

UCC § 9-301(4) [1972] vs. IRC § 6323(c)(1)(A)(ii) [1966]

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The effect of the Federal Tax Lien Act upon lenders tends to increase the potential risk factor inherent in both secured and unsecured loans to the contracting industry. This would be especially true in the case of a small undercapitalized contractor of relatively limited liquidity, whose volatile dependency on economic trends makes him a marginal risk even under reasonably "normal" conditions.¹

The present comment is mostly a quibble. Commercial Law cognoscenti will have already recognized that we intend to discuss one of the proposed 1972 revisions of Article 9 of the Uniform Commercial Code (UCC);² and more particularly, some practical effects of the way in which the new statute will interact with one of the more deeply buried provisions of the 1966 Federal Tax Lien Act.³ We will not iterate, any more than is absolutely necessary, existing analyses⁴

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1. From a letter to the authors written by a commercial loan officer of a large national bank. The writer requested anonymity for his bank and himself.

2. The 1972 round of amendments is nominally the work product of the Uniform Commercial Code's (UCC) Permanent Editorial Board (PEB). The PEB membership is drawn from and reports to the American Law Institute (ALI) and the National Conference of Commissioners on Uniform State Laws (NCCUSL). The ALI and NCCUSL approved the PEB's recommendations in 1972, and promulgated the amendments for adoption in all 49 states which have enacted the UCC. The amendments were directed principally to Article 9 though some few sections in other articles were revised where necessary to maintain their interrelation with the Secured Transactions article.

As of this writing, the 1972 revisions are in effect in 14 states: Arizona, Arkansas, California, Illinois, Iowa, Kansas, Nevada, North Carolina, North Dakota, Oregon, Texas, Virginia, West Virginia, and Wisconsin. 1 UCC REP. SER. APP. 2 (1975).

3. Act of Nov. 2, 1966, Pub. L. No. 89-719, §§ 101-14, 80 Stat. 1125, *amending* INT. REV. CODE of 1954, §§ 6321-7810.

4. The most comprehensive work is W. PLUMB, FEDERAL TAX LIENS (3d ed. 1972)

of the broader interplay between the two Codes of which these subsections are only minor parts, but will restrict our discussion to one curious place at which the draftsmen of the 1972 UCC revisions made, to put it simply, a mistake. This narrowness of focus is not meant to belittle the practical importance of their error. It is, in fact, our opinion that the financial interests at stake may well justify a correcting amendment before the enactment process reaches the point at which correction becomes politically impossible.

The discussion will proceed in four parts. In Part I we set out, in purely analytical terms, the manner in which § 9-301(4) [1972] fails fully to jibe with the state law delegations in Internal Revenue Code § 6323 (IRC). Part II is an overview of the industry and the transactions which are theoretically affected by this imperfect fit between the two subsections. Part III describes our attempt to ascertain the empirical accuracy of some of these theoretical suppositions. Finally, Part IV essays some casual observations about statutory drafting and ubiquitous codes.

I

The question concerns the competing creditors of a troubled business, and the relative priorities of their rights to its assets. On the one hand is a commercial lender or trade creditor armed with a perfected Article 9 security interest in all or a part of those assets (the debtor's accounts receivable, for example). On the other hand there is the Internal Revenue Service (IRS) with its claim for unpaid taxes (FIT wage withholdings and FICA contributions as well as the firm's own income taxes),⁵ expressed by a lien on the taxpayer/debtor's property (the accounts receivable, for example). The business debtor itself is

[hereinafter cited as PLUMB]. As to the Internal Revenue Code and Article 9 more particularly see Coogan, *The Effect of the Federal Tax Lien Act of 1966 Upon Security Interests Created Under the Uniform Commercial Code*, 81 HARV. L. REV. 1369 (1968) [hereinafter cited as Coogan]; Silberfeld, *The Federal Tax Lien Act of 1966: Has it Helped Commercial Secured Lending?*, 57 J. COMM. BANK LENDING 37 (Nov. 1974). On Article 9 and the pre-1966 tax lien law see 2 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY ch. 40 (1965) [hereinafter cited as GILMORE].

5. Employers are liable to the IRS for individual income taxes required to be withheld from their employees' wages (even if not collected from employees), INT. REV. CODE OF 1954 § 3403, and must report quarterly. Payments to the IRS or a tax-depository institution must be made at least quarterly, though typically monthly or more often, INT. REV. CODE OF 1954 § 6151; Treas. Reg. § 31.6151. The same applies to FICA ("Social Security") taxes, INT. REV. CODE OF 1954 § 3102, and employers' contributions, *id.* § 3111.

all but a financial carcass in many such priority dispute cases, and the contending claimants jostle for the first bite of assets which are insufficient to satisfy both appetites completely.

Although the Article 9 creditor can usually well protect itself against competition from other claimants whose rights are similarly determined by state law,⁶ it cannot always be prior to the IRS. The federal tax lien is made paramount, by federal law, to all private interests other than those to which the federal statute expressly subordinates the IRS' claim.⁷ Since 1966, however, the federal tax lien law has been far less insidious than it had been in decades past, and considerably more deferential to the claims of state-law-protected creditors.⁸ For example, until it has been filed for public record⁹ the

6. UNIFORM COMMERCIAL CODE §§ 9-201, 9-301, and 9-312 [hereinafter cited as UCC]; *but cf.* UCC § 9-310.

7. INT. REV. CODE OF 1954 §§ 6321, 6323.

8. For the three-plus decades prior to the passage of the 1966 Tax Lien Act, the law with respect to priorities was as dubious and uncertain as it was insidious. Federal case law before 1966 had slowly been developing to the conclusion that a security interest was "inchoate" and therefore unperfected as against a federal government claim until definite advances were actually made—*i.e.*, the security interest would only be protected to the extent of disbursements made before the lien was imposed.

This concept of an inchoate lien was first juridically articulated in *Spokane County v. United States*, 279 U.S. 80 (1929), which held that the federal priority accorded by REV. STAT. § 3466 (now 31 U.S.C. § 191, giving United States claims absolute priority over other claims when the obligor becomes insolvent) defeated local tax liens antedating the event prompting § 3466's application: The local liens were not sufficiently specific, perfected, or complete at the time the receiver was appointed.

Although at first the Treasury used the inchoate lien doctrine to attack only statutory liens, the Internal Revenue Service soon began to contend that the inchoate lien concept should be adopted by analogy to federal tax lien questions as well. See GILMORE, *supra* note 4, at 1052-53; Kennedy, *The Relative Priority of the Federal Government: The Pernicious Career of the Inchoate and General Lien*, 63 YALE L.J. 905, 911-30 (1954).

First to be attacked were inchoate judicial liens, in a series of not always unambiguous opinions by the Supreme Court. See *United States v. New Britain*, 347 U.S. 81 (1954); *United States v. Gilbert Associates, Inc.*, 345 U.S. 361 (1953); *United States v. Security Trust & Sav. Bank*, 340 U.S. 47 (1950).

Then, in 1958, the inchoate lien doctrine was employed by the Government in an attempt to defeat a *consensual* security interest. In *United States v. R. F. Ball Constr. Co.*, 355 U.S. 587 (1958), amounts owed to a subcontractor from the general contractor were claimed by both the United States and the subcontractor's surety. The subcontractor had assigned to the surety all sums to come due from its projects as collateral for any liability subsequently to be incurred by the surety under its bond. In a *per curiam* opinion, five justices held the assignment was inchoate.

Interpreting *Ball* most favorably to the Government, it could have meant that no consensual security interest could ever meet the federal choateness standard. First *State Bank v. United States*, 166 F. Supp. 204 (D. Minn. 1958) reached practically

tax lien is now subordinated to almost any private interest other than that of a general creditor which has not reduced its claim to judgment.¹⁰

that result. There the court implied that any security interest would be inchoate until there had been a default on the underlying obligation, since until then there would be no means of ascertaining the amount of the claim the secured party would assert against the collateral.

Aquilino v. United States, 363 U.S. 509 (1960) and *United States v. Durham Lumber*, 363 U.S. 522 (1960), appeared to be withdrawals from this extreme reading given to *Ball*. Both opinions relied upon peculiar features of the state law governing consensual liens, to reach the conclusion that the property in question was not subject to the tax lien and therefore the "choateness" test was inapposite. See *Kennedy, From Spokane County to Vermont: The Campaign of the Federal Government Against the Inchoate Lien*, 50 IOWA L. REV. 724, 752-53 (1965), which suggests that these decisions were judicial attempts to mitigate the harshness (or ineluctability) of the choateness doctrine.

Nevertheless, the Supreme Court seemed to have committed itself to the proposition that liens which are consensual security interests must indeed meet the same standards of choateness as non-consensual liens. See, e.g., *United States v. Pioneer Am. Ins. Co.*, 374 U.S. 84 (1963). Consequently, by 1966 the inchoate lien doctrine was a significant threat to the viability of consensual security interests and thus to secured financing. See *Silberfeld, The Federal Tax Lien Act of 1966: Has it Helped Commercial Secured Lending?* 57 J. COMM. BANK LENDING 37 (Nov. 1974). Consensual interests were vulnerable to the extent that the security included after-acquired property or involved future advances that had not yet been made. See, e.g., *American Surety Co. v. Sundberg*, 58 Wash. 2d 337, 363 P.2d 99 (1961), cert. denied, 368 U.S. 989 (1962).

This legal scheme therefore compelled the future advance lender who wished to be assured of priority to ascertain the existence of any federal tax liens before making each loan advancement. And the net effect of the choateness doctrine was to subordinate certain statutory and contractual security interests without affording affected creditors a practical opportunity to protect themselves. Because the competition arises when the debtor-taxpayer is insolvent, subordination of the private creditor often placed the risk of insolvency on the party least deserving of bearing the loss: Advances made by creditors often enhanced the value of the taxpayer's property, and thus the choateness doctrine permitted the tax lien to appropriate, without compensation, value for which the creditor had been responsible. It was this tangle and its unworkability which the Act of 1966 has attempted, by solidifying its deferences to state law rules of perfection, to avoid.

9. Prior to 1913 the government's claims were accorded priority even if *unfiled*. Under the IRC as it presently stands, filing of the tax lien is the critical step in its attaining any significant force vis-a-vis other interests. INT. REV. CODE OF 1954 § 6323(a).

Filing a lien is obviously not the IRS' first act whenever a tax delinquency is noticed. The procedures are more tortuous, and much fairer, than that.

The three basic steps involved in the creation of a federal tax lien are assessment, demand, and non-payment. If the taxpayer's return acknowledges a deficiency, assessment consists of the mere recordation of such deficiency in the office of the district director of the Internal Revenue Service. INT. REV. CODE OF 1954 § 6203. Assessment will usually occur just after the receipt of the return.

If the return does not acknowledge a deficiency, no liability will be discovered until an audit is made of the return. Conferences between the taxpayer and the IRS are

Even after the lien is filed, the Act still accords first priority to a long list of other creditors' property rights, including security interests in personal property which had been perfected prior to the lien's filing date.¹¹ (Perfection is a function, again, of state law.) Consequently a secured party, whose perfected advance or extension of credit takes place (and whose collateral is acquired) before the tax lien becomes publicly known, is now fully protected from IRS competition.

Most commercial lenders do not extend credit to all of their business borrowers by giving them a parcel of cash all at once. They make, instead, lending agreements which provide for future advances.¹²

often held, initially in the district director's office, and possibly later in the regional office. No assessment of a deficiency can be made until 90 days after the formal statutory notice of deficiency (or "90 day letter") is sent. *Id.* § 6212. Thereafter, the taxpayer may challenge any assessment by filing a petition in the Tax Court; if he does so, assessment is further delayed until the Tax Court renders its decision (and the appeal time has run).

The formal notification process is unnecessary and the government may make an assessment before an audit is completed in two situations: (1) where the district director and the Internal Revenue's Regional Counsel find that assessment or deficiency collection will be jeopardized if an immediate assessment is not made, *id.* § 6861(a); (2) where the taxpayer is in bankruptcy, *id.* § 6871(a).

Once the assessment has been made, notice of such assessment and a demand are to be sent within 60 days. *Id.* § 6303(a). A refusal to pay within 10 days after the receipt of assessment and demand for payment will give rise to a federal tax lien. *Id.* § 6321. While a lien does not exist until non-payment after demand, the federal tax lien dates from the time assessment is made. *Id.* §§ 6321, 6322.

One important point, however, needs to be underscored. Later in the present essay we try to show how the filing of a tax lien can interrupt the flow of funds in a partially completed construction project. If a tax lien predicated on a liability growing out of project *X* were to cover the contractor's receivables on project *X* alone, much of the perturbation we focus upon would be nonexistent *because* of the rather lengthy procedures which antedate the filing (and the 45-day "grace" period of § 6323 which follows it). That is not the case. The tax lien attaches to *all* of the taxpayer's property, *id.* § 6321—therefore a tax liability arising from project *A* can haunt project *Z* by encumbering *Z*'s receivables as well. So, for the project *Z* financier, the lien can strike like clear-sky lightning despite its own slow birth with respect to the IRS and the contractor/borrower/taxpayer.

10. INT. REV. CODE OF 1954 § 6323(a).

11. *Id.* § 6323(b).

