F.H. Buckley, *The Bankruptcy Priority Puzzle*, 72 VA. L. REV. 1393, 1461-70 (1986) (criticizing purchase-money priorities as unjustified); Kanda & Levmore, *supra* note 14, at 2138-41 (defending Article 9's rules on purchase-money priorities as striking "a difficult balance" between the danger to earlier creditors of risk alteration and the benefit to society of efficiency gained through later-in-time decisionmaking); and Paul M. Shupack, *Defending Purchase Money Security Interests Under Article*

this Article, however, is not to provide a detailed discussion of all of the different doctrinal rules about priority. Rather, my point is to offer a general framework for allocating priority. To further that end, it is better to provide a single illustration with sufficient attention to context<sup>40</sup> to demonstrate how my analysis would apply in other situations. For a number of reasons, the construction-loan context is particularly well suited to illustrate my analysis. To begin with, the rules of priority that apply there have peculiar importance because construction lending combines significant economic impact with an unusually high level of default.<sup>41</sup> Furthermore, it is widely agreed that the existing state of the law is wholly unsatisfactory. The most ridiculed aspect of the system is its reliance on a vague distinction that grants priority to advances that are "obligatory," but not to those that are "optional."<sup>42</sup> Furthermore, aside from the vagueness of the lien priority rules, the desire of courts and legislators to protect the

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9 of the U.C.C. from Professor Buckley, 22 IND. L. REV. 777, 783-97 (1989) (describing the benefits of the U.C.C.'s purchase-money priority system). The considerations relevant to purchase-money priority problems closely resemble the considerations that occur in several other situations in which the law already grants priority to later-in-time creditors that add value. See, e.g., 11 U.S.C. § 506(c) (1994) (granting priority for expenses during bankruptcy proceedings that enhance the value of collateral); Cagan v. Mutual Benefit Life Ins. Co., 28 F.3d 654 (7th Cir. 1994) (granting common-law priority to a later-in-time receiver for the costs of preserving collateral). I thank Dan Keating for pointing out the connection among those rules.

40. See Mann, *supra* note 1 (manuscript at 6-7, 63) (arguing that the scholarship about secured credit has been insufficiently attentive to the differing contexts in which secured credit is used).

41. See, e.g., Lawrence Ponoroff, *Construction Claims in Bankruptcy: Making the Best of a Bad Situation*, 11 BANKR. DEV. J. 343, 343 & n.2 (1995) (citing statistics about the size of the construction industry and its "notoriously high" rate of failure); see also Telephone Interview with Joseph C. Bonita, Chief Underwriting Counsel, Chicago Title Insurance Company 8 (Dec. 18, 1995) [hereinafter Bonita Interview] (transcript on file with the *Texas Law Review*) (describing lien claims in construction projects as "a big loss factor"); Interview with Jim Wood, Vice President, Mark Twain Bancshares, Inc., in St. Louis, Mo. 8 (Jan. 11, 1996) [hereinafter Wood Interview] (transcript on file with the *Texas Law Review*) ("[C]onstruction lending is probably the riskiest thing you can do, as far as real-estate lending, [with a few exceptions].").

42. See, e.g., RESTATEMENT, *supra* note 5, Reporters' Memorandum, at xx (Tentative Draft No. 1, 1991) (explaining that the "traditional majority view . . . has proven unpredictable and extremely confusing in practice"); James B. Hughes, Jr., *Future Advance Mortgages: Preserving the Benefits and Burdens of the Bargain*, 29 WAKE FOREST L. REV. 1101, 1115-17 (1994) (discussing "the lack of clear standards" for determining who has priority); Grant S. Nelson & Dale A. Whitman, *Rethinking Future Advance Mortgages: A Brief for the Restatement Approach*, 44 DUKE L.J. 657, 659-60 (1995) (arguing that "[t]he traditional common law approach . . . has proved inadequate and should be discarded").

Dissatisfaction with that system has led to a rule in the new *Restatement of Mortgages* that significantly broadens the first-in-time priority rule in the construction-loan context. See RESTATEMENT, *supra* note 5, § 2.3(a), at 88 (Tentative Draft No. 1, 1991) ("If a mortgage secures future advances, all such advances have the priority of the original mortgage."); see also *id.*, Reporters' Note, at 99 ("It would be simpler [than existing solutions] . . . merely to renounce the [existing approach], and to declare that all future advances take the priority of the original mortgage."). The reform also alters a number of other aspects of the law related to future-advances mortgages, which are beyond the scope of this Article. For a lucid explanation and defense of the entire topic, see Nelson & Whitman, *supra*, at 686-703.

contractors that supply the labor and materials that build a project has given rise to a body of confusing judicial and statutory rules that limits the value of whatever lien priority the lenders might appear to have.<sup>43</sup>

Second, it is an area in which it seems to me relatively easy to demonstrate how first-in-time priority can fail even with respect to voluntary creditors. To defend that view, this Part proceeds in two steps. First, subpart A presents a relatively abstract analysis of the incentives of the parties, designed to show why first-in-time priority should not work in this context. Second, subpart B explains the empirical evidence I have gathered to support my abstract analysis, to show that first-in-time priority in fact does not work in this context.

#### A. *A Model of Incentives in the Construction-Loan Context*

The basic construction-loan transaction involves three different types of actors: a borrower in the business of developing real estate; a lender (typically a bank)<sup>44</sup> in the business of lending money to finance construction; and a large number of contractors, each of whom is in the business of providing labor or materials used in construction. Because the construction lender normally agrees to finance the project before construction begins, the construction lender normally has the ability to ensure that it is the first to file, so that it would have priority under a strict first-in-time priority system.<sup>45</sup> The borrower typically enters into contracts with architects, engineers, and other contractors providing for the construction of the building.<sup>46</sup> Usually much of the work of actual construction will be provided by a general contractor through one or more tiers of subcontractors.<sup>47</sup> In that case, the amount of the contract with the general

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43. See Curtis R. Reitz, *Construction Lenders' Liability to Contractors, Subcontractors, and Materialmen*, 130 U. PA. L. REV. 416 (1981) (discussing judicial and statutory provisions that protect contractors and subcontractors against construction lenders).

44. FDIC statistics indicate that federally insured banks held about \$69 billion of construction and land-development loans at the end of 1995. DIVISION OF RESEARCH AND STATISTICS, FEDERAL DEPOSIT INSURANCE CORP., *supra* note 4, C-6 tbl.RC-4.

45. The liens of the competing contractors normally will have a priority date no earlier than the date on which construction commenced. See, e.g., 2 GRANT S. NELSON & DALE A. WHITMAN, *REAL ESTATE FINANCE LAW* § 12.4, at 188-89 (3d ed. 1993) (Practitioner Treatise Series) (summarizing differing approaches to determining the date from which mechanics' liens have priority). I emphasize that the construction lender will have the *opportunity* to obtain priority over the mechanics' liens because it appears that construction lenders frequently fail to act with sufficient care to obtain that priority. See Bonita Interview, *supra* note 41, at 3 ("[E]ven [in] states in which priority for the lender is legally possible . . . a large, large number of the transactions simply don't have it because they mistimed it or something.").

46. For a good general discussion of the contracting process, see 2 NELSON & WHITMAN, *supra* note 45, § 12.2, at 155-58.

47. Alternatively, the owner might hire a construction manager and contract directly with a variety of parties providing labor and materials related to construction. See, e.g., Ponoroff, *supra* note 41, at 345 n.5 (describing the use of construction managers). My analysis would apply in that context as

contractor will include amounts necessary to pay the direct charges of the general contractor, as well as amounts due to all of the subcontractors that the general contractor plans to hire to perform construction.<sup>48</sup>

When first-in-time priority elevates the rights of the construction lender over those of the contractors, a failure of the project will leave the contractors significantly exposed because the value of the uncompleted project will go first to pay the construction lender: the contractors are entitled to payment only out of any excess remaining after the construction lender has been paid in full.<sup>49</sup> Thus, because the contractors bear the primary risk of loss, it is the contractors as a group that have the primary incentive to account for and minimize that risk. Conversely, the construction lender has a diminished incentive to worry about losses because it will be paid in full so long as the project is worth the money that the construction lender has invested in it.<sup>50</sup>

By dividing the incentive to account for and prevent losses among the multiple contractors, first-in-time priority leads to two distinct problems. The first problem is the adjustment problem discussed in Part I. Because of the large number of subordinated contractors, no individual contractor has an adequate incentive to adjust its pricing for the risk that the construction lender's priority will prevent the contractor from getting paid.<sup>51</sup> As explained in Part I, that failure to adjust results in an

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well because the parties that provide labor and materials still would be entitled to liens to secure the owner's obligation to pay them.

48. See Interview with George Scherer, Chief Financial Officer, McCarthy, in St. Louis, Mo. 12-13 (Dec. 18, 1995) [hereinafter Scherer Interview] (transcript on file with the *Texas Law Review*) (statement of the chief financial officer for a large general contractor that his company typically subcontracts out about 75-80% of its work).

49. See LOPUCKI & WARREN, *supra* note 16, at 527-31; 1 NELSON & WHITMAN, *supra* note 45, § 7.31, at 669-72 (both summarizing general rules for the distribution of proceeds of a foreclosure on a property involving multiple lienholders).

50. I do not mean to suggest that granting priority to the construction lender vitiates that lender's risk of loss. As any lender making construction loans will say, the risk of loss is quite significant even with priority. See Interview with Harry C. Mueller, Senior Vice President, Mercantile Bank of St. Louis N.A., in St. Louis, Mo. 14 (Dec. 11, 1995) [hereinafter Mueller Interview] (transcript on file with the *Texas Law Review*) (describing the risk of loss on projects in which the construction lender has priority over the contractors). The risk of loss is, however, necessarily less than it would be if the contractors had priority over the construction lender. Accordingly, the construction lender's incentive to respond to the risk is lower. As discussed in the text, the evidence from my interviews strongly suggests that the alteration of priority is enough to make a noticeable difference in lending practices. See *infra* section II(B)(2).

51. Although the general contractor generally will have a greater incentive to worry about losses than other contractors, that does not undermine my thesis that putting the risk of loss on contractors rather than the construction lender substantially diminishes the incentive to prevent losses. First, the amount of the general contract typically amounts to only 75-80% of the construction loan. See Scherer Interview, *supra* note 48, at 13. Second, even with respect to that 75-80% amount, the risk of loss is heavily fractionated because the general contractor typically subcontracts a considerable portion of the work to be done under the general contract and because the contracts with the subcontractors normally include "pay-when-paid" provisions, which allow the general contractor to defer payment to



inefficient mispricing of credit. The second problem arises from the nature of the events most likely to lead to default in this context. Here, many of the defaults result from events that can be controlled by the parties (such as theft or misapplication of funds by the borrower or general contractor).<sup>52</sup> By putting the risk of loss on a large number of contractors, first-in-time priority places the risk of loss on parties that do not individually have an adequate incentive to adopt procedures to control that risk.<sup>53</sup>

Consider a simplified example of a construction loan from Bank to Developer in the amount of \$1 million. Developer plans to construct a building with labor and services contributed by twenty different contractors and subcontractors. Each of the contractors will have an equal claim<sup>54</sup>

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subcontractors until it receives payment from the owner. See Interview with James J. Murphy, Jr., President, Murphy Company Mechanical Contractors and Engineers, in St. Louis, Mo. 3 (Jan. 23, 1996) [hereinafter Murphy Interview] (transcript on file with the *Texas Law Review*) (statement of a subcontractor that it has no obligation to pay its subcontractors until it is paid by the general contractor); Interview with Robert J. Poelker, Vice President, Finance & Accounting, BSI Constructors Inc., in St. Louis, Mo. 5 (Jan. 25, 1996) [hereinafter Poelker Interview] (transcript on file with the *Texas Law Review*) (description by a general contractor of pay-when-paid provisions included in its subcontracts); Scherer Interview, *supra* note 48, at 12 (explaining that a general contractor does not bear all of the risk of loss from deferred payment because that type of loss "all works itself down the food chain"); see also AMERICAN INST. OF ARCHITECTS, STANDARD FORM OF AGREEMENT BETWEEN CONTRACTOR AND SUBCONTRACTOR §§ 11.3, 12.1 (1987) (standard pay-when-paid provisions). Although the New York Court of Appeals recently invalidated a pay-when-paid provision that placed the ultimate risk of loss from nonpayment on a subcontractor, even that decision recognized the validity of provisions that pass the risk of late payment to subcontractors. See *West-Fair Elec. Contractors v. Aetna Cas. & Sur. Co.*, 661 N.E.2d 967, 971 (N.Y. 1995). Because losses from late payments constitute the bulk of losses that contractors suffer on construction projects, see Scherer Interview, *supra* note 48, at 11-12, the clear validity of pay-when-paid provisions to transfer those losses to subcontractors has the effect of passing most of the risk of nonpayment from the general contractor to its subcontractors.

52. See, e.g., Bonita Interview, *supra* note 41, at 4 (explaining that the mechanics' lien risk can be "reduced by orders of magnitude by seeing to it that everybody's paid"); Interview with John C. Petersen, President, Disbursement Advisors, Inc., in St. Louis, Mo. 5 (Jan. 23, 1996) [hereinafter Petersen Interview] (transcript on file with the *Texas Law Review*) (stating that "the only way to be sure [that money has not been embezzled] is to know where the money went").

53. My analysis focuses on the multiplicity of the contractors, rather than their sophistication. Thus, I do not rely at all on the possibility that the increased sophistication of lenders makes them cheaper cost avoiders than contractors. See, e.g., James E. Krier & Stewart J. Schwab, *Property Rules and Liability Rules: The Cathedral in Another Light*, 70 N.Y.U. L. REV. 440, 447-49 (1995) (discussing the idea that entitlements should be assigned to place the risk of loss on the cheapest cost avoider). To the extent that contractors lack the sophistication and expertise that banks have in evaluating and controlling credit risks, a rule elevating the priority of contractors should improve affairs even more. I have not relied on that factor in my analysis, though, because I doubt that differences in sophistication have long-run significance. But see LoPucki, *supra* note 12, at 1956-58 (urging reforms to protect unsophisticated creditors). In particular, although some might believe that banks are more sophisticated under current conditions, I see no reason to doubt that in the long run sophisticated contractors and lenders faced with similar incentives would be equally effective at assessing and controlling risks.

54. Although it is unrealistic to assume that each contractor will have an equal claim, the assumption does not undermine the validity of my model. See *supra* note 51.

against the project for \$50,000.<sup>55</sup> Assume that the contractors would believe, based on general experience in the industry and without any contract- or project-specific investigation, that a reasonable estimate of the expected loss to each contractor from failure of the project is \$300<sup>56</sup>: three percent of the projects fail and each contractor loses 20% of its claim on each failure (for a total loss of \$200,000 in this hypothetical).<sup>57</sup>

Now assume that each contractor could do two things to assess and control the risk of the project. First, by expending \$2,000 to evaluate the credit of Developer and the viability of the project, a contractor could place the project into one of two classes: good projects and bad projects. Good projects (90% of all projects) have a total expected loss from failure of \$2,000.<sup>58</sup> Bad projects (10% of all projects) have a total expected loss from failure of \$42,000.<sup>59</sup> Second, by expenditure of an additional \$2,000 to implement heightened monitoring and disbursement procedures, the amount of the loss in cases of distress could be reduced by 60%: from \$200,000 in each case to \$80,000 in each case.

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55. For simplicity, I have chosen to have the amount of the construction loan equal the amount due to the contractors working on the project. That does not indicate that I am making the unrealistic assumption that the lender is funding 100% of the costs of the project. Rather, it reflects the likelihood that the amount due to the contractors working on the project is likely to be significantly less than the total costs of the project. That will be true because of, among other things, the costs of acquiring the land and the "soft" costs likely to have been incurred long before construction began. See Scherer Interview, *supra* note 48, at 12-13 (stating that a typical arrangement would involve a construction loan for about 80% of the total cost of the project and a general contract for about 75-80% of the amount of the construction loan); Interview with Lee Wielansky, President, Midland Development Group, in St. Louis, Mo. 1 (Dec. 12, 1995) [hereinafter Wielansky Interview] (transcript on file with the *Texas Law Review*) (stating that construction lenders will advance up to 90-95% of his construction costs, on projects that seem to me extremely conservative); Wood Interview, *supra* note 41, at 2 (statement of a lender specializing in \$500,000 to \$1 million construction loans that it usually advances the lesser of the total cost of the project or 75-80% of the estimated value of the completed project).

56. Given the difficulty of directly observing default and loss rates, I do not claim that the rates used in my hypothetical accurately reflect reality. I have chosen the three percent default rate as approximating the cumulative rate of default during the first two years on a class B corporate bond, as reported in Christine Chmura, *A Loan Pricing Case Study*, J. COM. LENDING, Dec. 1995, at 23, 28. The loss rates are arbitrary estimates based on my experience in private practice. In any event, the actual figures are not necessary to my analysis; they are designed simply to illustrate the hypothetical effect caused by fractionation of incentives. My argument that the effect is real rests on the empirical evidence discussed in subpart II(B).

57. The hypothetical assumes for simplicity that the bad projects will be worth \$1.8 million, so that the construction lender will be paid in full and the contractors will lose \$200,000. The \$300 figure is the product of the total loss on failure (\$200,000), the risk that the loss will occur (3%), and the contractor's share of that loss (5%).

58. I arbitrarily assigned to good projects a 99% chance of successful completion, a 1% chance of failure, and a loss of \$200,000 on each failure.

59. I arbitrarily assigned to bad projects a 79% chance of successful completion, a 21% chance of failure, and the same \$200,000 loss upon failure. Aggregation of the 10% risk of a 21% failure rate (on bad projects) and the 90% risk of a 1% failure rate (on good projects) produces the 3% overall failure rate described in the preceding paragraph.

Consider first the possibility that an individual contractor would spend the \$2,000 to investigate the caliber of the project and Developer. In an ideal world with perfect and costless knowledge, each contractor would charge \$50,100 for a good project and \$52,100 for a bad project.<sup>60</sup> The problem, though, is that no rational contractor would spend more than \$300 to investigate the project to find out if it is good or bad because \$300 is the expected loss a contractor faces from a failure of the project if it does not know whether the project is good or bad.<sup>61</sup> Because the costs of the investigation and monitoring in the hypothetical are \$2,000, no rational contractor would undertake the investigation. Similarly, a rational contractor would not incur the \$2,000 monitoring cost because that sum far exceeds the \$180 benefit each contractor would gain from the monitoring.<sup>62</sup> Thus, no individual contractor would take steps to assess or control the risk; instead, each contractor would charge a risk premium of \$300 to compensate it for the risk of loss from failure of the project. The result, then, is that both good and bad projects will pay the same \$50,300 price, even though they have strikingly different risk profiles. Thus, the relatively uncommon bad projects get a subsidy from the more common good projects.<sup>63</sup>

The incentives would change significantly if priorities were reversed, so that the contractors had priority over the Bank. In that case, when a bad project resulted in a shortfall of \$200,000, it would be the Bank that would bear the loss, not the contractors.<sup>64</sup> Because the Bank would bear all of that loss, the expected loss to the Bank on each project if it did not attempt to distinguish between good and bad projects would be \$6,000.