12. Future advances are simply extensions of cash or some usable form of credit, made some time after they have been contracted for. Many banks charge a "commitment fee" on the order of 1/2% or 1% of the maximum amount held available, with interest charges applied only to the advances which are actually made. Future advances may be either "optional" or "mandatory." Mandatory, in UCC parlance, means "pursuant to commitment," as defined in § 9-105(k): "[I]f the secured party has bound himself to make it, whether or not a subsequent event of default or other event not within his control has relieved or may relieve him from his obligation." Optional

The problem therefore arises when a loan agreement is made yesterday, a tax lien is filed today, and the borrower requests some of the funds tomorrow. If the lender honors the post-tax-lien request, it may be doing so on the strength of collateral to which an intervening tax lien has already attached. With a commendable awareness of the exigencies of commercial finance, the Tax Lien Act grants priority to certain private lenders in this case as well, *if* certain additional conditions—the important aspects of which are defined largely by state law (to wit, Article 9 of the UCC)—are met. For present purposes there are three such conditions to note: (1) The security interest must have been created in accordance with a written agreement which itself was entered into before the tax lien was filed;¹³ (2) The interest must have been prior, under state law, to a general creditor's intervening judgment lien which "arose" on the date the tax lien was filed;¹⁴ (3)

future advances are anything else provided for in the agreement. The distinction, upon which perfection of the security interest could conceivably rest, is a stupid one. First, we agree with Professor Gilmore that—

This distinction [between optional and mandatory future advances], deeply rooted as it is, has little or nothing to recommend it conceptually. . . .

It is universally held that a contract to lend money will never be specifically enforced: money and Blackacre are at opposite poles. Damages for breach of such a contract are restricted to any additional interest which the borrower may have to pay if he borrows the money from another source. . . . Even if the lender is not technically discharged, the damages the buyer may have suffered from not getting the loan when he expected it will not be, under standard contract theory, the direct and natural result of the lender's breach: they will be the result of the borrower's own deteriorated credit standing and hence not recoverable. The contract to lend money is thus a most peculiar animal: maybe it is not a contract at all; if it is, it is a contract which may be breached with impunity. Therefore, it is nonsense, at least on the conceptual level, to make a distinction between obligatory and optional advances; a lender although he is committed to the hilt is free as air; if he makes an advance, he makes it voluntarily. Nevertheless, the distinction between obligatory and future advances is always made or at least talked about in the future advance cases.

2 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 35.4 (1965). Furthermore, for a lender to promise a mandatory advance even if bankruptcy or other serious financial illness of his borrower intervenes, would be for the lender to act as, in effect, a guarantor of the borrower's financial health. Letters of credit aside, banks in the United States at least are typically not permitted to act as sureties. And finally, bankers do not consider their lending commitments to be obligatory in the UCC § 9-105(k) [1972] sense, even when they do describe them as "commitments." See data from questionnaire, *infra* note 59, at Q.18.

13. INT. REV. CODE OF 1954 § 6323(c)(1).

14. *Id.* § 6323(c)(1)(B).

The transaction which gave rise to the security interest must have been one of three specifically defined general types.¹⁵

With a literary grace peculiar to codification, the Tax Lien Act goes on to define each of the three transaction types in terms of legal characteristics which are in turn defined elsewhere, and which ultimately create additional qualifications to be met before the tax lien will subordinate itself to the private claim. For the sake of clarity we must describe here each of the three paradigm transactions. They are: (a) "Obligatory Disbursement Agreement"; (b) "Commercial Transactions Financing Agreement"; and (c) "Real Property Construction or Improvement Financing Agreement."

(a) *Obligatory disbursement agreements* involve advances of credit which are made mandatory by the terms of some pre-existing agreement, and which must be extended when the rights of a third person (other than the taxpayer) intervene.¹⁶ They are exemplified by letters of credit, guarantees, and suretyship arrangements. This category almost never describes those run-of-the-mill working capital loans which presently interest us. The limit to mandatory rather than

15. *Id.* § 6323(c)(1)(A).

16. Obligatory disbursement agreement.—

For purposes of this subsection—

(A) Definition.—The term "obligatory disbursement agreement" means an agreement (entered into by a person in the course of his trade or business) to make disbursements, but such an agreement shall be treated as coming within the term only to the extent of disbursements which are required to be made by reason of the intervention of the rights of a person other than the taxpayer.

(B) Limitation on qualified property.—The term "qualified property", when used with respect to an obligatory disbursement agreement, means property subject to the lien imposed by section 6321 at the time of tax lien filing and (to the extent that the acquisition is directly traceable to the disbursements referred to in subparagraph (A)) property acquired by the taxpayer after tax lien filing.

(C) Special rules for surety agreements.—Where the obligatory disbursement agreement is an agreement ensuring the performance of a contract between the taxpayer and another person—

(i) the term "qualified property" shall be treated as also including the proceeds of the contract the performance of which was ensured, and

(ii) if the contract the performance of which was ensured was a contract to construct or improve real property, to produce goods, or to furnish services, the term "qualified property" shall be treated as also including any tangible personal property used by the taxpayer in the performance of such ensured contract.

Id. § 6323(c)(4).

optional advances alone, quite apart from the "third person" requirement, would exclude the typical contractor's loan arrangement, since promising *mandatory* future advances to their contractor-borrowers is not among most commercial lenders' favorite things to do.

(b) *Commercial transactions financing agreements* are what most of us recognize as the working capital financiers' customary transaction mode. The lender whose credit arrangements stay within the limits of this category enjoys a priority over an intervening tax lien even if the advances are made after the filing date, even if they are "optional" rather than mandatory, and even if they are made against future acquisitions of (specific kinds of) collateral.¹⁷ To sacrifice detail for comprehensibility, we can do with mentioning one major limitation: The advance must have been made before the lender had notice of the filing of the tax lien. Because most commercial banks are informed of new lien filings on a daily or weekly basis, the post-lien advances are therefore protected only if made within a very short period of time. If for some reason the lender does not receive actual notice, then a statutory 45 day period becomes relevant—advances (no

17. Commercial transactions financing agreement.—For purposes of this subsection—

(A) Definition.—The term "commercial transactions financing agreement" means an agreement (entered into by a person in the course of his trade or business)—

(i) to make loans to the taxpayer to be secured by commercial financing security acquired by the taxpayer in the ordinary course of his trade or business, or

(ii) to purchase commercial financing security (other than inventory) acquired by the taxpayer in the ordinary course of his trade or business;

but such an agreement shall be treated as coming within the term only to the extent that such loan or purchase is made before the 46th day after the date of tax lien filing or (if earlier) before the lender or purchaser had actual notice or knowledge of such tax lien filing.

(B) Limitation on qualified property.—The term "qualified property", when used with respect to a commercial transactions financing agreement, includes only commercial financing security acquired by the taxpayer before the 46th day after the date of tax lien filing.

(C) Commercial financing security defined.—The term "commercial financing security" means (i) paper of a kind ordinarily arising in commercial transactions, (ii) accounts receivable, (iii) mortgages on real property, and (iv) inventory.

(D) Purchaser treated as acquiring security interest.—A person who satisfies subparagraph (A) by reason of clause (ii) thereof shall be treated as having acquired a security interest in commercial financing security.

Id. § 6323(c)(2).

matter how innocent or productive) made on the 46th or later day after the filing are not entitled, vis-a-vis the tax lien, to a prior right in the debtor's assets.

(c) *Real property construction or improvement financing agreements* are important precisely because they are protected (in this priority-to-collateral sense) without regard to the actual notice and 45 day limitations. They are structurally similar to case (b) transactions, but are restricted in purpose and in permissible collateral.¹⁸ There are two subcategories of "Real Property, etc." financing: *construction lending*,¹⁹ and *contractor lending*.²⁰ Because the distinction between the two is not only central to the balance of this comment, but also because its elision is a likely explanation for the Permanent Editorial Board's (PEB) oversight in § 9-301(4),²¹ we must digress briefly at this point to explore it. The consequences of the distinction have too often escaped the attention of many lawyers, a few bankers, and some draftsmen, though any contracting firm in the "Real Property, etc." industry realizes that the two forms are nearly night and day.

Construction lending is essentially real estate lending.²² The lend-

18. Real property construction or improvement financing agreement.—For purposes of this subsection—

(A) Definition.—The term "real property construction or improvement financing agreement" means an agreement to make cash disbursements to finance—

- (i) the construction or improvement of real property,
- (ii) a contract to construct or improve real property, or
- (iii) the raising or harvesting of a farm crop or the raising of livestock or other animals.

For purposes of clause (iii), the furnishing of goods and services shall be treated as the disbursement of cash.

(B) Limitation on qualified property.—The term "qualified property", when used with respect to a real property construction or improvement financing agreement, includes only—

- (i) in the case of subparagraph (A)(i), the real property with respect to which the construction or improvement has been or is to be made,
- (ii) in the case of subparagraph (A)(ii), the proceeds of the contract described therein, and
- (iii) in the case of subparagraph (A)(iii), property subject to the lien imposed by section 6321 at the time of tax lien filing and the crop or the livestock or other animals referred to in subparagraph (A)(iii).

Id. § 6323(c)(3).

19. *Id.* § 6323(c)(3)(A)(i).

20. *Id.* § 6323(c)(3)(A)(ii).

21. See text accompanying notes 135-37 *infra*.

22. As a general source see P. SHULKIN, COMMERCIAL BANK CONSTRUCTION

er finances a project, with a loan made to the owner or developer of the property. The expected loan repayment source is generally a take-out or permanent mortgage, and the security is the improved real property itself. Consequently, in construction lending the legal source for determining perfection against judgment liens (hence priority vis-a-vis tax liens) is principally the law of real property security, not Article 9 of the UCC.

Contractor lending is fundamentally different.²³ Here the lender finances the working capital needs of a contractor or subcontractor who normally has no direct interest whatever in the project or the property. Loans are made to that firm, not to the owner or developer. The expected loan repayment source is the account due the contractor as the job progresses, and the collateral is primarily *personal* property governed by Article 9: accounts, contract rights,²⁴ equipment (infrequently), and inventory (rarely). It is therefore this contractor lending (and there is a lot of it)²⁵ which has the following legal characteristics under the Tax Lien Act: A lender extending working capital loans to a contractor, and looking to contract rights and accounts as collateral security, will have an extraordinary priority over an intervening tax lien attached to the same property even if its future advances are optional rather than mandatory; even if the advances are made an indeterminate time after the tax lien is filed; and even if the lender has actual knowledge of the lien—if the arrangement was perfected under UCC Article 9 as against a hypothetical judgment lien creditor whose lien arose on the date the tax lien was filed.

At this point we turn to the 1972 revisions of § 9-301.²⁶ What the

LENDING, RESEARCH REP. NO. 47, FEDERAL RESERVE BANK OF BOSTON (1970). See *esp. id.* at iv.

23. See generally Bristow, *The Specialty Contractors' Financing Program*, 53 J. COMM. BANK LENDING 28 (June, 1970) [hereinafter cited as Bristow]; Dauer, *Government Contractors, Commercial Banks and Miller Act Bond Sureties—A Question of Priorities*, 14 B.C. IND. & COMM. L. REV. 943, 993-98 (1973) [hereinafter cited as *Priorities*].

24. See note 32 *infra*.

25. See Bristow, *supra* note 23, at 28 for a description of the contractor's need for financing. See also text accompanying notes 124-28 *infra*.

26. UCC § 9-301(4):

A person who becomes a lien creditor while a security interest is perfected takes subject to the security interest only to the extent that it secures advances made before he becomes a lien creditor or within 45 days thereafter or made without knowledge of the lien or pursuant to a commitment entered into without knowledge of the lien.

federal Code giveth the state Code taketh away. The draftsmen of the 1972 sections, with one eye on the 45 day limit in the class (b)²⁷ transaction and the other eye on the already-protected "mandatory" advances,²⁸ apparently failed to notice that the "Real Property, etc." transaction came in a personalty as well as a realty mode. Thus, with 9-301(4), the draftsmen denied protection as against a lien creditor to any optional future advance (even one otherwise fully protected) made more than 45 days after the lien was filed and with actual notice of the filing. Since protection of the advance under state law is one of the conditions which the Tax Lien Act requires before granting its extraordinary protection to contractor lending,²⁹ § 9-301(4) undoes the supra-tax-lien priority which § 6323(c)(1)(A)(ii) has allowed: Under § 9-301(4), if the secured party has notice of the existence of an intervening lien, optional advances made more than 45 days after the lien attached are *not* protected against a [judgment] lien creditor. Consequently, such advances would not pass the test of § 6323(c)(1)(B), and thus would lose out to the tax lien *even though* the "Real Property, etc." category does not have an actual notice limitation. To put it another way, § 6323(c)(3) makes notice irrelevant, but priority *vel non* still depends on "perfection." UCC § 9-301(4) makes "perfection" in the IRC sense dependent upon notice (!) thereby thoroughly confounding the supra-lien priority otherwise allowed to § 6323(c)(3) advances.

Strange it is that draftsmen who clearly intended to utilize all of the state law deferences in the Tax Lien Act that they could, and who on every other occasion seem to have preferred Article 9 interests to federal intrusions,³⁰ should do such a thing. But they did.