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60. Each contractor should charge an amount equal to its \$50,000 costs plus a premium to account for its 5% share of the amount that would be lost upon failure of the project. Because good projects bear an expected loss of \$2,000, each contractor would charge a \$100 risk premium on good projects (5% of \$2,000); because bad projects bear an expected loss of \$42,000, each contractor would charge a \$2,100 risk premium on bad projects (5% of \$42,000).

61. For a similar analysis, see Bebchuk & Fried, *supra* note 9, at 885-87 (arguing that small creditors may not have an adequate incentive to adjust). For simplicity, I assume that there is no likelihood of adverse selection.

62. The \$180 figure is 60% of the individual contractor's expected loss of \$300.

63. Bebchuk and Fried offer a similar numerical example, explaining why individual small creditors would be better off charging a risk premium than expending funds to evaluate risk on a case-by-case basis. Bebchuk & Fried, *supra* note 9, at 886-87. Their framework, however, is considerably less detailed than mine. First, they do not consider the possibility that the level of risk is itself a variable subject to control by the lender; my framework assumes that lenders will react to a perception of risk by expending funds to adopt procedures that will reduce the risk. Furthermore, Bebchuk and Fried do not identify the subsidy for risky projects that follows inevitably from a price structure in which lenders rationally refrain from spending funds to assess risk in the first place.

64. As I explained *supra* at note 57, my simple hypothetical assumes that bad projects will be worth \$1.8 million, which will produce enough to pay the contractors all of their \$1 million in claims, but will leave the Bank \$200,000 short.

Accordingly, it would be rational for the Bank to expend \$2,000 to distinguish between good and bad projects.<sup>65</sup>

Similarly, it will be in the Bank's interest to spend the \$2,000 to implement monitoring procedures to limit the amount of the loss on projects that fail, but only on the riskier projects. The \$2,000 cost of those procedures would be more than the expected benefit of \$1,200 on the good projects.<sup>66</sup> By contrast, the cost of those procedures would be much less than the benefit of \$25,200 on the bad projects.<sup>67</sup> After those expenditures, the Bank will be able to price its loan for each project in a way that takes account of the risk of failure and minimizes that failure when it is efficient to do so. Thus, the Bank will charge \$1,004,000 for good projects<sup>68</sup> and \$1,020,800 for bad projects.<sup>69</sup>

In sum, my model shows how uniting the risk of loss in a single party enhances the incentive to investigate the risk of loss and thus increases the likelihood that the credit system will separate or discriminate between good and bad projects. Uniting that risk also enhances the incentive to incur expenditures for enhanced monitoring that may be appropriate in riskier projects. Thus, uniting the risk of loss enhances the efficiency of the system in two ways: by diminishing the gap between the private and social cost of construction projects, and by decreasing the losses from the inevitable failed projects.<sup>70</sup>

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65. The expenditure of the funds would not be rational because of any reduction in the bank's risk of loss: the bank would be able to charge a risk premium equal to the anticipated loss even if it did not expend those funds. It would be rational because it would allow the bank to charge lower prices for the better projects. A rational borrower with a good project would prefer for the bank to expend the funds to distinguish between good and bad projects because that expenditure would result in a lower total price for the loan. In this example, the expenditure would reduce the charge on good loans from \$1,006,000 (the \$1,000,000 in costs plus the \$6,000 expected loss on a loan of unknown quality) to \$1,004,000 (the \$1,000,000 in costs, plus the \$2,000 assessment fee, plus the \$2,000 expected loss on a good loan). Accordingly, borrowers would be willing to submit to that expenditure because a refusal to submit to that expenditure would signal the borrower's belief that it had a bad project.

66. The \$1,200 figure represents 60% of the bank's expected loss of \$2,000 on good projects.

67. \$25,200 is 60% of the bank's expected loss of \$42,000 on bad projects.

68. \$1,004,000 is the \$1 million loan amount, plus the \$2,000 information costs, plus \$2,000 to account for the risk of loss from the failure of a good but poorly monitored project.

69. \$1,020,800 is the \$1 million loan amount, plus the \$4,000 information and monitoring costs, plus \$16,800 to account for the remaining risk of loss on a bad but well-monitored project.

70. Strategic considerations suggest to me that construction lenders should not be permitted to circumvent the system I propose by obtaining advance waivers of priority from individual contractors. If lenders differentiate between good and bad projects and contractors do not, a system allowing lenders to obtain enforceable advance lien waivers might end up functioning even worse than a first-in-time system, because of the ability of lenders to obtain lien waivers only on bad projects. It is important to distinguish those advance waivers (which my system would not enforce) from the common practice under which construction lenders refuse to advance funds without requiring contractors to "waive" any right to a lien for past work. See generally 2 NELSON & WHITMAN, *supra* note 45, § 12.4, at 191-92 (distinguishing between "no-lien" clauses and course-of-construction lien waivers). As I explain below, the course-of-construction lien waiver seems to me an integral and valuable part of the system for

A common response of readers of drafts of this Article has been that contractors could solve the problems discussed above by entering into joint arrangements for risk assessment and monitoring, so that each would bear its pro rata share of those costs. That solution, however, requires the parties to bear the costs of forming those arrangements. Those costs could be saved entirely by adoption of my approach, which results in a risk united without the incurrence of transaction costs.<sup>71</sup>

Another objection to my system is that it might increase the price that construction lenders charge for construction loans and (if contractors are not currently charging for all of the risk) that the increased charges might cause some proposed projects to fail for lack of financing that would be available under a first-in-time rule. But I see nothing wrong with that result because the only projects that would be deterred would be projects that could be supported only because of the failure of contractors to charge a price that reflected the actual risk of the project.<sup>72</sup>

*B. Risk of Loss in the Construction-Loan Context: An Empirical View*

The abstract economic analysis of subpart A presents a comparison between two simple priority systems—one in which construction lenders have priority (a first-in-time system) and one in which contractors have priority (a nontemporal contractor-first system)<sup>73</sup>—and concludes that the latter system would improve the allocation of financial resources by causing more accurate pricing of credit. Because that analysis is highly stylized and relies on a number of reductionist assumptions, I find it insufficient standing alone to support the significant legal reform that this Article urges.

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controlling the risk of defalcation by the owner and the general contractor. *See infra* note 102 and accompanying text (discussing course-of-construction lien-waiver requirements in construction-loan disbursement procedures).

71. Cf. Krier & Schwab, *supra* note 53, at 470-71 (suggesting that the risk of loss should be placed on the "best chooser" and that "[i]n most instances, the best chooser will be the smallest-number party"). The fact that the marketplace does not contain such arrangements even though they would be beneficial for contractors suggests that the costs of forming and enforcing them would be likely to exceed the benefits that they could provide. Given the large number of contractors involved in significant construction projects, that result is not surprising.

72. Cf. Bechuk & Fried, *supra* note 9, at 917-21 (arguing that a partial diminution of the first-in-time priority rule generally would limit financing only for projects that are unduly risky); LoPucki, *supra* note 12, at 1910-11 (arguing that giving tort creditors first priority would deter only activities that generate more tort liability than profit). For a mathematical formulation of the excessively risky incentive of borrowers to pass the risk to creditors that will not be paid in the event of loss, see Michelle J. White, *Public Policy Toward Bankruptcy: Me-First and Other Priority Rules*, 11 BELL J. ECON. 550, 556-60 (1980).

73. I purposely refer to the rule that I propose as a contractor-first rule rather than a last-in-time rule to emphasize the nontemporal nature of my approach: the contractors should have priority whether they are first or last.

To respond to that concern, I attempted to verify empirically the key factual conclusion that drives my analysis: the single construction lender is more likely to act to assess and control the risk of loss on a construction project than the multiple contractors that contribute labor and services to the project. The research consisted of two general steps. First, during the summer of 1995, I participated in the negotiation and drafting of documents for a mid-sized (\$30 million) construction loan on a shopping center. Second, during the winter of 1995, I conducted a series of fourteen interviews with a variety of participants in the construction business: borrowers, lenders, contractors of various sizes and specialties, title insurers, and construction consultants. Those interviews provided considerable evidence to support the validity of my model: evidence that lenders in fact do more than contractors to assess and control risk, and evidence of the feasibility of a contractor-first system. I address those points in turn.

*1. Responding to Risk in General.*

*a. Assessing risk.*—The central premise on which my analysis of construction contracting rests is the assertion that a single construction lender is more likely to assess the risk of loss from a construction project and adjust the terms of its transaction to account for that risk than the body of contractors subordinated by a vigorous application of first-in-time priority. Practice in the construction industry provides considerable (albeit anecdotal) support for that premise.