27. That is, the Commercial Transactions Financing Agreement of INT. REV. CODE OF 1954 § 6323(c)(2). The "Official" (1962) version of the Code was similarly flawed. That is to say, under § 9-301, 1962-style, the optional future advance lender was subordinated to a lien creditor not because of any time limits, but because § 9-301 referred to an *unperfected* interest, which pre-1972 any optional future advance most probably was. See note 95 *infra*. The occasion of the present criticism, however, remains, since it was the draftsmen's intentions in 1972 to exploit the Tax Lien Act's general concessions to state law, and because in the 1972 revisions the draftsmen, aware of the "perfection" problem, attempted to reverse the negative connotations of the 1962 Code, particularly §§ 9-204(1) and 9-303(1). See note 41 *infra*, and text accompanying notes 40-41 *infra*.

28. See text accompanying note 135 *infra*.

29. INT. REV. CODE OF 1954 § 6323(c)(1)(B), which applies to all three transaction types, requires that the arrangement "[be] protected under local law against a judgment lien arising, as of the time of tax lien filing, out of an unsecured obligation."

30. On the intention of § 9-301(4), see, e.g., AMERICAN LAW INSTITUTE, PRO-

There are, to be sure, some perplexities in the preceding, somewhat simplified, analysis which ought to be set to rest. They may best be described in the context of a brief and straightforward scenario: Lender (a commercial bank) and Borrower (a contractor) on June 1 sign a security agreement, and file a financing statement, covering the contract rights which Borrower has against the owner of the underlying project and providing for non-mandatory working capital advances from time to time as payments are earned.³¹ No money is advanced on that date and no part of the contract right has yet be-

CEEDINGS OF THE 48TH ANNUAL MEETING 306-11 (1971) [hereinafter cited as PROCEEDINGS] and UCC § 9-301 (1972 version), Comment 7 which underscores the expansive impact of the UCC vis-a-vis the tax lien.

Other examples in the UCC include § 9-108 (designed to avoid after-acquired collateral's being upset as a voidable preference in bankruptcy under § 60 of the Bankruptcy Act); and the draftsmen's response in 1966 to *In Re Kravitz*, 278 F.2d 820 (3d Cir. 1960), resulting in an amendment to § 2-702(3) on sellers' reclamation rights. See PERMANENT EDITORIAL BOARD FOR THE UCC, REPORT NO. 3, at 3 (1967).

31. Contractor lenders "police" and apportion their advances in a variety of ways, ranging from no control at all to oversight of each payment made by the borrower out of loaned funds, with most lenders somewhere along that continuum. Similarly, "loan availability" can be dependent upon work certified to have been done, or not dependent upon project completion at all. The model we are using here is, even if not ubiquitous, at least typical among more experienced lenders: A maximum job-credit availability is established, but advances are made against particular billings. That is to say, when the contractor has billed the owner for a \$10,000 (e.g.) progress payment, (out of which \$1000 may be withheld as retainage), he has a \$9000 account receivable. At that point the lender may advance 80% of the amount due, or \$7200. An excellent description of this process appears in Bristow, note 23 *supra*. Although our questionnaire survey (described note 59 *infra*) did not inquire into the details of specific loan availability procedures, we did get a fair measure of the incidence of "job-by-job" [as opposed to blanket line-of-credit] lending. We asked our respondents to indicate the percentage of all contractor loans made on a "job-by-job" basis. The results may include equipment loans as well as working capital loans; consequently, the following figures for percentage of loans made job-by-job are probably understated:

% of Contractors' loans made "Job-by-Job."

	<i>Mean</i>	<i>Median</i>	<i>Mode</i>
Class I lenders	47.2%	35%	Bimodal at 80-
Class II lenders	48.3%	50%	100% and 0-20% in
Class III lenders	50.2%	70%	all 3 cases.

[The "class I" etc. scoring is explained at note 60 *infra*.]

As to "policing" of job status (which term was variously defined by our respondents) the following were reported:

Question 3. "Generally speaking, on what basis do you extend credit to contractors?"

come an account.³² On June 2 a tax lien is filed. (Let's assume, initially, the unlikely case that the lender never receives actual notice of the filing.) On June 30 Borrower has "earned" an unpaid progress payment, and Lender makes an advance. On June 48 (just to be clear that we are beyond the 45 day period) a second progress payment is earned but unpaid, and Lender makes a second advance. If everything (including Borrower's business life) stopped right there, and if the project's owner began a "stakeholder" action against both Lender and the IRS to determine which of them had the prior right to each of the two progress payments, what outcomes would there be?

The Lender's security interest for the first advance is fully protected, either as a "Commercial Transactions Financing Agreement" (assuming no actual notice) *or* as a "Real Property, etc." transaction. About that there should be little argument, if we are to believe that these two statutes have any correlated meaning at all.

The second advance, however, demonstrates the problem. To review briefly, we propose that if § 9-301(4) (1972) ended after the words "takes subject to the security interest . . .", *i.e.* if it omitted the possibility of a UCC-imposed *unperfected*,³³ then the § 6323(c) (1)(A)(ii) exception would accord priority to the lender over the taxman for this later advance as well; but, we believe, § 9-301(4) as it is presently drafted results in just the opposite.

The analysis thus far could be said to encounter two principal and two trivial difficulties, all of which are caused by the use of infelicitous language in both statutes. One major problem is reminiscent of the

(e)—% Job status is periodically "policed."

	<i>Mean</i>	<i>Median</i>	<i>Mode</i>
Class I lenders	65.5	80	90
Class II lenders	45.0	50	10
Class III lenders	42.5	25	10/0

32. The pre-1972 UCC defined a "Contract Right" as, roughly, a right to payment not yet earned by performance; and an "Account" as an *earned* right to payment. UCC § 9-106. The 1972 revisions omit the phrase "Contract Right," and expand "Account" to cover both: "[A] right to payment . . . for services rendered . . . whether or not it has been earned by performance." UCC § 9-106 [1972 version]. Because the distinction is still descriptively useful, we shall employ these terms in this paper according to their pre-1972 meanings.

33. The section would then read, "A person who becomes a lien creditor while a security interest is perfected takes subject to the security interest." The effect of so truncating § 9-301(4) would be to avoid reversing the rule after 45 days (as the 1972 revision now does), thereby satisfying without time limit § 6323(c)(1)(B)'s "is protected under local law against a judgment lien. . . ."

difference between §§ 70(c) and 70(e) of the Bankruptcy Act.³⁴ The other, which is the more complex, involves a process of running time backwards, or if not backwards then at least along a Möbius strip.

First we can dispense with the trivialities. Recall that § 6323(c) (1)(B) requires all three transaction types to be "protected under local law against a 'judgment lien' arising, as of the time of tax lien filing, out of an unsecured obligation" in order to qualify for their respective supra-tax-lien priorities. Yet § 9-301(4) [1972] refers to the rights of a "lien creditor" vis-a-vis the secured party. So, is a "lien creditor" the same as a creditor with a "judgment lien"? Yes.³⁵ And even if the answer is taxonomically "No," every court knows it ought rationally to be "Yes." Therefore it probably will be so construed.³⁶ Furthermore, even if the phrases do mean the same thing, what do they both mean? A "judgment lien," technically speaking, in most states applies only to real property.³⁷ So, does "judgment lien" mean judgment lien? Probably not.³⁸ If it did, most of § 6323 which lists personalty

34. We mention this (analytically irrelevant) statute only because it has a dichotomy between two of its sections which is familiar to most commercial lawyers. In particular, § 70 of the Bankruptcy Act, 11 USC §§ 1-1103 (1970), determines when property of the debtor succeeds to the trustee, and when it is removed from the bankrupt's estate by virtue of a security interest in a third party. The test of the security interest is whether it is impervious to attack by a state lien creditor. In § 70(c) the test is a *hypothetical* judgment lien creditor; in § 70(e) the trustee succeeds to the assets only if the security interest was traversed by an *actual* creditor. See J. WHITE & R. SUMMERS, HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE 871 (1972).

35. This very point was raised during the A.L.I. discussions; see PROCEEDINGS, *supra* note 30, at 309-10; and was "resolved" in favor of reading the two phrases as having the same meaning. See also Coogan, *supra* note 4, at 1382-83; and the report of the legislative history of the Tax Lien Act of 1966 in S. REP. NO. 1708, 89th Cong., 2d Sess. (1966) — "This bill is in part an attempt to conform the lien provisions of the internal revenue laws to the concepts developed in this Uniform Commercial Code."

36. One court may already have so held: Texas Oil and Gas Corp. v. United States, 466 F. 2d 1040, 1047-48 (5th Cir. 1972), *cert. denied*, 410 U.S. 929 (1973).

37. See remarks of Professor Countryman in PROCEEDINGS, *supra* note 30, at 309.

38. It seems to most commentators to mean "lien creditor." See, e.g., R. HENSON, SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE 107 (1973); and compare UCC § 9-301(4) (1972 version), with the use of the hybrid "judgment lien creditors" in Comment 7, in view of the definition of "lien creditor" in § 9-301(3). But the key instrumental problem is whether the term will apply to liens (however obtained, judgment or otherwise) on personal property as well as on realty. The most telling point is therefore the IRC itself: § 6323 refers to judgment liens on "qualified property." INT. REV. CODE OF 1954 § 6323 (c)(1)(A) & (B). "Qualified property" means different things at different times, but most often is defined in the IRC to mean personalty. See *id.* § 6323(c)(2)(B), (C); (c)(3)(B); (c)(4)(B). Moreover, the IRC's own definition of "Security Interest" (presumably the Article 9 variety) in § 6323 (h)(1) refers to pro-

as "qualified property" would be internally absurd.³⁹ Therefore it cannot sensibly mean that. Two quibbles gone.

Now notice, again in § 6323(c)(1)(B), that perfection is, in effect, tested as of the time the tax lien is filed. One major problem, therefore, which occurs when considering an optional future advance is whether it is logically possible for there to be such a thing as adequate perfection as of some preadvance date. That question exists on two levels: the first, *viz.* whether it is statutorily possible to perfect such an interest under the UCC, has been much debated in the literature⁴⁰ but may well have been solved by the 1972 revisions of § 9-204(1) and (3), and therefore need not concern us further.⁴¹ The second

tection against a "subsequent judgment lien." Since security interests under Article 9 cannot be taken in real property, UCC § 9-102(1), if "judgment lien" meant only real property lien then even § 6323 (h)(1) would be internally absurd. Enough.

39. See note 38 *supra*.

40. See generally GILMORE, *supra* note 4, at ch. 35 (1965); Ege, *Priority of Future Advance Lending Under the Uniform Commercial Code*, 35 U. CHI. L. REV. 128 (1967).

41. As proposed in the PEB's 1972 revisions, § 9-204 would read as follows:

(1) Except as provided in subsection (2), a security agreement may provide that any or all obligations covered by the security agreement are to be secured by after-acquired collateral.

(2) No security interest attaches under an after-acquired property clause to consumer goods other than accessions (Section 9-314) when given as additional security unless the debtor acquires rights in them within ten days after the secured party gives value.

(3) (5) Obligations covered by a security agreement may include future advances or other value whether or not the advances or value are given pursuant to commitment (subsection (1) of Section 9-105).

Though it would be far afield for us fully to enter the thicket of §§ 9-204 and 9-303 at this point, it is worth noting that a gap between intention and implementation exists in these revisions as well. Nowhere do the drafters unequivocally state that an arrangement for optional future advances can be "perfected" before the disbursements are actually made. That this was their intention, however, is clear. In PERMANENT EDITORIAL BOARD FOR THE UCC, FINAL REPORT OF THE REVIEW COMMITTEE FOR ARTICLE 9 (1971), it is stated that "the Committee proposes to clarify the present uncertain state of the law by a new Section 9-301(4) providing that a lien creditor does not take subject to a future advance made more than 45 days after he becomes a lien creditor unless it is made 'pursuant to commitment.'" *Id.* at 228. Clearly, therefore, the drafters must have intended that *within* the 45 days even optional advances would be protected, or else this comment makes no grammatical sense whatever. See also *Id.* at 48, and 115-16, where the "reason for change" is given as the need to make future advance priority over lien creditors "absolute" for the first 45 days, and only thereafter to depend upon lack of knowledge of the lien at the time of disbursement or commitment. For further evidence that the draftsmen thought it would be possible to have pre-disbursement optional advance "perfection," see the 1972 versions of 9-307(3), 9-312(7) and 9-312 (Comment 7). In each instance, there is a discussion of perfected interests, with a direct or indirect reference to perfected mandatory interests, thereby

level is whether the necessary perfection, which sometimes can be assessed only by looking at the actual later advances and collateral acquisitions, can be said to have been achieved before or "as of" the date of tax lien filing. In other words, on June 48 could we have said

implying that it is possible to have perfected non-mandatory interests (even though they may not be *prior* in the contexts covered by those sections).

Nevertheless, there is one other route through the statute which leads to the opposite conclusion: 9-301(4) speaks of "perfected" interests; 9-303 still requires "attachment" as a precondition to perfection; 9-203(1) still requires, for attachment to occur, that "value" be given; and 1-201(44) still defines value in a way that could preclude unmade optional future advances. This is, patently, inconsistent with 9-204(3) and with the implication of 9-204 (Comment 5), and with the evident sense of 9-301(4) and the necessary implications of 9-307 and 9-312.

The drafters may have conflated validity, perfection, and priority. They clearly made optional arrangements *valid*; they intended to make them (sometimes) *prior* to other interests; but they forgot to make it clear that they could be *perfected*, even though priority without perfection is a truly ludicrous idea.