The strongest support rests on the categorical difference between the ways that lenders and contractors react to differing levels of risk in a proposed construction project. Although sophisticated contractors are careful to evaluate the financial strength of the parties with whom they deal,<sup>74</sup> they tend to evaluate the financial information that they acquire under a relatively blunt standard, dividing projects into two categories: acceptable and unacceptable. If the contractor believes that the financial position of the owner and the project is unacceptable, the contractor declines to participate. If the contractor believes that the financial evidence meets that minimum standard, the contractor typically does not discriminate further in setting the terms on which it will do business. The perspective of the chief financial officer of one large general contractor is illustrative: “[Y]ou couldn’t put enough money in there, to be honest with you, to

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74. The chief financial officer of the largest general contractor to whom I spoke explained that before doing a project with a company that was “not a household name brand like Motorola” he typically would seek information about the company’s financial strength from Dun & Bradstreet and his company’s investment bankers. Scherer Interview, *supra* note 48, at 13. He went on to explain: “If they’re a private corporation we’re not shy at all about asking for financial information. Sometimes it puts them off . . . [but] [w]e have to do our due diligence [for] our shareholders . . .” *Id.* For similar descriptions of pre-bid financial investigation by a subcontractor and a general contractor, respectively, see Murphy Interview, *supra* note 51, at 4–5 and Poelker Interview, *supra* note 51, at 6.

cover the downside risks if the job falls apart.”<sup>75</sup> When I asked him if he “put a little more in [the bid]” to account for a greater risk of loss in questionable cases, he responded negatively: “I really don’t think we do it.”<sup>76</sup> Similarly, the president of a \$170-million-per-year subcontractor explained: “[W]e’d rather be preventive about the situation, and have a good feel for what we’re going into such that we’re at the level that we’re not going to have financial, payment-oriented problems.”<sup>77</sup> As he concluded, if he has concerns about the financial strength of the owner or the contractor: “We just will not quote the job.”<sup>78</sup> Yet another general contractor executive acknowledged that financial concerns did not normally enter into his pricing decisions, but concluded that “if we would have a doubt [about the owner’s financial strength], we probably would decline to bid.”<sup>79</sup> In sum, under that apparently typical approach, all acceptable projects receive the same financial terms from the contractor.<sup>80</sup>

In contrast, construction lenders discriminate much more precisely in setting terms to account for the risk of loss in construction transactions. The simplest way lenders can discriminate is by altering the nominal price of the transaction: raising or lowering the interest rate to reflect the lender’s judgment of the risk of the particular transaction. It is clear that lenders do not charge a single interest rate for all construction projects; rather, they charge different rates based on such things as the strength of the borrower and the general contractor, the lender’s prior relationship with the borrower, and the perceived riskiness of the project.<sup>81</sup>

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75. Scherer Interview, *supra* note 48, at 14. My impression is that the reason the contractor would not be able to put enough money in to compensate for risk is not that the necessary sum would be incalculable, but that inclusion of a full risk premium would make the bid uncompetitive. For example, the only contractor that suggested to me that he did attempt to take the risk of loss into account in setting his contract price followed that statement with an anecdote in which the owner advised the contractor that it was pointless for the contractor to submit a bid after the contractor expressed concern about the owner’s solvency. See Interview with Allan M. Gallup, President, Gamco Incorporated, in St. Louis, Mo. 4 (Jan. 23, 1996) [hereinafter Gallup Interview] (transcript on file with the *Texas Law Review*).

76. Scherer Interview, *supra* note 48, at 14.

77. Murphy Interview, *supra* note 51, at 4.

78. *Id.* at 8.

79. Poelker Interview, *supra* note 51, at 6.

80. Jim White suggests an alternate mechanism that might allow contractors as a group to price projects in a way that reflects more sensitivity to risk than any individual contractor could achieve. He suggests that contracts let by the most creditworthy developers will attract a larger number of bids, thus forcing the price closer to the competitive equilibrium; contracts let by more doubtful developers might attract fewer bids, resulting in less price competition and a greater potential for supra-competitive pricing. See Letter from Professor James J. White, University of Michigan Law School, to Ronald J. Mann, Washington University School of Law 2 (Mar. 20, 1996) (on file with the *Texas Law Review*). Although none of my interviews provide any support for that suggestion, it does seem plausible. I doubt, however, that it would provide the same effects as the careful risk assessment that is characteristic of sophisticated construction lenders.

81. See Interview with Richmond W. Coburn, Vice President, Commercial Real Estate Division, The Boatmen’s National Bank of St. Louis, in St. Louis, Mo. 3, 6 (July 6, 1995) [hereinafter Coburn

Similarly, lenders frequently protect themselves by requiring an assurance from a financially responsible third party that the general contractor will complete construction of the project as required by its contract: typically a performance bond from a third-party surety or a letter of credit from a financial institution. The starting position for lenders is to require a bond in the entire contract amount,<sup>82</sup> which is likely to cost at least one-half of one percent of the amount of the contract, even for a contractor with exceptionally strong credit.<sup>83</sup> Frequently, however, a lender will accept a less onerous assurance, especially in cases in which the lender is impressed with the reputation or financial strength of the contractor.<sup>84</sup> For example, the lender might agree to accept a letter of credit for a portion of the contract amount.<sup>85</sup> Although a letter of credit

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Interview] (transcript on file with the *Texas Law Review*) (explaining that interest rates on construction loans would depend on, among other things, "how much equity the borrower is putting in," "how strong they are financially," and the bank's previous relationship with the borrower); Telephone Interview with Cynthia C. Sanford, Senior Vice President, NationsBank of Texas, N.A. 6 (July 20, 1995) [hereinafter Sanford Interview] (transcript on file with the *Texas Law Review*) (discussing "risk profiles" of the project, property location, and previous relationship with borrower as factors in setting interest rates); Wood Interview, *supra* note 41, at 3-5 (description by construction lender of factors involved in setting interest rates).

82. See Interview with Carol C. Ballance, Real Estate Officer, and Richmond W. Coburn, Vice President, Commercial Real Estate Division, The Boatmen's National Bank of St. Louis, in St. Louis, Mo. 9 (Dec. 8, 1995) [hereinafter Ballance & Coburn Interview] (transcript on file with the *Texas Law Review*) (explaining that the bond requirement "starts as a standard requirement," but that the lender ends up getting the bond in only about half of its projects); Mueller Interview, *supra* note 50, at 5 (stating a preference for insisting on bonds in transactions above the range of \$3 million).

83. See, e.g., Murphy Interview, *supra* note 51, at 5 (statement of the president of a subcontractor that bond costs for his company are on a sliding scale starting at 0.75% and descending to just under 0.50%); Petersen Interview, *supra* note 52, at 6 (statement of a construction consultant quoting rates of "between one-half and seven-eighths of a point" on projects exceeding \$100,000,000, "depending upon how good the contractor is"); Poelker Interview, *supra* note 51, at 3 (statement of a general contractor describing a sliding scale starting at 0.90% and descending to 0.40%); Scherer Interview, *supra* note 48, at 4 (statement of the chief financial officer of a large contractor that bonds typically cost his company about 0.50% of the contract amount); 2 NELSON & WHITMAN, *supra* note 45, § 12.2, at 159 n.7 (outlining a "typical" declining schedule of bond prices with a marginal cost that always exceeds 0.50%: 1% of the first \$100,000, 0.65% of the next \$2.4 million, and 0.525% of the next \$3.5 million).

84. See Ballance & Coburn Interview, *supra* note 82, at 10 (statement of lending officers that they "certainly" will not accept a letter of credit if they "are not altogether comfortable with [the general contractor]"); Mueller Interview, *supra* note 50, at 13 (explaining that the willingness to permit a departure from the bonding requirement is "a function of whether or not we know the contractors"); Wood Interview, *supra* note 41, at 6-8, 12-13 (discussing the importance of the reputation of contractors in assessing a lender's willingness to make a construction loan without requiring a surety bond).

85. Because an issuer's payment obligation under a letter of credit is more absolute than the obligation of a surety to pay on a performance bond, I expected that construction lenders would prefer letters of credit to surety bonds. For evidence that industry professionals recognize the differing levels of legal obligation, see Interview with T. Barton French, Sr., in St. Louis, Mo. 6-7 (Jan. 9, 1996) [hereinafter French Interview] (transcript on file with the *Texas Law Review*) (statement of a prominent retired St. Louis lender explaining the losses his bank took when it was forced to pay on a letter of credit issued to back up a construction contract, even though a bonding company could have avoided



is likely to cost more per dollar than a bond,<sup>86</sup> the total cost tends to be cheaper because lenders tend to accept letters of credit for relatively small fractions of the contract amount.<sup>87</sup> Finally, in cases of exemplary strength, the lender might waive entirely any secondary assurance of performance by the general contractor.<sup>88</sup> That is particularly common in relatively small transactions, which tend to be performed by relatively small general contractors that tend (without regard to the details of their financial record) to be unable to obtain surety bonds.<sup>89</sup> Those practices indicate that a contractor can achieve considerable cost savings if it is able to satisfy a lender that it is sufficiently stable to justify a waiver of the bond requirement. My interviews suggest that those cost savings are

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payment in the same circumstances) and Petersen Interview, *supra* note 52, at 7 ("The argument for [a letter of credit] is that instant cash is better than a lawsuit against a solvent or insolvent bonding company."). Part of my expectation was fulfilled: lenders shared my view about the strong predilection of sureties to avoid payment. *See, e.g.*, Ballance & Coburn Interview, *supra* note 82, at 9 (statement of an experienced lender that he knew of no one who successfully had sued a surety company on a payment and performance bond); Mueller Interview, *supra* note 50, at 6 (characterizing surety companies as "terrible" and stating that "we've never succeeded in [enforcing collection on a performance bond], where they actually came and finished a job [and] took whatever lumps there were"); French Interview, *supra*, at 4 ("[T]he underwriters at a bonding company told me years ago that their premiums are so reasonable because they expect no actuarial loss . . . . That means that they will fight it until the highest court tells them to pay."); *see also* 2 NELSON & WHITMAN, *supra* note 45, § 12.2, at 160-62 (describing legal doctrines that enable a surety to avoid payment on a performance bond).

Nevertheless, one of the lenders who criticized sureties for their unwillingness to perform on their bonds still preferred surety bonds to letters of credit, apparently because of the perception that the surety called upon to issue a bond would do a more careful job of evaluating the credit of the contractor than a bank called upon to issue a letter of credit. *See* Mueller Interview, *supra* note 50, at 6-7, 13.

86. The chief financial officer of one fiscally strong contractor told me that his company's cost for a letter of credit is usually about 0.75% of the amount of the letter of credit per year while its cost for a performance bond is a one-time charge of 0.50% of the bond amount. Scherer Interview, *supra* note 48, at 5.

87. *See* Ballance & Coburn Interview, *supra* note 82, at 9, 11 (stating that cost is "usually the explanation that's given" when borrowers prefer letters of credit, and that the typical amount of the letter of credit is one-third to one-quarter of the amount of the construction contract); Mueller Interview, *supra* note 50, at 5-6 (explaining that the primary reason that contractors prefer letters of credit to bonds is that the letter of credit is cheaper); *see also id.* at 13 (suggesting that a letter of credit for 15% of the contract amount would be typical); Scherer Interview, *supra* note 48, at 4-5 (offering an example of a letter of credit for 5% of the contract amount).

88. *See, e.g.*, Ballance & Coburn Interview, *supra* note 82, at 10-11 (statement of a lender emphasizing the reputation of a general contractor as the key to a waiver of bond and letter of credit); Poelker Interview, *supra* note 51, at 4 (statement of an officer at a general contractor that his company has done jobs financed by third-party construction lenders without having to obtain a bond); Scherer Interview, *supra* note 48, at 4 (statement of an officer at a general contractor that bonds or letters of credit are "almost" always required by construction lenders); Wielansky Interview, *supra* note 55, at 2 (statement by a successful developer that "[t]here's no lender that makes us [get a performance bond]").

89. *See* Wood Interview, *supra* note 41, at 6-7 (explaining that his bank typically does not require performance bonds because the borrowers are, for the most part, small, local contracting companies); *see also* French Interview, *supra* note 85, at 3-4 (reporting a general absence of bonds in small construction transactions).

enough to make a considerable difference in competition for construction work.<sup>90</sup>

A third way in which lenders can discriminate in protecting against the risk that a project will fail is in establishing the terms of credit-enhancement devices such as guaranties. It is normal in the construction-loan context for lenders to obtain some form of guaranty or other individual liability from the individual principals of the borrowers.<sup>91</sup> But on a case-by-case basis lenders may agree to provisions that allow that recourse liability to dissipate even before the loan has been repaid. For example, it is not unusual for a lender to agree that the principal will bear only "partial" recourse liability, so that the lender can sue the borrower's principal personally only for a stated sum or a stated percentage of the loan amount.<sup>92</sup> Similarly, negotiations over the conditions under which that recourse liability will "burn down" are one of the focal points of negotiations of a construction loan, and one of the key points on which lenders compete against each other for business.<sup>93</sup> Finally, in exceptional cases the strength of the borrower alone is sufficient that the lender might be willing to waive the guarantee requirement entirely.<sup>94</sup>

In sum, actual contracting practices coincide with the prediction of my model. Contractors (acting individually to further their fractionated interests) respond to credit risks in a relatively blunt manner. Lenders, by contrast, use much more precise mechanisms to adjust the terms of transactions on a case-by-case basis to account for the risk of nonpayment. Because the relatively precise adjustment by lenders (and relatively blunt

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90. One lender who specialized in relatively small commercial construction loans explained that point as follows: "[W]hat it comes down to is that we have dealt with that guy before and he tried to screw us or screw our customer and so we're leaving him out of our preferred list. There's no list written down, it's just a matter of who we know is good and who we know is not good." Wood Interview, *supra* note 41, at 8; *see also id.* at 12-13 (further discussing the importance of the reputation of contractors in assessing the need for bonds). The contractor's perspective is similar. One contractor's vice president for finance assured me that his company frequently has the low bid on jobs solely because of his company's relatively favorable bond rate. *See* Poelker Interview, *supra* note 51, at 4.

91. *See* Ballance & Coburn Interview, *supra* note 82, at 23 (describing the importance of guaranties to construction lenders); Coburn Interview, *supra* note 81, at 3-4 (noting that the lender "always conditionally required recourse"); Wood Interview, *supra* note 41, at 5 (statement of a construction lender that it has a "cardinal rule" requiring personal guarantees by the principals of the borrower).

92. *See* Coburn Interview, *supra* note 81, at 4 (acknowledging that lenders on occasion will agree to partial-recourse financing).

93. *See* Sanford Interview, *supra* note 81, at 7 (describing competition among lenders for construction loans based on willingness to "burn down" recourse liability). That point is strongly supported by my experience on a recent \$30 million shopping center construction loan transaction, in which the extent and duration of recourse liability were the key points in the negotiations over the business terms of the construction loan.

94. *See* Wood Interview, *supra* note 41, at 6.

adjustment by contractors) occurs for the most part in an environment in which the risk of loss by lenders is diminished by their general ability to obtain priority under the first-in-time system, that evidence firmly supports my view that adoption of my contractor-first priority rule would result in enhanced care in risk assessment: lenders would be even more careful about adjustment in a system in which they bore the initial risk of loss than they are under the first-in-time system that is currently dominant.<sup>95</sup>

*b. Controlling risk.*—The second problem with first-in-time priority in the construction-loan context is that it limits incentives to control the risk of loss during the course of construction and disbursement. Specifically, the model presented in subpart II(A) predicts that the parties will take more care to prevent losses during the course of disbursement if the primary risk of loss is on the construction lender than they will if the primary risk of loss is on the contractors as a group.

The main risk of loss during the course of disbursement is that the owner or general contractor will divert the funds from the project for which they have been disbursed. That can happen for any of a number of reasons. The owner or contractor might be experiencing cost overruns on another project and want to spend the funds to defray costs on that project; it might need the funds to meet other personal expenses; or it might simply want to “steal”<sup>96</sup> the money and start a new life in another community. Whatever the cause of the problem, contractors are not often in a very good position to protect themselves from diversion. The general contractor does not typically have any control over funds until the owner has refrained from diverting them, and subcontractors, in turn, do not typically have any control over funds until both the owner and the general contractor have refrained from diverting them. Thus, about the most that a contractor can do to prevent losses from diversion of funds is to try to obtain assurances from parties further up the chain that they will segregate funds for the contractor’s benefit.<sup>97</sup> That practice, however, protects at best a limited portion of the funds—the funds due to the contractor that obtains the assurance.<sup>98</sup>

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95. For discussion of evidence regarding what lenders actually do under such a system, see *infra* section II(B)(2).

96. “Steal” is a harsh term for the diversion of money that technically belongs to the owner or contractor, but it does reflect the sentiments of the lender and the subcontractors.

97. See Gallup Interview, *supra* note 75, at 4-5 (recommending the use of escrow funds as a way to protect the contractor from the defalcation or insolvency of a developer or an owner); Scherer Interview, *supra* note 48, at 8 (statement of the chief financial officer of a large general contractor explaining that his company sometimes “will insist that the lender write us a letter . . . indicating that the money for our contract has been segregated in the loan and set aside purely for our purposes so that the developer or the owner can’t use it for any other purpose”).

98. Legislative responses normally treat the diversion as a criminal offense and also typically grant the contractor a lien on the project. See LOPUCKI & WARREN, *supra* note 16, at 652. Assuming that

By contrast, it is quite common for lenders to use a variety of techniques to control the risk of diversion by the developer and the general contractor. The most common is to condition disbursement of funds on presentation of a draw request that includes a schedule of invoices from contractors, to attempt to ensure that funds are disbursed only for work that actually has been done.<sup>99</sup> A related technique (common on smaller projects) provides for draws of specific sums of money upon completion of predefined portions of the work: pouring the slab, enclosing the roof, and the like.<sup>100</sup> As a related requirement, lenders generally will not disburse the entire amount of the invoices, but instead will "hold back" or retain some percentage of those amounts as a fund to protect against future problems.<sup>101</sup> Similarly, lenders typically insist that the draw request include lien waivers from all contractors working on the job, indicating that they have been paid for all work they previously have done on the project.<sup>102</sup> Furthermore, in some cases the lender will insist on an escrow arrangement in which the funds are disbursed directly to the respective contractors.<sup>103</sup>

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the lien is subordinate to the lien of the construction lender, neither of those devices goes far to protect the contractor.

99. See, e.g., Ballance & Coburn Interview, *supra* note 82, at 14-15 (describing the procedure for draw requests that requires evidence of work done by specific contractors); Bonita Interview, *supra* note 41, at 3-4 (noting accounting procedures designed to "see to it month by month that all the trad[e creditors] were being paid" and explaining that "the mechanics' lien risk has been reduced by orders of magnitude by seeing to it that everybody's paid"); Mueller Interview, *supra* note 50, at 2-4 (describing procedures for reviewing draw requests consisting of invoice submission and review by an independent architect as a condition to the disbursement of construction-loan proceeds); Wielansky Interview, *supra* note 55, at 3 (describing a process in which contractors and subcontractors submit a monthly "componentized breakdown" of need before loan proceeds are disbursed). For textbook discussions, see FRANK P. JOHNSON & RICHARD D. JOHNSON, BANK MANAGEMENT 223 (1983), and MICHAEL T. MADISON & ROBERT M. ZINMAN, MODERN REAL ESTATE FINANCING: A TRANSACTIONAL APPROACH 645-50 (1991) (both describing the construction-loan disbursement process).

100. See, e.g., LOPUCKI & WARREN, *supra* note 16, at 651.

101. See, e.g., MADISON & ZINMAN, *supra* note 99, at 649 (stating that a 5-15% holdback or retainage is typical); Ballance & Coburn Interview, *supra* note 82, at 15 (discussing policies that typically require 10% retainage, but sometimes require only 5% retainage after completion of 50% of the work); Bonita Interview, *supra* note 41, at 4 (stating that there is generally a 10% holdback on payments for labor and services).