The Tax Lien Act itself has a similar infelicity. Under § 6323(h)(1), a security interest (such as a "Real Property, etc." loan, see § 6323(c)) cannot "exist" until the secured party has parted with "money or money's worth." So, again, can an optional advance deal be an *existing* security interest before it is disbursed? That is, does the (h)(1) definition really apply to § 6323(c) as well as to § 6323(a) and (b)? Here, the answer may lie in the legislative history. See H.R. REP. NO. 1884 89th Cong. 2d Sess. (1966), reprinted in [1966] U.S. CODE CONG. & AD. NEWS 1316. It is worth noting that the original version of the bill which eventually became the 1966 Tax Lien Act provided that, vis-a-vis the definition of "security interest" in (now) subsection (h)(1), the qualifications of "existence" such as "money's worth" were to be determined "as though such notice were filed 45 days after the date of actual filing . . ." or, if no 45 day limit, then presumably not until the construction project were completed, hence protecting optional advances equally with those that are mandatory. *Id.* at 5, 22. In Secretary Surrey's opinion, moreover, "*nonobligatory* advances made after the filing of notice of a tax lien to complete construction . . . will take priority . . ." *Id.* at 48 (emphasis added). And, according to the Chairman of the ABA's Special Committee on Federal Liens, "The advances which would be protected are . . . advances which, *even though technically voluntary*, are made to finance the completion of construction work. . . ." *Id.* at 67 (emphasis added).

There is, we found, but one judicial opinion construing the (h)(1)(B) phrase, and that is inapposite to the present question. *Fritz v. United States*, 328 F. Supp. 1343 (D. Minn. 1971). One other opinion, however, though commenting on after-acquired property rather than optional advances, suggests an argument which concludes that the (h)(1) definition is qualified by the § 6323(c) definitions, rather than vice versa. See *Texas Oil & Gas Corp. v. United States*, 466 F.2d 1040, 1047 (5th Cir. 1972), *cert. denied*, 410 U.S. 929 (1973).

The commentators are split on the question, with Plumb agreeing with our conclusion that the "money's worth" limit does not apply to the optional § 6323(c)(3) advances, and with Coogan seeming to disagree. Compare W. PLUMB, *FEDERAL TAX LIENS* 89 n.45, 91 n.57, 96-97 (3d ed. 1972), with Coogan, *The Effect of the Federal Tax Lien Act of 1966 Upon Security Interests Created Under the Uniform Commercial Code*, 81 HARV. L. REV. 1369, 1389-94 (1968).

that the June 48 advance had been perfected as of June 2 to the extent necessary, considering that as of June 2 we did not know what we now know about the June 48 advance—*e.g.*, that it was made without actual notice? Once again the answer lies in common sense rather than in recursive epistemology. Notice that § 6323(c)(1)(B) falls, not surprisingly, entirely within § 6323(c)(1).⁴² The latter covers *only* security interests which “came into existence” after the filing date, while the former—included within the latter—tests perfection by reference to a judgment lien arising “as of” the filing date. The only sensible conclusion, we would therefore submit, is to read § 6323 as if it said something like

if the *agreement* entered into before the filing date will result in security interests perfected as they arise, and if the security interests are executed in accordance with the agreement and within the limits of § 6323(c) (2, 3, or 4) as viewed prospectively from the filing date as to the agreement and retrospectively (if possible) as to things like the 45 day and actual notice limits.

The other, less serious of the major problems is what for familiarity's sake we have styled as the § 70(c) vs. § 70(e) analogue, *i.e.*, whether the security interest's priority over the tax lien is dependent upon its invulnerability to a *hypothetical* lien/judgment creditor as of the date the tax lien was filed, or whether the secured party will lose to the IRS only if there has been an *actual* lien creditor under 9-301(4) who upset the security interest on or before that exact date. Or to put it another way, if an Article 9 interest would have been vulnerable to a lien creditor (other than the IRS) as of the critical date, but no such party in fact appears, is the security interest nevertheless subordinated to the tax

42. INT. REV. CODE OF 1954 § 6323(c)(1) reads:

(c) Protection for Certain Commercial Transactions Financing Agreement, etc.—

(1) In general.—To the extent provided in this subsection, even though notice of a lien imposed by section 6321 has been filed, such lien shall not be valid with respect to a security interest which came into existence after tax lien filing but which—

(A) is in qualified property covered by the terms of a written agreement entered into before tax lien filing and constituting—

(i) a commercial transactions financing agreement,

(ii) a real property construction or improvement financing agreement, or

(iii) an obligatory disbursement agreement, and

(B) is protected under local law against a judgment lien arising, as of the time of tax lien filing, out of an unsecured obligation.

lien? Apparently the draftsmen of Article 9, 1972 style, would answer the question affirmatively; that is to say, the hypothetical lien creditor analysis is the proper one. In Comment 7 to § 9-301(4), for example, they suggest that

the importance of the rule chosen for actual conflicts between secured parties making subsequent advances and judgment lien creditors may not be great; but the rule chosen for the first 45 days is important in effectuating the intent of the Federal Tax Lien Act of 1966.

Such a conclusion would appear to be intuitively sound. There is little reason to suppose that the tax lien was intended to take priority over a security interest only when there was an actual third competitor with, incidentally but inexorably, priority over the IRS under § 6323(a)!⁴³ Consequently, and although there is no clear semantic stipulation, it seems reasonable to conclude that the state-law-determined legal status of "perfection" rather than the factual status of supra-lien-creditor priority will be determinative.⁴⁴

The purpose of the preceding few paragraphs has been defensive -- to deflect a series of arguments which could have undercut our original assertion about the effect of § 9-301(4) [1972] by their pointing to other aspects of the two statutes which erode the linguistic bases of the analysis. The upshot is that our conclusion stands: As § 9-301(4) [1972] is presently drafted, a contractor and its lender cannot take that full advantage of exemption from a tax lien's priority which Congress clearly intended to permit.⁴⁵

II

Does it really matter very much? In the present section we shall address that question at a somewhat simplified theoretical level, and

43. Judgment liens which have attached as of the date the tax lien was filed take priority over the IRS. INT. REV. CODE OF 1954 § 6323(a). Thus, if we did need an *actual* lien creditor before the Article 9 interest would be subordinated to the tax lien, it would have to be an actual lien creditor as of the filing date. Consequently the IRS would defeat the secured party only when it lost to the judgment lien creditor! The absurdity of the conclusion shows its premise (*i.e.*, *actual* lien creditor) to be equally absurd.

44. As the legislative history makes clear, the "judgment lien" language in § 6323 was meant only as a *rest of protection under local law*. See S. REP. NO. 1708, 89th Cong., 2d Sess. (1966).

45. [The Act] gives priority in the case of security interests arising from disbursements for these purposes even though a notice of a tax lien has been filed because . . . the completion of the construction . . . usually increases

will defer an empirical discussion of our theorizing for the section next following.

The pattern traditionally followed when analyzing the “wisdom” of some commercial statute or decision comprises a relatively few necessary steps. The first is to identify both the actors whose pertinent environments may most immediately be affected by the rule in question, and the mechanism of those effects. (Within certain constitutional constraints⁴⁶ it is generally, and correctly, considered to be insufficient to stop at this level and inquire only whether the rule is “fair” to one party or the other when the actors are fictitious “legal persons,” as they are in the present case.) The second step is to articulate (speculate about, sometimes) the changes in those actors’ behaviors which the rule may incite. Third, is an identification of the secondary parties who may in turn be affected by the first set of behavioral consequences. The discussion could stop at this point and assess the “fairness” of these secondary incidents by referring them to a set of policy norms, the generation of which is the fourth step. But again, if the subjects at this second level are still firms, steps two and three are repeated as many times as is necessary to avoid ascribing critical finality to the question of whether some outcome is “fair” to a class of legal entities whose existences are relevant only insofar as they serve instrumentally to further the goals of individuals. Another aspect of the efficiency of the proposal can then be essayed—are there alternative routes to the same goal which have fewer costs, or whose costs can be distributed among “more appropriate” groups? Express articulation of the final steps can often be elided, but only so long as we are all in agreement that the statement, *e.g.*, “Rule X will depress the sale of municipal bonds” is thoroughly bereft of normative meaning unless it is understood to connote “and therefore these individuals will be affected in the following ways which for the following reasons are bad. . . .”

Application of that standard scheme in the present instance leads to something more or less like the following: The most immediate effects of the “rule” of § 9-301(4) [1972] and § 6323(c)(1)(A)(ii) [1966] will be felt by the United States Treasury and those firms, typically commercial banks, which do (or otherwise would) make working capital loans

the value of the property underlying the security interest for tax lien purposes by more than the amount of the disbursement being accorded the priority.
Id. at 3730.

46. Such as due process and equal protection, *inter alia*, which apply to corporations as well as to individuals.

to those members of the construction industry who are in need of external financing. In particular, the commercial lenders' ability safely to make optional future advances to a tax-liened contractor (when it would be in their financial best interests to do so) is incrementally diminished, while the ability of the Treasury to collect its due may or may not be potentially enhanced. We would then expect there to be either or both of two sets of behavioral outcomes on the part of lenders.

First, lenders may tend to refuse to make such advances after a tax lien has been filed. This could create a cash flow crisis for a contractor sufficient to cause it to default on the underlying construction project.⁴⁷ The tertiary result in turn could be either a surety takeover, a relet,⁴⁸ an unfinished project, or at the minimum a completion delay and its attendant perturbations⁴⁹ in other phases of the project or in the developer's use of it. What these eventually become is "waste" of social resources, reflected in some market or other as otherwise avoidable cost increases, and which in any of a variety of ways can limit the net welfare potential of some individual or social group.

A second possible set of responses by commercial lenders would be for them to subsume such future potential risks into the initial credit-granting decision—either by increasing the price of borrowed

47. See text accompanying notes 80-86 *infra*.

48. In the case of a bonded contract, *i.e.* one for which the contractor has posted a performance bond for the benefit of the owner (or the subcontractor for the benefit of the prime contractor), any serious failure to pursue the job in accordance with the relevant contract will give the surety several options from which to choose: The surety may allow the breach to continue, in which case the owner (or prime) will relet and the surety will pay the costs; the surety may "takeover" the job and relet itself, paying excess costs directly; the surety may finance the contractor to completion. (Notice that surety *financing* is *not* "mandatory" within IRC § 6323(c)(3) and therefore suffers risks *vis-a-vis* tax liens approximately equal to those of post-default commercial lenders.) The decision is, essentially, the surety's alone. See generally Downs, *A Surety's Basic Rights and Remedies*, 15 DEFENSE L.J. 139 (1966); Mansfield & McCahon, *Claims Under Contract Bonds*, 21 INS. COUNSEL J. 265 (Symposium, 1954). See also A.I.A. FORM NO. A311 (Performance Bond), in *Construction Default: The Contractor's Bond*, 122 P.L.I. 53-54 (1976).

In the case of unbonded contracts, owners have similar rights *vis-a-vis* general contractors (and generals *vis-a-vis* subcontractors). See generally A.I.A. STANDARD FORMS, arts. 21, 22.

49. Delay or stoppage by, *e.g.*, a structural steel subcontractor may require the postponement of all work scheduled to begin upon completion of the steel work. Other subcontractors may therefore have idle periods, resulting in resource waste of varying kinds. Similarly, drywall and finish work must await completion by the plumbing and electrical firms.

capital⁵⁰ (ultimately resulting in the price effects on individuals as noted above), or by reducing its supply (selectively by ruling out worse risks, or broadly by generally curtailing credit commitments⁵¹ to the contracting industry). If the latter (*i.e.* supply reduction) occurs, there may be either of two mediate effects—an increase in the cost of inefficiently allocated contracting services, and/or a restriction of competitors within the contracting industry. The latter of these two in turn affects individuals both by reducing the opportunity for movement from laborer to entrepreneur,⁵² and by reducing the efficiency of resource use through a pricing of the industry's services above their efficient marginal costs.

The balance of this discussion will focus upon the first set of effects and will eschew the second. That is to say, we are concerned with the "waste" potentially occasioned by the *interruption* of a course of financing already begun, rather than with the marginal diseconomies of a contraction in its availability *ab initio*. There are two reasons

50. Contrary to transaction-cost-free economic theory, bankers' interest rates do not vary smoothly as the risk of given credits change. It is the authors' experience that rates are based first on demand and the lenders' cost of capital. Then, borrowers are lumped into classes: prime, small-business prime, auto, home, consumer credit, charge-cards, etc. Contractors in need of secured financing, therefore, may be able to borrow at the established "X points over prime" or not at all. The amount loaned may vary infinitely, but the price is relatively "sticky." Fine degrees of risk differentiation are generally costly. Cf. G. CALABRESI, *THE COSTS OF ACCIDENTS* 61-62 (1970).

51. A "credit commitment to the X industry" refers to the bank's internal allocation of its lendable funds, assessed and modified from time to time. It has been the authors' experience that, interestingly enough, when commitments must be curtailed (when lendable funds are "short") it is *secured* lending which contracts the most. This may be a function of a very curious attitude on the part of bankers, *viz.* that secured lending is *more* risky than unsecured! That requires a word of explanation: Clearly, for one single borrower the risk in a given loan would be reduced if some security were taken. But the important element of "risk" seems not to be eventual payment-after-a-struggle, but payment without any inhibition or problem whatever. Thus, "secured credits" mean a lower class of borrowers; "prime" credits, who get the lowest rates, often provide no formal collateral security at all. Thus a secured loan is often seen as a loan to a borrower for whom some collateralization was necessary, therefore a "riskier" loan in one important sense of that word.