102. See, e.g., MADISON & ZINMAN, *supra* note 99, at 648 (describing the requirement "that [contractors] waive their lien rights for work and materials for which they have received payments"); 2 NELSON & WHITMAN, *supra* note 45, § 12.4, at 191-92 (characterizing the lien-waiver procedure as "extremely useful to owners and construction lenders"); Ballance & Coburn Interview, *supra* note 82, at 16-17 (describing the requirement of month-by-month lien waivers); Mueller Interview, *supra* note 50, at 3 (describing the requirement that contractors seeking payment waive any claim for work done in previous months); Petersen Interview, *supra* note 52, at 1 (describing the practice of paying contractors "on a one-month lag basis [and] keep[ing] them honest, before they get their next money, with lien waivers"); Wielansky Interview, *supra* note 55, at 3 (describing the requirement that subcontractors sign "waivers that [they] have been paid from the previous draw").

103. See MADISON & ZINMAN, *supra* note 99, at 650; Scherer Interview, *supra* note 48, at 8.

That procedure may be expensive,<sup>104</sup> but it limits the risk of diversion considerably. The main point, though, is that construction lenders choose from a range of procedures that can protect more (or less) carefully against the risk of diversion. Their ability to choose procedures with varying levels of expense and intrusiveness gives them a considerable flexibility to take account of the perceived riskiness of the transaction.

2. *Responding to Risk in a Contractor-First World.*—My view that a contractor-first system would lead to more attention to risk is bolstered significantly by the perspectives of parties who already operate under such a system. At least one state (Missouri) already has rules that approximate that system.<sup>105</sup> I interviewed lenders from three institutions that make construction loans in both types of jurisdictions: Missouri (where construction lenders are subordinate) and other states (where construction lenders generally have priority). All of those lenders are aware of the difference in the legal regimes and understand that the Missouri rule puts them at a greater risk of loss.<sup>106</sup> When I asked them if the rule discourages them

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104. See Ballance & Coburn Interview, *supra* note 82, at 16 (explaining that it is cheaper for the general contractor to cut individual checks than for the lender to do it). The vice president for finance for one contractor explained that disbursement controls are expensive not only because of the costs of the procedure itself, but also because they deprive the general contractor of the ability to use disbursement as a device to reward superior and punish inferior performance by its subcontractors. Poelker Interview, *supra* note 51, at 4. In particular, he complained that disbursement controls effectively deprive him of the ability to police subpar work that becomes evident after the time for submitting a draw request. *Id.*

105. See *H.B. Deal Constr. Co. v. Labor Discount Ctr., Inc.*, 418 S.W.2d 940, 953-54 (Mo. 1967) (holding that principles of equity require subordination of the lien of a lender that funds construction to the liens of parties that supply labor and materials to the project). One of the most interesting aspects of this project was my learning that the cursory and ambiguous decision in *H.B. Deal* has resulted in a broad understanding in the industry that Missouri law is set firmly against construction lenders in this context. That understanding ranges from the leading legal commentators, see R. KRATOVIL, *MODERN MORTGAGE LAW AND PRACTICE* § 214, at 138-40 (1972) (noting Missouri's "curious" rule on that issue), to title insurers, see Bonita Interview, *supra* note 41, at 11 (statement of a chief underwriting counsel for an insurer that issues insurance in all domestic jurisdictions where it is lawful, describing Missouri's mechanics' lien laws as the "nastiest" in the nation); Telephone Interview with Jim Gosdin, Stewart Title Guaranty Company 2-3 (Jan. 11, 1996) [hereinafter Gosdin Interview] (transcript on file with the *Texas Law Review*) (stating that his company does not issue mechanics' lien coverage in Missouri because of past losses), to nonlawyer executives, see Petersen Interview, *supra* note 52, at 3-4 (statement of a disbursement advisor with experience in "23 or 24" states that "there is no mechanics' lien situation in the country any tougher than Missouri"). Dale Whitman has pointed out to me that the conventional understanding of *H.B. Deal* as a common-law decision is difficult to reconcile with the actual setting of the case. In his view, the unique outcome is attributable to an unusual provision of Missouri statutory law that mandates that construction liens be subordinated to labor and service liens. See Letter from Professor Dale A. Whitman, Brigham Young University Law School, to Ronald J. Mann, Washington University School of Law 2-3 (Apr. 2, 1996) (on file with the *Texas Law Review*) (citing MO. REV. STAT. § 429.050 (1994)).

106. See Ballance & Coburn Interview, *supra* note 82, at 4; French Interview, *supra* note 85, at 1-2; Mueller Interview, *supra* note 50, at 2, 13-14.

from doing construction loans in Missouri, all had the same general response: they are willing to make loans in Missouri despite the lower priority, but they are more careful about risk there than they are in jurisdictions where they have a better priority position.<sup>107</sup> That increased care is exactly what the system should seek because that increased attention to risk results in pricing that more accurately reflects the value of individual construction projects.

The primary way that lenders deal with the increased risk appears to be through increased care in the disbursement process.<sup>108</sup> Indeed, one lender told me that the system under which lenders themselves disburse funds to the individual contractors originated as a specific response to the contractor-first priority rules adopted in Missouri, based on the idea that control over disbursement was necessary to make it acceptable to bear the risk of construction lending in a contractor-first system.<sup>109</sup>

Another response to the contractor-first priority system comes from title insurers. Whether contractors or lenders have priority, lenders generally try to pass the risk of loss from competing claimants to a title insurance company. The traditional way of transferring that risk is to obtain an endorsement to a title-insurance policy that insures the lender against any loss the lender suffers from a contractor obtaining a lien that defeats the lien of the lender.<sup>110</sup> In states where the legal system permits lenders to obtain priority over the contractors, the risk of the insurer in offering such insurance is essentially a procedural one: the insurer is at risk only if the lender fails to follow the procedures necessary to obtain priority over the contractors.<sup>111</sup> By contrast, the risk is much more substantive in a system (like the one in Missouri) in which the contractors have prior-

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107. See Ballance & Coburn Interview, *supra* note 82, at 23 (stating that the harshness of Missouri lien rules "would be reflected in the procedural requirements in our construction loan agreement"); French Interview, *supra* note 85, at 1-2 (observing that disbursing controls were implemented in Missouri in response to the risk of loss to contractors' liens); Mueller Interview, *supra* note 50, at 2 (stating that he accounts for the increased risk "primarily through the disbursing process").

108. See Ballance & Coburn Interview, *supra* note 82, at 23 (rejecting the possibility of higher interest rates or guaranties to accommodate priority risk, and explaining: "No, no, the only changes you're going to see would be reflected in the procedural requirements in our construction loan agreement."); Mueller Interview, *supra* note 50, at 2 (noting the use of detailed loan agreements and third-party inspections to protect disbursements); Petersen Interview, *supra* note 52, at 4 (suggesting that Missouri's priority system has caused the development of "extraordinary rules about the handling of money"). Petersen's suggestion is supported by the statement of one general contractor that he frequently was asked to submit to disbursing controls in Missouri but never had been asked to submit to such an arrangement on work that he did in Illinois. See Poelker Interview, *supra* note 51, at 5.

109. See French Interview, *supra* note 85, at 1-2.

110. See MADISON & ZINMAN, *supra* note 99, at 635-36 (describing typical title-insurance requirements for construction loans); Ballance & Coburn Interview, *supra* note 82, at 4-5; Mueller Interview, *supra* note 50, at 4-5 (statements of lending executives that they always insist on title-insurance coverage to protect against contractor claims, whether or not the loan is in Missouri).

111. See Gosdin Interview, *supra* note 105, at 3.

ity over the lender as a matter of law. In that system, the lender and the insurer are at risk whenever a party performs work on the project without being paid.<sup>112</sup> The result is that lenders and title insurers in Missouri tend to monitor disbursement of the loan proceeds with more care than they do in other states,<sup>113</sup> frequently insisting that they supervise any disbursement of proceeds to ensure that all of the insured loan amount is expended to pay parties providing work on the project, and that none of the funds are diverted to other purposes or projects.<sup>114</sup>

Those procedures may be expensive: various individuals reported a standard charge by a title company ranging from 0.50% to 1% of the loan amount for monitoring the disbursement.<sup>115</sup> But I see no reason to believe that the costs are wasted. Although one of the lenders suggested that the charge was "standard," it is clear that title-insurance companies do not insist on supervising disbursement in all cases. On the contrary, in cases

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112. I was surprised to learn from the chief underwriting counsel of a major national title insurer that title insurers frequently accept that same risk voluntarily in other states, by issuing mechanics' lien coverage even in cases in which they know that the mechanics will have priority, most commonly because construction commenced before the time of the loan. Bonita Interview, *supra* note 41, at 3, 5-6; see also Gosdin Interview, *supra* note 105, at 6 (describing situations in which there was "a decision to provide coverage" in the face of a known problem).

113. See, e.g., Mueller Interview, *supra* note 50, at 2 (stating that the "disbursing process" is the primary way that lenders respond to the risk that mechanics' liens will have priority over their liens under a contractor-first priority system); Petersen Interview, *supra* note 52, at 3, 5, 3-5 (suggesting that obtaining adequate coverage in other states is "a piece of cake" compared to obtaining coverage in Missouri and that insurers in other jurisdictions "don't pay much attention" to issues that would be "routine" requirements in Missouri).

114. See Ballance & Coburn Interview, *supra* note 82, at 8 (statement of lending executives who had dealt with the same title insurance company in multiple states that the title insurance company's disbursement procedure outside Missouri "was not nearly as tough as in Missouri"); Bonita Interview, *supra* note 41, at 5 (statement of the chief underwriting counsel for a major national title insurer agreeing that he analyzes the economics of a project more carefully in states where the contractors have priority over the insured construction lender's lien); Petersen Interview, *supra* note 52, at 2 (stating that one of the three or four title insurance companies that issues mechanics' lien coverage in Missouri "almost always insists that they handle the money"); Wood Interview, *supra* note 41, at 9-10 (statement of a lending executive who specializes in relatively small commercial construction loans that he generally requires use of that procedure on Missouri transactions above \$250,000). Indeed, the risks are so substantial that some insurers refuse entirely to do business in states where the priority of the lender is not sufficiently clear. See Ballance & Coburn Interview, *supra* note 82, at 7-8 (stating that "only a handful" of companies will issue mechanics' lien coverage on large commercial projects in Missouri); Gosdin Interview, *supra* note 105, at 2 (explaining that his company refuses to issue mechanics' lien coverage in several states (including Missouri) because past losses suggest that the risk is unacceptably high).