52. The construction industry may well be the paradigmatic case of movement from the laboring to the self-employed class. Dauer, *On Lenders and Bonded Contractors*, 56 J. Comm. Bank Lending 46, 57 (Feb. 1974). For example, of the 794,838 construction "firms" active in recent years, over 53% are firms "Without Payroll"—*i.e.*, small proprietorships and partnerships with no permanent staff of employees. BUREAU OF THE CENSUS, *CENSUS OF CONSTRUCTION INDUSTRIES* (1967), in *1 INDUSTRY STATISTICS AND SPECIAL REPORTS* 1B-13, Table B7 (1971). For the industry structure generally, see *Priorities*, *supra* note 23, at 988-93.

for this choice. First, by dint of factors discussed below,⁵³ it was not possible for us to generate empirically refutable hypotheses about the price and supply responses which could demonstrate the effects with sufficient reliability.⁵⁴ And second, at the level of theorizing, a descriptive analysis of portions of the question has been essayed elsewhere.⁵⁵ But before dropping this price/supply matter entirely we would like to indicate, for whatever it may be worth, one item of information which we happened upon during the course of this study.

Prior to conducting our questionnaire survey we wrote to a small number of randomly⁵⁶ selected commercial bankers. Our letters asked them open-ended questions about their policies in lending to contractors.⁵⁷ One of the items we invited them to comment upon was "a

53. See text accompanying notes 93-101 *infra*.

54. We would, for example, have had to assign weighted decision factors to each credit request denial in the sample to be certain that this one factor was operative in the test cases. Even apart from the difficulty of coding an aggregate subjective judgment, and holding all other variables (such as changes in the money markets, changes in the industry picture, the relationship of each project's bid price to its "second-low", etc.) constant, it would have been nearly impossible to collect sufficiently refined data from bankers' files of loans they didn't make.

55. See, e.g., *Priorities*, *supra* note 23, at 988-93.

56. Strictly speaking, the selections were not "random" in the purest sense. The population from which our samples were randomly drawn was a group of bankers and banks on a list provided to the authors by Charles Huntington of the Robert Morris Associates (RMA). The list contained the names of those bankers who had attended one of RMA's six "Workshops in Contractor Lending" during 1973 and 1974. This population was drawn nationwide, and reflected banks of all sizes. There were some 350 bankers on the lists. The biases which this sampling method may have introduced are obvious, though probably not very great in magnitude. Because the senior author of the present paper was a lecturer at five of the six workshops, we can say with some certainty that the matter of tax liens was not discussed on those occasions. We therefore felt that our population would not have been "contaminated" for present purposes. This group was chosen, on the other hand, because we felt that the sample population's familiarity with the author would produce a better overall response. (It didn't work. The response rate for Phase I was 30 out of 150, or 20%; for Phase II it was 70 out of 230, or 30.4%).

57. The relevant portion of the "Phase I" letter was as follows:

What I need to know are two things: first, a brief description of how you typically lend to contractors ("line of credit", job-by-job, policed or unpoliced, secured or unsecured, etc.—and, the system of job progress review, if any); and second, a discussion of those "legal matters" which you consider important in making (or not making) any given loan (e.g., surety priorities, mechanics' liens, etc., etc.) for the first, a brief description would be helpful indeed, though the more detail you can provide the better our analyses will be. For the second, I would like to compile a complete list of those laws or legal problems that either encourage or discourage contractor financing by commercial

discussion of those 'legal matters' which you consider important in making (or not making) any given loan . . . those legal problems that either encourage or discourage contractor financing." There were 29 responses which touched on that item, of which seven did not specify any particular identifiable legal matters. Of the usable 22, six (27%) mentioned *sua sponte* that competition from tax liens was an identifiable "legal problem" which tended to discourage their lending to contractors.⁵⁸

In the later questionnaire⁵⁹ two questions sampled the generalized

lenders, or that make it risky, or that impair your prospects of satisfactory liquidation of a loan, and so on—with some indication of their relative importance (crucial, important, or trivial).

58. The six responses were these:

1) When mechanics' liens or tax liens are filed against a contractor, what action should the bank take?

2) Liens filed are naturally of concern to us especially tax liens.

3) Concerning legal matters . . . [o]ur number one priority would be to protect the Bank against intervening liens, such as tax liens, judgments and mechanics liens.

4) [T]he relationship of the bank vis-a-vis the surety is the single biggest problem. . . . Mechanics liens and tax problems are secondary.

5) As support for financing a contractor . . . we require . . . (7.) A statement of current tax liability and provision for future taxes.

6) We recognize the mechanics' lien hazard as part of the business which, in a credit properly structured, should be minimized. This would apply also to tax liens.

59. The questionnaire, in its entirety, was as follows:

The following questionnaire is designed to elicit information about the effect which certain specific rules of law have on the ability of commercial lenders to provide financial assistance to firms in the contracting industry. The purpose of our research, of which this survey is a part, is to assess critically the need for reform of those rules of law which may impact unfavorably upon that function.

The questionnaire asks certain questions about *loans to contractors*. By that we mean loans made for working capital purposes, and *not* loans to owner-developers (or others) for "construction financing", interim mortgages, or "take-out" credits.

Most of the questions call for very short responses. We are aware, and appreciative, of the limited time you have for responding to such surveys, and have designed this form for the maximum ease of response consistent with high-quality data collection.

ALL RESPONSES WILL BE KEPT STRICTLY CONFIDENTIAL. Although we would appreciate having you indicate the name and address of your bank at the end of this page, so that we can correlate responses with bank size and location, you may if you wish omit this information.

A postage-paid envelope is enclosed for your convenience. *THANK YOU* for your assistance.

importance which lenders seem, formally at least, to attach to their borrowers' relationships with the taxman. Question nine asked:

Bank name _____
 Location (City and State) _____
 Approximate size of bank (Total deposits) \$ _____

1. Roughly speaking, what is your bank's total credit available for the contracting industry? \$ _____
2. Approximately how many contracting firms are presently active credit customers of the bank (if you have this information readily available)? _____

3. Generally speaking, on what basis do you extend credit to contractors?
 _____% Line of credit

Total = 100%

_____% Job-by-job

_____% Secured by some collateral

Total = 100%

_____% Not secured by collateral

_____% Job status is periodically "policed".

Total = 100%

_____% Job status is not "policed".

Please describe briefly any other significant and particular characteristics which contractor credits typically have: _____

4. The following are the forms of collateral ordinarily available to secure contractor credits. Please indicate your *preference* (1st, 2nd, etc.) among them, assuming them all to be equally available:
 - a. _____ accounts receivable or contract rights.
 - b. _____ equipment.
 - c. _____ inventory.
 - d. _____ personal guarantees of principals.
 - e. _____ other (please describe _____).
 - f. _____ other (please describe _____).
5. Referring again to the list in question four, could you please rank them in the usual order of actual *availability*: (indicate 1st, 2nd, etc.).
 - a. _____ accounts receivable or contract rights.
 - b. _____ equipment.
 - c. _____ inventory.
 - d. _____ personal guarantees of principals.
 - e. _____ other (please describe _____).
 - f. _____ other (please describe _____).
6. Do you have a regular and customary means of ascertaining if (and when) a federal tax lien is filed against a contractor borrower? For example, by checking periodically public records, or from a legal newspaper, or otherwise:

_____ Yes
 _____ No
 _____ Sometimes (please explain briefly) _____

When you undertake the initial and periodic analyses of a contractor, do you examine Federal Tax and FICA withholdings and payables owed the Federal Government?

7. If your answer to question six was "Yes" or "Sometimes", could you describe briefly *what method* of discovering such items you employ, and *how often* the information is updated? _____

8. If you do take a considerable interest in and try to follow federal tax liens filed against your contractor borrowers, could you please indicate which of the following is the most important reason for doing so, the next most important reason, etc. (Indicate 1st, 2nd, etc.)
 _____ to determine the accuracy of the contractor's representation of its financial position made at the time the loan arrangement was initiated.
 _____ to determine if the contractor's present cash flow difficulty may cause it to be close to or in default on the *loan obligation*.
 _____ to determine if the contractor's present cash flow difficulty may cause it to be close to or in default on the *construction contract*.
 _____ because of problems of government priority in the event of such filing, on *unsecured* loans.
 _____ because of problems of government priority in the event of such filing, on *secured* loans.
 _____ because of problems of surety priority in the event of default on the underlying contract.
 _____ other (please explain briefly) _____
9. When you undertake the initial and periodic analyses of a contractor, do you examine Federal Tax and FICA withholdings and payables owed the federal government?
 _____ Yes
 _____ No
 _____ Sometimes (please explain briefly) _____
10. When you undertake a credit analysis of a contractor do you determine if the principal has any significant outside investments?
 _____ Yes
 _____ No
 _____ Sometimes (please explain briefly) _____
11. Is the filing of a federal tax lien against a contractor typically defined in the loan agreement as a condition of default, permitting the bank to accelerate, realize on the collateral, etc.?
 _____ Yes
 _____ No
 _____ Sometimes (please explain briefly) _____
12. If a contractor were to default on a construction project before the project was completed because it lacked sufficient capital to complete the job, would you nonetheless ever consider making further advances, if there

Question 11 was:

Is the filing of a federal tax lien against a contractor typically defined in the loan agreement as a condition of default, permitting the bank to accelerate, realize on the collateral, etc.?

was a substantial probability that the bank would *more likely* have its loan repaid by the contractor if it "financed to completion"?

- Yes
 No
 Sometimes

13. If the answer to number 12 is "yes" or "sometimes", what factors would be determinative in your decision? (Indicate "v" for very important, "m" for marginally important, and "i" for irrelevant.)

- a. financial condition of contractor.
 b. proportion of the project cost already advanced.
 c. stage of project's completion.
 d. the existence of a private "competitor" to the contractor's receivable, such as a surety.
 e. the existence of a governmental "competitor" to the contractor's receivable, such as the government with its tax lien.
 f. other (please specify) _____

14. In the event of default by a contractor as described in question 12, under what circumstances would such a further advance of credit seem reasonable and prudent?

15. The 1972 version of the Uniform Commercial Code makes a distinction between "mandatory" and "optional" advances of loan monies extended under a credit commitment. "Mandatory" advances are referred to by the Code as those made "pursuant to commitment", and are defined as advances which the secured party has *bound* himself to make, "whether or not a subsequent event of default or other event not within his control has relieved or may relieve him from his obligation." With respect to all *secured* loans you extend to contractors, what percentage would you characterize as having been made "pursuant to commitment" as it is defined in that statute?

_____%

16. With respect to all *unsecured* loans you extend to contractors, what percentage would you characterize as having been made "pursuant to commitment" as it is defined in that statute?

_____%

17. Do you consider the distinction between advances made "pursuant to commitment" and other advances to be operationally meaningful to you?

- Yes
 No

The respondents were divided by a “sophistication index” we divined, “Class I” representing the most “sophisticated” lenders.⁶⁰ The responses to these two questions were as follows:

		Class I (N=24)	Class II (N=18)	Class III (N=24)	All Rs (N=66)
Q. 9	Yes	50%	28%	33%	38%
	Sometimes	21%	39%	42%	33%
	No	29%	33%	25%	29%
Q. 11	Yes	74%	61%	62%	66%
	Sometimes	9%	22%	13%	14%
	No	17%	17%	25%	20%

For methodological reasons we must refrain from expressly drawing *quantitative* inferences about supply/price effects out of these data. But we should observe that the number of *sua sponte* mentions of tax liens as loan-discouraging “legal problems” seems significant, given what has previously been known about the swamping effect of other legal and financial risks in some types of contractor lending.⁶¹ Beyond that we can permit the other data to speak for themselves, and allow the reader to determine how much they are saying about an

18. Could you briefly explain your answer to number 17? _____

[The questionnaires and letters were addressed to particular individuals in each bank —persons known to the authors to be “platform officers” or above, *i.e.*, assistant to executive vice presidents actively engaged in the process of commercial lending.]

60. This index was made up of three factors: bank size (total deposits); size of credit commitment to the contracting industry; and number of active contractor customers. The divisions were arbitrary:

	Total Deposits	Credit Commitments	Contractor Customers
Class I	Over \$700MM	Over \$20MM	55-1000
Class II	\$200-699MM	\$5-19MM	22-50
Class III	Under \$200MM	Under \$5MM	0-21

Of the 66 responses which formed our data base, 61 fell neatly into one of the classes as measured by all three indices. The remaining five were classified into that group for which two of the three indices were satisfied. The data used to classify were reported by the respondents on the questionnaire form.

61. For example, surety priorities, and bureaucratic difficulties in public works projects. See *Priorities*, *supra* note 23, at 1018-19, 1021-24.

unnecessarily increased cost or decreased supply of contractor financing *ab initio*.

Back now to "waste," and to the mediate set of effects first mentioned—*i.e.* the diminished propensity of commercial lenders to continue dispensing loan moneys once a course of contractor financing has begun. A skeletal scenario may help illuminate how and why this effect, in theory at least, can occur.

Assume that a contractor is the successful bidder on a 10-month, \$100,000 sub-contract to install the electrical system in a major construction project. Direct labor and materials costs will be about \$70,000 and \$20,000 respectively. After an overhead allocation of \$6,000 (and assuming the rental price of capital to be zero), the project should net the contractor \$4,000 in pre-tax profits.⁶² Assume further that the firm has other similar jobs presently in progress, at various stages of completion.

The contractor's cash financing needs in this example arise because certain of its costs—most notably labor, though materials and equipment costs are often similar—must be paid almost as incurred. Payments to the contractor, however, are often delayed by a month or more.⁶³

At a level rate of labor and material expenditures (with materials on a 30 day basis and labor payments twice per month), by the end of the first month the contractor will need \$9600 in working capital. If at that point he bills the owner for \$10,000, and if the owner pays not earlier than 30 days later, the contractor near the end of the second month will have \$19,200 in expenses and \$9000 in present receivables,⁶⁴

62. In actuality, profit margins are normally much thinner than 4%—typically, in the neighborhood of 1.14 to 1.5% of gross revenues. Dykehouse, *Construction Surety Bonds: Their Adequacy and Availability*, Supplement to HUD Report on the Availability of Crime Insurance and Surety Bonds in Urban Areas 236 (1970).

63. In addition to the normal trade period of 30 days, subcontractors especially face another source of delay: Typically, their agreement with the prime contractor conditions their (the sub's) payment on the prime's receipt of payment from the owner—thus permitting a variety of extrinsic factors to slow the payment down. In addition, retentions are often paid only after the entire project is completed—which for a specialty contractor whose work was done at the outset (excavation, structural steel, concrete, etc.) may mean a delay of several months or occasionally years. Since retentions average 10% of the contract price while profit is only 2% or so, progress payments are normally not a source of working capital for other, partially simultaneous jobs.

See, e.g., the fairly typical form subcontract in 4 AM. JUR. *Legal Forms* 2d § 47:62, at 15 (Cum. Supp. 1976).

64. *See* note 63 *supra*.

plus present rights to the payment of another \$9000 30 days later and \$2000 upon satisfactory completion of the job. Under these assumptions, therefore, the contractor may need even at this very early stage as much as 19% of the total contract price in working capital.⁶⁵ Part of this amount can come from revenues generated by other jobs, although that source of funds will do only if the payments are a) ample, b) paid on time, and c) represent *profits* rather than merely receipts. If any one of the three conditions fails to obtain, the difficulties with one job can cascade into the others which were financially dependent upon it. Because these three conditions seldom occur simultaneously, extrinsic financing is commonly necessary.⁶⁶

The commercial lender who participates in financing the working capital needs of contractors may therefore be called upon either to provide a blanket line of credit or to advance loans against specific jobs.⁶⁷ In either case the lender can expect there to be various drawings on the line from time to time, larger as materials and labor costs accumulate and receivables and retentions build up, and larger still if other work in progress encounters such difficulties as to constrict the availability of internally generated funds.⁶⁸

The repayment sources for such loans are the contract receivables. Unfortunately, those are also the loan collateral: Very often equipment is either leased or already encumbered with purchase-money liens, and the typical contractor's inventory is normally not stock-piled.⁶⁹ Con-

65. It can, even under relatively normal circumstances, be higher. For an excellent graphic illustration of the fluctuations in loan demand see Bristow, *supra* note 23, at 41-43.

66. See note 63 *supra*.

67. Survey data on the relative frequencies of "job-by-job" versus "blanket lines" appears at note 31 *supra*.

68. See Bristow, *supra* note 23.

69. For data concerning accounts as collateral, in terms of their availability as compared with other forms of collateral see text accompanying notes 115-16 *infra*. Those data are consistent with early findings by the same author—see *Priorities*, *supra* note 23, at 1044 (Q.15).

The relative unavailability of inventory and equipment for use as collateral security is true of many small businesses, to be sure. Contractors, however, may be peculiarly so characterized. In many of the specialty contracting trades heavy equipment is often leased on a job-by-job basis rather than owned, so that costly idle time during other phases of the work can be minimized. Furthermore, unlike small manufacturers, the small contractor very often orders materials only on a job basis rather than maintaining an inventory and shelf of goods-in-process. Materials, once delivered to the job site, are also generally subject to mechanics' and suppliers' liens, which in many states are prior to competing security interests held by the contractor's financier. See

sequently, the contract rights of the firm (and the homes of the firm's principals) are often the major form of loan security.⁷⁰

Contracting, as lenders see it, is an inherently risky business.⁷¹ Even though "sales" are already contracted for prior to the incurring of significant production costs, the fact remains that cash-flow planning is not always reliable. The risks are well evidenced by the fact that in recent years contracting firms accounted for 10-18% of all business failures,⁷² while they represent only 8.5% of all corporations⁷³

generally E. Dauer, "Preventive Law" For Lenders 11-12 (Robert Morris Associates Occasional Paper 1975).

70. Personal guarantees, often "backed-up" by the principal's real property even if not technically secured by it, are very common among contractor credits. Our survey showed that such guarantees were first in order of availability, text accompanying notes 115-16 *infra*, and, in terms of desirability from the lender's point of view, 62.5% of our respondents ranked personal guarantees as the first most desirable security for contractor loans. (This may bear out our suspicion that lenders do not savor security which—like accounts and contract rights—is identical with the expected "normal course" loan repayment source.)

71. Strikes, inappropriate weather, materials shortages, unexpected building or ground conditions can all seriously perturb any contractor. In addition, most firms operate on very slim margins, with median revenue to working capital ratios typically in excess of ten or twelve to one (20 or 30 to one for the smaller firms). Robert Morris Associates, Annual Statement Studies 145-52 (1972 ed.). The risk in contractor lending, which is a combination of industry characteristics and a very complex and unfavorable (to the lender) legal environment, was borne out by our own survey. In response to the question "Please describe briefly any other significant and particular characteristics which contractor credits typically have," we received answers such as: "Considered very high risk and treated accordingly." "Greater risks." "We do not generally extend credit of any kind to contractors unless there is a substantial net worth and a source of repayment independent of the contracting venture." Of the 30 respondents answering this question, 11 mentioned the greater risks in either the contracting industry or in making loans to that industry.

72. In 1974 there were 1,840 failures among construction firms, out of a total of 9,915 for all industries. These data cover all firms, including partnerships and proprietorships as well as corporations. "Failure" means, for this purpose, discontinuation of business following receivership, attachment, bankruptcy, foreclosure, or other business termination known to have left one or more business creditors unpaid in full. UNITED STATES DEPT OF COMM., BUREAU OF THE CENSUS, STATISTICAL ABSTRACT OF THE UNITED STATES 508 (1975) [hereafter cited as STATISTICAL ABSTRACT].

Perhaps because so many contracting firms are financially small, and "die" leaving relatively small debts (of the 1,840 failures, 1,152 left debts under \$100,000), *id.*, the proportion of all bankruptcies borne by the construction industry is somewhat lower. Nevertheless, in 1969 the construction trade accounted for 10% of all business "straight" bankruptcies. D. STANLEY & M. GIRTH, BANKRUPTCY—PROBLEM, PROCESS, REFORM 109 (1971).

73. STATISTICAL ABSTRACT, *supra* note 72, at 490. Construction firms are 7.9% of all proprietorships, 6.1% of all partnerships, 8.5% of all corporations, and 7.6% of all firms. *Id.* (Data are from 1972).

and capture only five percent of all business revenues.⁷⁴ The point is, simply, that contracting firms are more likely than other business borrowers to become “workouts”⁷⁵ for their working capital financiers.⁷⁶

Financial difficulties usually begin when the other jobs in progress generate insufficient profits to support the project in question, or when other unexpected project or cash timing perturbations occur. “Taxes due” may then be the first illegal harbor the cash-shy firm enters. For one thing, about \$7000 of the \$70,000 labor cost in this example is for FICA contributions due the IRS from the contractor.⁷⁷ And there is another \$6,000 or so in FIT withholdings which the firm handles as temporary trustee.⁷⁸ These sums are money, even though they are not assets.⁷⁹ The contractor’s cash flow needs make the furtive use of these FIT and FICA funds quite attractive: First, they are physically available even when outside financing may not be, or has been temporarily exhausted. And second, they represent a “float” against the United States Treasury, resulting in a capital cost of nearly zero. (Recall that the contractor’s profit is four percent of revenues. If capital costs were one percent of total project costs,⁸⁰ then outside financing would devour \$960÷\$4000, or 24% of pre-tax profits). It is,

74. As reflected on Federal Income Tax returns for United States corporations in 1972. *Id.* at 498.

75. In the argot of commercial banking, the term “workout” varies greatly in meaning, depending upon each banker’s sense of when things have not gone well. Generally speaking, a “workout” is a loan which is not being repaid precisely as planned, and which requires some special handling or supervision. The term is also used to refer to that special handling: a workout could be extending payments, reducing fees, adding (or collecting) collateral, etc. More precisely still, the tenses of the word could be: Loan, Workout, Liquidation, Charge-off.

76. *Priorities*, *supra* note 23, at 1005-09. *See esp. id.* at 1008 n. 328.

77. The employer is a conduit for, and therefore a temporary holder of, the withheld FICA contributions of its employees, at present 5.85% of wages up to \$15,300. In addition, the employer’s FICA contribution is presently another 5.85% of the same wage base. INT. REV. CODE OF 1954 §§ 3101, 3111; 42 U.S.C. § 409 (1970). Thus, the contractor “handles,” for a period of time, 11.7% of qualified FICA wages for the IRS.

78. The withholding of FIT varies with pay scales and other factors. For an employee earning \$10,000 annually, who is married and has two children, the withholding rate is over 8% of gross wages. CCH, 1976 STAND. FED. TAX REP. 7819 at ¶ 162A.

79. *See* note 5 *supra*.

80. Referring again to Bristow’s examples, *supra* note 23, at 40, an average daily loan balance for a \$426,000 (cost) job is about \$38,000. If the interest rate is two points over prime (11%, say), then the interest charges are $11\% \times \frac{38,000}{426,000} = 0.98\%$ of project cost.

therefore, not surprising that in one recent year some 26% of all overdue employers' federal tax liabilities were attributable to contracting firms.⁸¹ What better way to tide over a rough spot if the project is losing money or if the feeder jobs don't pan out, than to "borrow" these sums from the IRS to meet a payroll?

If matters have deteriorated long enough, the imposition of a tax lien is a possible even if not an inevitable event. And, of course, the receivables of interest to the lender may be thus affected by a lien whose existence was first caused by unpaid taxes attributable to other, older, and not necessarily financed jobs.⁸² Recall, now, that a fair portion of the payroll and materials costs were being paid with commercial borrowings secured by earned receivables—the very receivables now covered with an IRS lien. When a contractor begins to encounter job or cash-flow difficulties, therefore, among the numerous creditors who may contemplate liquidating the obligations owed to them are the commercial (working-capital) lender and the IRS. For both, the firm's receivables (such as they are) are often the prime (and sometimes only) assets to look to or to lien. Unfortunately their value is seldom sufficient to satisfy everyone; and furthermore, any major cash flow interruption is likely to have the cascading effect

81. See internal Treasury Department memorandum, dated Feb. 12, 1965, in *Hearing on H.R. 11,256 and 11,290 Before House Comm. on Ways and Means*, 89th Cong., 2d Sess. 41-42 (1966) [hereinafter cited as *Hearings*].

[A]lthough the construction industry is estimated to pay only about 5.67 percent of trust fund taxes collected annually, 26 percent of the dollar value of delinquent trust fund taxes is attributable to the construction industry. . . . in the almost unanimous opinion of the 58 district directors of internal revenue all across the country, employers in the construction industry gave them the greatest difficulty in terms of number, frequency, dollar volume, and duration of delinquencies. *Id.* at 42.

82. For a description of the pre-lien assessment procedure see note 9 *supra*. And recall that the District Director may "bargain" with lenders and creditors to withhold the filing of a lien. We have no data on the frequency of such bargaining, nor on its typical outcomes.

Recall too, note 9 *supra*, that the lien may apply to Job Z's receivables even though the delinquent taxes are attributable more directly to Job A, completed X years or months ago. Consequently, although we did not incorporate it in the textual example (for the sake of clarifying the explanation in the text) it is important to note that this old-job's-taxes but new-job's-assets phenomenon moots all such questions as, "If the lien is filed 90 days after the delinquency, which occurs 60 days after the taxes were withheld, and there are still 45 post-lien days in which safely to lend, aren't we only talking about post-195-day advances, thus nothing very important is involved?"

If the question isn't moot, then at least the answer is "no." The tax lien could be filed against a job's receivables (or the 45-day "grace" period could expire) on day 1 of the job being financed, or day 30 or day minus-30.

previously mentioned, thereby endangering the underlying project's timely completion as well as the value of the receivables themselves.