115. Ballance & Coburn Interview, *supra* note 82, at 24-25; French Interview, *supra* note 85, at 2 (both offering 1% as a standard fee); Petersen Interview, *supra* note 52, at 2-3 (offering 0.50% as a standard fee). There does not appear to be any savings in lower expenditures by the lender because lenders appear to review the draw requests just as carefully even if the title-insurance company is making the actual disbursements. See Ballance & Coburn Interview, *supra* note 82, at 24-26 (explanation of construction lending executives that "we don't put as much faith in the title companies when it comes to the nuts and bolts as maybe some people think we do").

in which parties of unquestioned financial probity and strength are involved, lenders and title companies alike are much more lenient about the disbursement process.<sup>116</sup> For example, an officer at one major title insurer explained that his company does not universally insist that it control disbursements. Instead, it decides how cautious it will be after assessing the economics of the project and the experience of the general contractor and developer.<sup>117</sup> That insurer's perception is consistent with the practices reported by financially strong developers, as well as those that lend to them. For example, one shopping-center developer to whom I spoke indicated that lenders and title insurers typically trust it to cut the individual checks to the various contractors to whom payment is due.<sup>118</sup> Finally, an experienced Missouri lender reported that the title insurance company normally will not insist on controlling disbursement if the contractor and the developer "were really strong financially."<sup>119</sup>

In sum, the end result is the same as my model predicts: pressures of the market lead to a relatively sensitive discrimination in contracting practices that expends greater efforts to limit losses in riskier transactions but is more lenient in safer transactions.

### III. Trading Adjustment Against Other Concerns

#### A. *Balancing Simplicity and Adjustment*

Although Part II explains the adjustment-related benefits of a rule giving contractors priority over construction lenders, the case for that rule is not complete until I address the possibility that my rule is not optimal because of the complexity that it adds to the credit system. As I explain above, the first-in-time priority rule compares favorably to many systems that determine priority based on nontemporal factors (like possession) because a first-in-time system allows parties to obtain priority and determine that they have priority at a relatively low cost.<sup>120</sup> If my rule

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116. See Petersen Interview, *supra* note 52, at 2 (suggesting that title companies evaluate "the credit reputation of the contractor and the strength of the owner" in deciding what coverage to issue).

117. See Bonita Interview, *supra* note 41, at 6; Petersen Interview, *supra* note 52, at 2 (suggesting that insurers decide whether to insure a job "based upon the strength of the indemnities they get out of the contractor and the owner").

118. See Wielansky Interview, *supra* note 55, at 3-4.

119. See French Interview, *supra* note 85, at 3.

120. See *supra* section I(A)(1). That point is crucial to my general thoughts about lien priority because it is the center of my skepticism about the "tort-first" movement. See *supra* note 34 and accompanying text (citing representative tort-first literature). Specifically, I doubt that a simple elevation of the priority of all creditors whose claims technically sound in tort would produce satisfactory results because I believe that many tort creditors in fact have a practicable opportunity to adjust to priority losses in setting the terms of their relationship with the tortfeasor. For that reason, I doubt that elevating all tort creditors above secured creditors would improve the efficiency of the credit system.



theoretically increases the ability of parties to adjust and account for risk, but at the same time makes the system unacceptably complicated, then my proposal would not be superior to a pure first-in-time system. Although reasonable minds could differ, this subpart explains my view that the system that I propose would not significantly increase the costs that parties expend to obtain and evaluate their priority position.

First, I see no reason to believe that construction lenders or contractors would spend any more on obtaining priority under my system than they do under the system that dominates current practice. Construction lenders undoubtedly still would search the real-estate records to ensure that they are aware of all prior liens not related to their project. Nor does it seem reasonable to suppose that the elevation of contractors to higher priority would give contractors an incentive to conduct any more lien searches than they do now.

Similarly, I doubt that my system would leave parties in any significantly greater doubt about their priority than the current system. Even if construction lenders cannot discover the claims of contractors by searching the real-estate records before they make their loans (because those claims would not yet exist), they have no reason to be surprised when the contractors subsequently appear and do work: it is inconceivable that a reputable lender would make a construction loan without a detailed understanding of the work to be done by the major contractors, as well as the amounts anticipated to be paid to each of them.<sup>121</sup> The construction lender may not be able to predict in advance which (if any) of the contractors ultimately will go unpaid, but that does not suggest a flaw in my proposal. The difficulty of predicting losses is the problem that the current system does not address adequately. Adoption of the contractor-first rule should make that problem better, not worse, by bringing more appropriate incentives to bear on that problem.

My view that a contractor-priority rule is workable is strongly supported by the perspectives of businesspeople who work in both lender-first and contractor-first systems. I spoke to contractors, borrowers, lenders, and title insurers that work on transactions in both lender-first and contractor-first systems. I heard little or no concern about the workability of the contractor-first system.<sup>122</sup> None identified any difficulty beyond

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121. Construction lenders are surprisingly sanguine about their ability to identify all of the parties on the construction site. See Mueller Interview, *supra* note 50, at 3 (statement of a construction lender that he typically has a detailed understanding of the contractors and subcontractors who will be working on the project and the amounts of their contracts). Even if they are not so capable as they believe, I do think that it is fair to believe that any reasonably competent construction lender will have a detailed understanding of at least the major expenses to be paid and their recipients.

122. The single exception was a title insurance professional who indicated that his employer's loss experience on mechanics' lien coverage in contractor-first states like Missouri had caused it to stop

the one I discussed above: it has a tendency to increase the costs of construction lending in cases in which the borrower and the contractor have less than redoubtable financial strength.<sup>123</sup> But I see that as a benefit, not a detriment. Assuming that the parties are acting rationally,<sup>124</sup> they would not be incurring the costs if they were not appropriate to protect against significant risks of loss. If the costs of protecting against those losses increase the costs of high-risk projects in comparison to the costs of low-risk projects, that does not suggest a problem with the system. It suggests that the system is working exactly as it should, to make sure that projects that involve large risks of loss bear prices that reflect those risks.

Finally, if there is any concern about the uncertainty of a system under which unidentified contractors can gain unanticipated priority over the lien of a construction lender, I must point out that even the broad defense of first-in-time priority for construction lenders in the *Restatement* contemplates a loophole that leaves open the possibility of priority for contractors in circumstances that are much less certain than those I propose. Specifically, the *Restatement* suggests that courts should

impos[e] . . . a duty of good faith and fair dealing on construction lenders, so that those who injure junior lienors by the use of negligent or lax disbursement procedures are held liable for the losses they cause. Elevation of the junior lienors' priority is an appropriate way to impose that liability.<sup>125</sup>

The twofold motivation for that approach is commendable: it offers a rule that plausibly could be adopted by courts without statutory enactment, and

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issuing title-insurance coverage in those states. It is clear, however, that other insurers are happy to provide that insurance. See, e.g., Ballance & Coburn Interview, *supra* note 82, at 8 (listing title insurance companies willing to issue that coverage on commercial projects in Missouri); Bonita Interview, *supra* note 41, at 3 (statement of the chief underwriting counsel for Chicago Title Insurance Company remarking that Chicago Title is willing to issue that coverage in Missouri); Petersen Interview, *supra* note 52, at 2 (statement of a disbursement adviser noting that "there are three or four companies" that issue that coverage in Missouri). My assessment of the situation is that it is not profitable to issue the coverage unless the insurer is willing to devote the resources to ensure that it has trained employees capable of dealing with the unique problems of the system. The fact that several companies do so suggests that it is feasible for title insurers to accommodate the risks in question.

123. It would be extraordinarily difficult to determine by direct observation whether an alteration of the priority rules changes the price of construction loans or the price of newly constructed buildings. The immense number of factors that go into determining the cost of any particular loan or project, including the effects of all of the relevant legal rules, would make it very difficult to attempt to isolate the effect of a change in rules of lien priority. I do think, however, that the anecdotal evidence presented in this Article supports my view that an alteration of the rule of priority would have the beneficial effects that my model predicts.

124. The sophistication of the parties and the amount of money they have at stake convince me that their actions are not far from rational.

125. RESTATEMENT, *supra* note 5, § 2.3, Reporters' Note, at 100-01 (Tentative Draft No. 1, 1991). Because that discussion appears in a reporters' note rather than the body of the *Restatement* or its comments, it does not reflect the views of The American Law Institute. Telephone Interview with Grant Nelson, Reporter, *Restatement (Third) of Property—Sec. (Mortgages)* (Mar. 4, 1996).

it would provide some enhancement of the lender's incentive to adopt the kinds of risk assessment and control procedures that are the focus of my proposal.

But the uncertainty inherent in that system would prevent it from working nearly so cleanly as my proposal. Because it relies on a completely open-ended standard—a duty of “good faith and fair dealing”<sup>126</sup> to be violated by “the use of negligent or lax disbursement procedures” and with an alteration of priority as an “appropriate” remedy—that proposal in fact would create a strong likelihood of the kind of expensive and time-consuming litigation that a first-in-time rule is supposed to avoid.<sup>127</sup> My broader proposal, by comparison, would provide a clear rule of contractor priority that should minimize the need for litigation about priority issues.