The lender, in an extreme case, therefore occasionally faces the following predicament: If at some point it refuses to make a further advance against a tax-liened receivable (or retention), and if the cause of the cash crisis also affects the short-term availability of internally generated funds, then the troubled contractor may have to commit the unpardonable sin of missing a payroll,⁸³ or of being "shut off" by materials suppliers or equipment lessors. Default becomes a real possibility. That, in turn, will cause "backcharges" to be assessed by the owner or prime contractor against the receivables (and retentions) already assigned for past advances,⁸⁴ making even the former collateral dubious in the extreme and the asset value of future receivables truly minimal.⁸⁵ Backcharges result from the fact that it inevitably costs more for a relet or takeover (or almost any other action after breach) than for the project to be completed on schedule by the original contractor.⁸⁶ Backcharges and other breach damages are therefore an indicator of the central component of the resource waste we have been referring to.

If, on the other hand, the lender can make further mid-crisis advances, the "waste" of project default could be avoided, the lender's security in the already assigned accounts could be more assured, and

83. If a payroll is missed, the contractor can expect his workers' unions to order a work-stoppage almost instantly. Some contractors have informed us that the same will be true even if only a "fringe" is unpaid—such as a union dues checkoff.

84. A "backcharge" to a contractor or a lender, is a "setoff" to a lawyer. If a receivable is earned but unpaid, and if the account obligee "breaches" the contract, the obligor will set off the breach damages against the receivable.

85. The backcharges may be applied to existing and assigned receivables even if the owner (or prime contractor) knows of the assignment. UCC § 9-318(1)(a); cf. RESTATEMENT (SECOND) OF CONTRACTS § 168 (Tent. ed. 1973).

86. The phenomenon seems intuitively correct, although we have been unable to locate any *quantitative* studies. Because many construction projects are bonded, it is tempting (at first blush) to examine data collected by surety bond companies which reflect both original project cost and cost to complete. These figures, however, could be misleading: Some such increases may result from changes in labor and materials prices (inflation) from the bid date to the relet date; some may reflect a "holding up" by relet bidders who know that there is a distress situation; and some may reflect the fact that the original bid was unrealistically low. In none of these cases would "waste" of the sort we are focussing upon be implicated. Furthermore, and on the opposite side of the coin, construction bond sureties often do not reflect in their loss-ratio records their own efforts and expenses which went into curing or forestalling a potential default before a formal claim on the bond was made. See generally SURETY ASS'N OF AMERICA, *THE UNSEEN SERVICES OF A CONTRACT BOND SURETY* (1973).

the retentions (possibly reflecting profit) are more likely ultimately to be paid. The net effect is that the lender may be better off by loaning more, the net project cost can be kept lower by avoiding the waste of a default and takeover, and the contractor can salvage the maximum possible profit from the project (often to the benefit of the IRS as

See esp. id. at 3. That sureties recognize the true increased costs of completing a defaulted project, is plain. For example,

[a]nother factor is the pragmatic necessity of keeping the job moving without disquieting the subcontractors, materialmen and the experienced labor force already engaged. Any "break" in the job invites the loss of key workmen and supervisory personnel.

Id. at 7.

Because adequate quantitative data was unavailable, we conducted for this purpose a series of 13 "in-depth" interviews with those members of surety (8) and contracting (5) firms most directly experienced with default and relet or "take-over." All of those interviewed alleged that costs to complete after a default (*i.e.*, with a new contractor) almost always exceed what the costs would have been had the original contractor not defaulted. One interviewee reported the result of his own informal study that the cost differential was commonly 22%, discounted for inflation. (We were unable to determine exactly how much of this figure may have been infected by the other distortions just mentioned).

Some of the components of this cost increase upon which our interviewees agreed, and which we would style as resource "waste," are as follows:

a) *Renegotiation costs*—cost of calculating new bids, of arranging (under time constraints) for changes in the "supply lines" of equipment, materials, and (sometimes) personnel and subcontractors.

b) *Delay*—affecting other phases of the project (*e.g.*, other subcontractors' idle time) and affecting occupancy and use by the owner as originally scheduled.

c) *Unknown risks*—the knowledge the original contractor had about peculiarities of the job (hidden defects, site conditions, etc.) is not always available to the "takeover" firm which must cover itself by reflecting this duplicative information (or risk) cost in its bid. A further component was cited as "familiarization" cost, *i.e.*, the duplicative investment the new firm must make to become sufficiently familiar with the job in both its overall context and in terms of the state and nature of the work already done on the defaulted portion.

d) *Contractor overpayment*—many contractors "front load" their jobs. That is to say, they bill more for the early stages of the work and less for the later, even if costs throughout are uniform, so that their cash flow from progress payments runs faster at the outset. Upon default the portion of the contract price still due is less than the portion of work still to be done. A new contractor must therefore charge a price to complete which is higher than the price still unpaid. Though not "waste" in the same sense as are the other elements, this factor (especially when the defaulting contractor is judgment-proof) often does inflate completion costs by a significant amount.

e) *Commencement costs*—include moving equipment to a new job site; re-arranging work-in-process schedules; overtime wages to make up for delays; etc.

well). This is, in effect, just a special case of the fact that half-completed things often aren't worth one-half of completed things, and completing them *as planned* usually costs less than the value added by completion. The punchline is that the lender's perception of the safety (priority) of its post-lien loans will tend to affect what would otherwise be its waste-minimizing decision to lend after lien or not.

A lender's judgment can never be mathematically certain, especially during the chaos of impending default and financial muddle. In other words, salvage loans do not always work. When they don't, there will be a number of losers, including the lender and the IRS. Section 6323 was designed to effect Congress' intent that this risk be disproportionately borne by the IRS.⁸⁷ That risk allocation is in fact the phenomenon we have been discussing. It is the priority factor which can affect

87. See note 45 *supra*: "[T]he disbursements *generally* enhance the value of the property for purposes of the tax lien." (emphasis added)

There are some fundamental problems with our assertion that Congress "intended" that contractor lenders have the higher priority, which assertion of course is critical to the way we have structured the balance of our inquiry. The difficulty becomes plain if we consider two questions: (1) If Congress so "intended," is § 6323 preemptive of § 9-301(4)? (2) Again, if Congress so intended, could it not have legislated the result without the delegation to state law? That is to say, Congress may have only *permitted* a pro-lender judgment, rather than have *decided* in favor of one, or even have intended to *encourage* such an outcome.

There are a series of responses to such queries, which we present in increasing order of importance:

1) Even if Congress intended only to "permit," a criticism of the PEB is still valid, on two counts. First, one could argue that the PEB made the wrong choice, and that the interest of the fisc is better served one way or the other, or that it is less important in both distribution and efficiency terms than is the interest of contractor financiers. Obviously, we have made no such discussion here, for the reason that we think this avenue is not the only correct one. But even if this conclusion is flawed, there is the second count: As we have indicated, the PEB intended to take advantage of the federal delegation, but failed to do so. We would therefore accept the PEB's decision, and focus our critique on the drafters' implementation of their own choice. The import of our study would then become a demonstration of the costs *on one side only* of the PEB's error.

2) It is possible to interpret the federal delegation to mean something like: "States, make your decision on the basis of local factors and count the federal interest for zero." The states, in other words, could resolve the matter as best served all interests other than the federal fisc (Congress feeling that the latter is amply protected, or is less important, or whatever). If this be the correct reading of the federal law, the balance of our analysis stands fairly well as it is, though we would not have available the spear of "federal intention to aid construction lenders" as an additional device on which to impale the UCC.

3) A third reading, and the one which we believe to be the best of the three, is to view the state law delegations in § 6323 as matters of definitional convenience rather than indifferent delegation or even mere encouragement. The case for this reading is

the lender's judgment to take the risk or not. That is not to say that lenders will act irresponsibly if the tax lien is subordinated; quite the contrary is true. *Without* interference from a tax lien the lender's decision to optimize its own welfare (*i.e.*, whether or not to protect the repayment source of past advances from backcharges caused by the lack of future advances) will normally be coincidental with the optimal (waste-minimizing) solution from the contractor's and owner's perspectives (and therefore the public's) as well: If the lender determines that a loan of \$1.00 will result in a repayment of that dollar *plus* a backcharge reduction (to the lender, collateral enhancement) of \$0.10, it will make the loan. That is also to say that resources worth \$1.00 result in a product of \$1.10. It is when the tax lien *is* interposed that the lender's ability to judge this coincidence of interests is

difficult to make, given the form in which our hypothetical antagonist's questions are put, though there is both evidence and logic to support it.

The drafters of § 6323 were quite aware of the then existing Uniform Commercial Code, and were plainly using it as the major existing feature of the legal environment in which a "cure" of the tax lien mess would reside:

The [UCC] is an historic revision of the laws governing commercial practices in the United States. That revision in turn requires a revision of the rules governing Federal tax liens, as these rules play an important part in day-by-day commercial activity.

Hearings, supra note 81, at 37.

Perhaps more to the point, in order to fix the date as of which security interests come into being vis-a-vis the Federal tax lien, the proposed legislation provides that the security interest will be deemed to arise at the time when it becomes perfected under local law. . . .

Id. at 49. The existing state law therefore was a convenient definition of the interests to be protected for Federal purposes. And, even more directly, were the reasons cited in House Ways and Means Comm., Final Report, H.R. Rep. No. 1884, 89th Cong., 2d Sess. 41 (1966) that "the priority granted a security interest over a Federal tax lien under subsection (c) may not be greater than the priority accorded such security interest under local law against such a judgment lien," and that "This bill is in part an attempt to conform the lien provisions of the internal revenue laws to the concepts developed in the Uniform Commercial Code." *Id.*, at 1.

Congress was quite right to utilize the UCC's "perfection" concept, since the UCC already required a putative secured party to do certain socially useful things before it would "earn" a prior (or even protected) position—*e.g.*, a written agreement, filed for public notice, limited in certain ways, and so on. One cannot read the legislative history of the Tax Lien Act without being impressed with the fact that Congress *did intend* to accord the superpriority to the contractor lender, and utilized the "local law" device not as a delegation of the right to choose, but as a very rational definitional matter—one designed to conform the rules of superpriority to the "normal" requisites and procedures of perfected secured lending. *See, e.g., Hearings, supra* note 81, at 48, "advances . . . to complete the construction of a building will [emphasis added] take priority . . . if the advances are secured. . . ." *See generally* H.R. REP. NO. 1884, 89th Cong., 2d Sess. (1966), *reprinted in* [1966] U.S. CODE CONG. & AD. NEWS 1316.

marginally perturbed: If the IRS gets the \$1.00 later loaned,⁸⁸ the lender will refuse to invest \$1.00 for a return to it of \$0.10.

Congress in enacting § 6323 must have recognized what seems intuitively true, *i.e.* that lenders are for obvious reasons in the best position to make such a decision; and that, as the legislative history makes clear,⁸⁹ the public fisc benefits as well from having the most rational possible decisions made about whether to end the matter and divide the residue, or whether to invest further in the hopes of greater payoff for all, including the IRS.

But for yet another reason we are, in the present essay, in the odd position of not having to argue that part of the analytical scheme which is generally styled as the distributive policy analysis. If we were, it could be a matter of choosing (after measuring) between the beneficiaries of the federal fisc (all of us) on the one hand and the beneficiaries of construction-contract waste avoidance (fewer than all of us) on the other, after assessing which choice would be Pareto-superior and after deciding whether Pareto-superiority (as opposed to Pareto-optimality)⁹⁰ is a sufficient distributive criterion. *For present purposes* we are content to say that Congress has already made that choice.⁹¹ Whether it should have been extended to every industry rather than just contracting, and whether it is the choice we would have made if voting in Congress, are interesting but, presently, not necessarily relevant questions. The pertinent observation is that the draftsmen of § 9-301(4) [1972] mistakenly failed to implement the choice which Congress made. We would not be surprised if we were to learn that the PEB did not do its own allocative calculations and distribution-norm judgments as part of its 9-301(4) drafting exercise.

88. That is, if the IRS has the prior claim on receivables subject to the lien. The same effect occurs even if, in this example, the IRS priority is only to some value greater than \$0.10.

89. See note 45 *supra*.

90. "[A]n equilibrium is said to be 'Pareto-optimal' if (and only if) there is no possible movement from it that could make *everyone* better off." P. SAMUELSON, *ECONOMICS* 460 (9th ed. 1973). In contemplating any structural or legal change, the change is a move toward Pareto-optimality if it results in gain to some (or all) persons with no loss to any other person. "Pareto-superiority" applies to the consequences of a change by which the gainers will gain more than the losers will lose.

91. See note 87 *supra*.

III

Our theory of why the misfit between § 9-301(4) [1972] and § 6323(c)(1)(A)(ii) [1966] is a matter of some actual significance has been relatively simply stated, though in a mode familiar from most legal theorizing about the effects of financial priority rules. When we considered attempting to validate our suppositions with an empirical view of the matter, we at first thought two questions to be worth asking. One was whether the priority position of the federal tax lien did in fact create some marginal disincentive to the making of post-lien optional advances. The other was that of the magnitude of the incremental effect, and the actual amount in dollar terms of the waste of resources at stake. For methodological reasons common to both questions but fatal to the second, we pursued only the first of these two inquiries.