Construction lenders may not know in advance the amount of unpaid contractors' claims that will be associated with any particular project. But they do have the incentive and the ability to obtain detailed information about the work that will be done and thus to form reliable estimates regarding the risk that contractors will go unpaid. That system may not be as certain and simple as a pure first-in-time system, but empirical evidence suggests that it is completely practicable. Moreover, it definitely is more certain than either the system we have now<sup>128</sup> or the system described in the *Restatement*. Given the potential for a contractor-first priority system to enhance risk assessment and control, it is fair to say that changing to that system would bring an improvement over current rules.

#### B. *Adjustment and Other Costs: The Case Against Fixed-Fraction Priority*

Where the *Restatement* responds to the difficulties that exist in current construction law by enhancing the priority of first-in-time construction lenders, Lucian Bebchuk and Jesse Fried recently argued in the *Yale Law Journal* that the general problem of nonadjusting creditors justifies a

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126. The use of a duty of “good faith and fair dealing” as a tool to protect contractors is particularly debilitating to the lenders' ability to estimate future costs because of the possibility that violations of that duty will result in punitive or other extracompensatory damages. The *Restatement* offers nothing to dispel that concern. For a contemporaneous decision that the need to allow lenders to estimate costs justifies a limitation on the availability of extracompensatory damages, see U.C.C. § 5-111 & cmt. 4 (1995) (rejecting the availability of consequential, punitive, and exemplary damages for wrongful dishonor or repudiation of a letter of credit).

127. For a similar reaction to a proposal by Professor LoPucki that would subject first-in-time secured creditors to a vague and uncabined subordination, see Susan Block-Lieb, *The Unsecured Creditor's Bargain: A Reply*, 80 VA. L. REV. 1989, 2014 (1994):

In many instances, however, the law accepts a degree of imprecision when it embraces a prophylactic rule rather than a factual standard—the imprecision of an objective standard often is overlooked as less problematic than both the uncertainty created ex ante and the judicial effort required ex post by a subjective standard.

128. For sources discussing the ambiguity of the current system, see *supra* note 42.

reform in the opposite direction, a partial limitation of priority for first-in-time secured creditors. Under their proposal, first-in-time secured creditors would retain some priority, but a portion of the value of their collateral would be allocated to nonadjusting creditors.<sup>129</sup>

Bebchuk and Fried offer two different ways of calculating the fund available for later-in-time creditors. The first is an adjustable-priority rule, under which "claims of nonadjusting creditors would not be subordinated to secured claims with respect to which they were nonadjusting."<sup>130</sup> They abandon that proposal, however, principally because "it would clearly not be feasible to determine whether each creditor had in fact 'adjusted' to each particular security interest."<sup>131</sup> They recognize that it would be possible theoretically to identify particular classes of creditors entitled to priority (tort and small-dollar claimants, to use their examples), but end up rejecting that approach because it would leave secured creditors uncertain of the magnitude of the debts in front of them, and thus uncertain of the value of their security interest: after all, it is difficult for a secured creditor at the time it makes a loan to predict the dollar value of claims to be held by future small-dollar claimants.<sup>132</sup> Their second proposal is for a fixed-fraction priority rule, under which a secured creditor would have priority only to the extent of a fixed fraction of its claim (they suggest seventy-five percent, the figure they say is used in an analogous German proposal).<sup>133</sup> They acknowledge that a decrease in the priority of secured creditors would vitiate some of the efficiency benefits of secured credit, but argue that benefits flowing from the increased potential for adjustment under their fixed-fraction priority scheme justify its adoption as a reasonable compromise.<sup>134</sup>

At least in the context I discuss in this Article, my contractor-first proposal is superior to the fixed-fraction priority rule that Bebhuk and Fried support. The basic difference between that proposal and mine is that theirs gives the second-in-time creditors partial relief from first-in-time priority, where I would alter the priority completely. They do not expressly state their reasons for supporting only a partial inversion of priority, but the limitation of their proposal to a partial alteration of priority appears to represent a compromise designed to increase the poten-

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129. Bebhuk & Fried, *supra* note 9, at 909-34.

130. *Id.* at 905-09.

131. *Id.* at 908.

132. *See id.* at 908-09 (noting that such an approach would create uncertainty for secured creditors).

133. *Id.* at 909-11 (citing Jochen Drukarczyk, *Secured Debt, Bankruptcy, and the Creditors' Bargain Model*, 11 INT'L REV. L. & ECON. 203, 205 (1991)). The fixed-fraction priority scheme closely resembles a plan proposed in England during the early 1980s. *See* John Hudson, *The Case Against Secured Lending*, 15 INT'L REV. L. & ECON. 47, 59 (1995) (discussing the English proposal).

134. Bebhuk & Fried, *supra* note 9, at 913-23.

tial for adjustment and at the same time minimize the uncertainty costs that would be associated with an adjustable-priority regime. As I explained above, however, my proposal does not inflict the kinds of uncertainty costs that would accompany their adjustable-priority regime. My proposal does not leave the construction lender behind the vague and undefinable classes of creditors discussed by Bebchuk and Fried: tort and small-dollar claimants.<sup>135</sup> Rather, my proposal leaves the construction lender behind a class of creditors holding claims in an amount that the construction lender has a practical ability to predict and control.<sup>136</sup> In light of the ready ability of construction lenders to operate in a similar system now, I see no reason to believe that adoption of my proposal would undermine the certainty of the system significantly.

Bebchuk and Fried also identify three efficiency costs of partial priority, which (they suggest) cut against any proposal to depart from first-in-time priority, and thus provide a factor limiting the size of the fraction of collateral value to be allocated to second-in-time creditors.<sup>137</sup> My proposal does not significantly implicate any of those concerns. The first is increased information-acquisition costs, by which Bebchuk and Fried mean expenditures incurred to evaluate risk.<sup>138</sup> My proposal would be likely to bring an increase in the expenditures to evaluate the risk, but that is only because the current system's fractionation of the risk of loss artificially (and inappropriately) depresses the incentive to respond to risk. By uniting the highest possible portion of the risk of loss in the construction lender, my proposal gives a single party an incentive to expend funds to evaluate risk whenever the expenditure appears likely to produce information sufficiently valuable to justify the expenditure. Thus, although my proposal should increase expenditures, the new expenditures should be value-increasing, and thus their existence does not suggest a defect in my proposal.

The second cost that Bebchuk and Fried identify is the increased cost of coordinating monitoring efforts among creditors.<sup>139</sup> On that point, my proposal actually should improve matters over the current system, again because it unites the risk in a single party. Under the current system, effective monitoring is hindered by the costs that the parties that bear the

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135. *See id.* at 908-09.

136. *See supra* note 121 and accompanying text (discussing the ability of construction lenders to identify the amount of potential adverse claims).

137. I provide a different (and considerably more extensive) categorization of the benefits of priority for secured creditors in Mann, *supra* note 1. Because my present purpose is to respond to the analysis presented by Bebchuk and Fried, I organize the discussion here according to the framework that they present.

138. Bebchuk & Fried, *supra* note 9, at 914-15.

139. *Id.* at 915-17.

bulk of the risk of loss would have to incur to reach agreements on monitoring and risk assessment.<sup>140</sup> My proposal, by contrast, would put the bulk of the risk of loss on a single party, thus reducing substantially the need to incur those costs.

The final possible cost of limiting first-in-time priority identified by Bebchuk and Fried is the possible reduction in financing for desirable activities.<sup>141</sup> On that point, however, they conclude (as I argue here), that a reduction of first-in-time priority that enhances adjustment in fact increases efficiency because the activities from which financing is likely to be withdrawn are activities that could have been financed only through the externalization of the risk of loss to nonadjusting creditors.<sup>142</sup> That point, if anything, demonstrates why my proposal is superior to the fixed-fraction priority proposal Bebchuk and Fried advance. For the same reason that a fractional limitation of first-in-time priority provides some enhancement of the incentive to adjust, my priority-flipping proposal provides the most complete possible enhancement of that incentive because it puts a much greater share of the risk of loss on a single party, bringing the incentive to incur the costs necessary to make a prudent adjustment as close as practicable to the socially optimal level.

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In a sense, it is unfair to compare my proposal to the fixed-fraction proposal that Bebchuk and Fried articulate. Their project aims to provide an abstract general analysis of priority questions, and thus they have no occasion to consider the context-dependent reasons I can advance to support my proposal. But the difference of analysis goes deeper than the scope of individual projects. Attention to context is a fundamental part of my approach, which rests on the premise that we can make no sense of commerce without attention to the rich variety of sophisticated commercial practice. Because I start from that premise, I believe that it is fruitless to try to design a system for commercial law without first understanding the underlying commercial practices.<sup>143</sup>

Of course it could be counterproductive to create an open-ended system with dozens of pigeonholes for all sorts of transactions: litigation over the boundaries and propriety of the various pigeonholes could consume more resources than the contextualized rules could save. But I do

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140. See *supra* note 71 and accompanying text.

141. Bebchuk & Fried, *supra* note 9, at 917-21.

142. Cf. LoPucki, *supra* note 12, at 1910-11 (making a similar argument with respect to giving priority to tort creditors).

143. I have attempted to further that goal in the secured-credit context in my work on the general pattern of secured credit, Mann, *supra* note 1.

think that the analysis in this Article provides a first example of the way in which contextualized analysis can bring significant benefits to the system, by retooling a discrete area that currently is beset with complicated, inconsistent, and counterproductive rules.

#### IV. Conclusion

The programmatic thesis of this Article is simple: rules of lien priority matter. And they matter not just because we care who wins and loses in the struggles for survival in our economy. They matter because changing the rules for lien priority can change significantly the incentives of the parties governed by the rules, in ways that directly affect the allocation of productive assets in our economy. In an era so troubled by what many perceive to be an excessive rate of business failure, there is no excuse for ignoring the effects that legal rules can have on the incentives of parties to reduce the social dislocation of business failures. This Article shows how priority rules can do just that.