A lender's decision to make an optional future advance in a work-out situation is a subjective calculation accommodating numerous factors, almost always very highly individualized to the facts of each particular case.⁹² Consequently, to study the magnitude of this one component would require our isolating it from an exceedingly subtle mix of other variables. That could have been accomplished of course, but the methods for doing it were impracticable. One possibility might have been to compare the activities of lenders which are in jurisdictions having the 1972 rule with those which are not.⁹³ If, after correcting for any spurious covariants,⁹⁴ respondents in the 1972 sample reported fewer post-lien advances than did those in the non-1972, it might have been possible to infer a causal connection between the new Code and the effect in question, and perhaps even to

92. Our questionnaire asked (Q.14) for a brief description of the circumstances under which a post-default advance would be reasonable and prudent. The responses, which are too lengthy to reproduce here, displayed a richness of factors and subjective judgments. One respondent said, simply, "Best judgment as to least loss." And another, "We would probably advance additional funds if there was better than a 50% chance of eliminating a loss. This is always a matter of judgment and each situation is unique."

93. See list of enacting jurisdictions note 2 *supra*.

94. One which could not be controlled for, of course, would be the *other* parts of the 1972 revisions. That is to say, there would be other variables of theoretically potential relevance (e.g. revised § 9-204) which would co-vary with the one variable in question. While as a methodological matter this is not always fatal, it could be in the present case since the covariables might be expected to have effects on the same dependent variables as would the independent variable in question.

quantify it. The difficulty, however, was that the 1962 version of Article 9 is not clearly opposite to that of 1972 so far as tax lien priorities are concerned.⁹⁵ There were, among those who think about such things, significant questions under the pre-1972 Code about the "perfection" for § 6323 purposes of all non-mandatory future advances.⁹⁶ It was that very question which may have impelled the 1972 draftsmen to attempt to mesh their product with the Tax Lien Act's broader outlines.⁹⁷

Another possibility would have been to divide a sample of cases into two groups—those cases in which loans were extended into a workout without tax lien imminency, and those in which the tax lien was in fact present or threatened. While this would have yielded some useful data about the effect of tax liens on secured lenders, it would not have made it possible precisely to quantify what would have happened if there had been a *subordinate* tax lien, since a "no-lien" case is financially different from a "subordinated-lien" case in ways that are relevant to workout credit decisions.⁹⁸ This method would have been impracticable even for collecting data on "effect" alone. We would have had to collect a number of identifiably pertinent cases large enough to wipe out random movements of other variables, or else match pairs of otherwise identical cases.⁹⁹ As to the first, such

95. One problem is that for tax lien purposes, a security interest "arises" or "exists" only when it has been, in state law parlance, perfected. INT. REV. CODE OF 1954 § 6323(h)(1). Then, under the UCC, perfection occurs when the security interest has, *inter alia*, "attached." UCC § 9-303(1). Attachment occurs when, *inter alia*, "value is given." (N.B.—this accords with the additional requirement in § 6323(h)(1) that the secured party has parted with "money or money's worth.") "Value" in turn means ordinary consideration, and specifically, a *binding* commitment to lend. § 1-201(44)(a), (d). Hence, there is some significant question whether an optional future advance, agreed-to yesterday but made tomorrow (with a tax lien filed today) was—because it was optional—perfected at the time the lien was filed. For the effect of the 1972 Revisions on this problem see note 41 *supra*.

96. See, e.g., Coogan, *supra* note 4, at 1389-94; Gilmore, *supra* note 4, at 1072-73; Plumb, *supra* note 4, at 87-96. As these authorities indicate, even mandatory advances are open to "sharpshooting." (Gilmore's treatise was written before the 1966 Tax Lien Act became law.)

97. See text accompanying notes 133-38 *infra*.

98. There are a number of obvious reasons why subordinated debt is different from no debt at all. In the present instance, for example, recall that the tax lien covers *all* of the debtor's property, INT. REV. CODE OF 1954 § 6321, including assets not subject to the putatively superior Article 9 interest. Moreover, under the "paymaster" theory a lien for unpaid FIT/FICA withholding taxes applies to property of the principals as well as of the firm. *Id.* § 3504.

99. For a brief general description of multivariate analysis see H. BLALOCK, AN

records simply do not become available without the expenditure of heroic time and expense, and even then not all of the relevant cases would necessarily be identifiable from the banks' files.¹⁰⁰ The issue simply did not justify such an investment. As to the latter, we suspected on the basis of our familiarity with bank lending procedures that matching pairs of otherwise identical cases would be impossible. The factors to be matched would be too numerous and variable to systematize, even if they were to have been recorded. No multiple regression could ever be intelligently made on the basis of bankers' reports of their own troublesome credits.

Many of these methodological difficulties affected our choice of procedures with respect to the first question ("Is there such an effect?") as well. Controlled experimentation was structurally prohibited. Historical reconstruction was financially (and temporally) unjustifiable, as was contemporaneous participant observation. In fact, the only justifiable method open to us was the survey questionnaire. Because we anticipated a near-zero usable response rate if we asked for precise and individual case histories, we determined to assess lenders' self-reports of generalized dissuasion cognitively attributed to the superior priority of tax liens. The results were about as good as the method employed. Although they tend to support our hypotheses, they suffer from certain infelicities of method and implementation. And, in addition, we are acutely aware (and advise the reader to be aware as well) of the relatively narrow role which the survey plays, given the broad range of theoretical statements the analysis thus far has generated. We therefore would be cautious in staking very much on our data alone. But on the other hand, not very much really *is* at stake. Correcting the PEB's error would be so nearly costless in other than political terms¹⁰¹ that even the low-level inferences which can be

INTRODUCTION TO SOCIAL RESEARCH 21-26 (1970). See also the discussion of "Component Variables" in M. ROSENBERG, *THE LOGIC OF SURVEY ANALYSIS* 40-52 (1968).

100. One of the present authors has had substantial experience in dealing with bankers' credit and job files. Bankers, like most other people, often don't explicate for the record all of the pertinent information about all of their work, and about all of the variables which nevertheless inform their judgments.

101. The PEB's and NCCUSL's legitimate interest in nationwide enactment of the 1972 revisions would not necessarily be well served by their endorsing the red flags of minor errors. This is really all we mean by political costs. And, to extend the gesture of fairness, we should add that the 1972 revisions were made (less-than-broadly) available during the earlier drafting stages, when comments and corrections were both easier to accommodate and were solicited from a (somewhat restricted) group of advisors and others. However, see text accompanying notes 136-40 *infra*; note 139 *infra*.

drawn from our study would impel us, at least, to advocate that correction should be made. This is not a matter in which substantial interests remain open on the other side. Indeed, as we have already indicated, Congress has already made that decision about allocating risks which needed to be made.¹⁰² We are aware of no other significant tradeoffs.¹⁰³

The first phase of the study produced the results previously indicated: a fair proportion (27%) of a small number (22) of respondents mentioned on their own volition that tax liens (priority) were a "legal problem" which tended to discourage their financing of contracting firms. That phase of the research, however, was employed mostly to provide us with some additional "feeling" for the context of the banking industry, to assist us in preparing the questionnaires for the second phase. The following summarizes the relevant information which those later questionnaires provided.

Three questions inquired directly into the extent of lenders' general interest in tax liens filed against their borrowers. Question 6 asked if the respondent had a regular means of ascertaining if and when such liens are filed.¹⁰⁴ Question 7 asked how often that information was obtained.¹⁰⁵ Question 8 asked for a rank ordering of selected reasons for obtaining the information.¹⁰⁶ The overall results for Question 6 were 71% "yes"; 17% "sometimes"; and only 12% "no" (N=66). As to the frequency of checking (Q.7) the results were as follows:¹⁰⁷

As to the PEB's own expression of its views, anent the relative importance of uniformity, exactitude, and enactment of their product see PERMANENT EDITORIAL BOARD FOR THE UCC, REPORT NO. 2, at 11-13 (1965).

102. See note 87 *supra*.

103. Other than one very minor possibility, involving judicial lien creditors, which occurs only because corrective language would be too complex to draft in a way which would obviate even that minor cost. See text accompanying notes 145-46 *supra*.

104. For the exact language of the question see note 59 *supra*.

105. *Id.*

106. *Id.*

107. The "frequently," "occasionally," and "in workouts only" categories are all coded. That is, we interpreted the responses into groups rather than scoring them in their diverse literal terms.

There is a possible ambiguity in these responses, which may have made the data less reliable than at first appears. Question 6 asked, "Do you have a regular and customary means of ascertaining if (and when) a federal tax lien is filed . . . ?" Question 7 asked only for a frequency response, not again mentioning the phrase "tax liens." See note 59 *supra*. The ambiguity arises for this reason: many of our respondents sub-

daily	36%
weekly	27%
monthly	7%
frequently	9%
occasionally	16%
in workouts only	5%
Total	100%
	(N=56)

In Question 8 six possible reasons for collecting tax lien information were presented, and the respondents (N=54) were asked to rank those reasons as most important [1] through least important [6]:

PER-CENT RANKINGS FOR EACH "REASON"¹⁰⁸

	<u>1</u>	<u>2</u>	<u>3</u>	<u>4</u>	<u>5</u>	<u>6</u>	
a) to determine accuracy of original financial presentation	9	13	13	4	13	48	(t=100%)
b) cash flow problem may cause default on loan	59	13	6	15	2	6	(t=100%)
c) cash flow problem may cause default on project	9	30	17	9	17	19	(t=100%)
d) U.S. (IRS) priority vis-a-vis unsecured loans	11	26	24	20	4	15	(t=100%)
e) U.S. (IRS) priority vis-a-vis secured loans	9	7	22	20	19	22	(t=100%)
f) surety priority if contract is defaulted	2	6	17	17	19	41	(t=100%)

scribe to credit report services, rather than "check the books" themselves. The daily (or weekly, or whatever) reports typically contain lists of *all* filings—tax liens, judgments, bankruptcies, mechanics' liens, executions, and so on. Thus, banks which indicated that they do, *e.g.*, a daily checking in question 7, may be doing so for reasons not entirely explained by their concern for tax liens. Consequently, the "frequency of checking" data may not demonstrate as avid an interest in tax liens as first appears. The balance of the data, however, should be unaffected—*viz.*, (1) banks do *get* actual notice of tax liens with the frequency indicated; and (2) questions 6 and 8 in the survey form were tax-lien specific.

108. If all of our respondents had "played the questionnaire's game" according to the rules the columns would have totalled 100% both horizontally *and* vertically. The fact that they do not is attributable to the decisions we made about treating incorrect or incomplete responses. A few respondents merely checked off those "reasons" they (presumably) thought relevant. When that was done, we gave each checked category the average of the number checked: thus, if 3 were checked, each was assigned the rank of $(1 + 2 + 3)/3 = 2$. *Omitted* reasons (either not checked or not numbered) were assigned the number 6: thus, if a respondent indicated 1, 2 and 3, leaving 3 reasons unnumbered, we gave *each* unnumbered reason the value of 6. This was a conservative

The rankings were remarkably (and surprisingly) consistent across all three groups of lenders.¹⁰⁹ Most important overall was the cash flow problem affecting loan repayment (mean rank=2.04),¹¹⁰ then, in decreasing order of importance: Tax lien priority vis-a-vis *unsecured* loans (3.24); cash flow problem affecting completion of the project (3.50); tax lien priority vis-a-vis *secured* loans (3.98); indicator of accuracy of original financial presentation (4.43); and least important, surety priority in the event of project default (4.67).

This general concern with their borrowers' having tax liens filed or taxes assessed against them was again reflected by our respondents in Questions 9 (Do you examine FIT and FICA payables when doing a credit analysis?)¹¹¹ and 11 (Is the filing of a tax lien a condition of default, allowing acceleration of loan maturity date and liquidation of collateral?).¹¹² As we had expected, responses to both questions varied generally with (our assessment of) the sophistication of the lender,¹¹³ and tended to support the inference that tax liens are regarded as significant, even if not determinative, factors in the minds of commercial lenders.

One other interesting factor appeared with respect to Question 9: In another place, we asked each respondent to rank in terms of availability each of four types of security used to support loans to contractors—accounts and contract rights; equipment; inventory; and personal guarantees of the firms' principals.¹¹⁴ We then grouped the questionnaires according to the rank (1=most generally available; 4=least gen-

method, resulting in an understatement of the aggregate importance of the variables. The number of responses which needed to be so treated was quite small.

109. We would have expected slight but positive differences in lines e) and f) of question 8, with the Class I lenders ascribing slightly more importance to these factors than did the Classes II and III lenders, since their greater experience should have taught them more about such risks. Each "Reason" was ranked from 1 (most important) to 6 (least important). The mean ranks for reasons e) and f), by lender "class" rank, were as follows:

	<i>Class I</i>	<i>Class II</i>	<i>Class III</i>	<i>All Rs</i>
Q.8 (e)	4.14	4.18	3.73	3.98
Q.8 (f)	4.38	4.91	4.82	4.67

110. "Mean rank" simply means the weighted average of all of the rankings given by all of the respondents for that "reason." A mean rank of 3.50 would be the exact median of the means.

111. See questionnaire note 59 *supra* for the precise language of the question.

112. *Id.*

113. See tables at text accompanying notes 59-60 *supra*.

114. See questionnaire, *supra* note 59, at question 5. For the results of this question see text accompanying note 116 *infra*.

erally available) given to the item "accounts and contract rights" to see if the responses to some of the other questions varied significantly when segmented in this way. The only question among those tested (6, 8, 9, 11, 12 and 13) which seemed to covary at all was Question number 9:

Q. 9 Response (Do you examine FIT and FICA payables and withholdings?)

	Rank availability of accounts			
	<u>1</u>	<u>2</u>	<u>3</u>	<u>4</u>
	(N=11)	(N=23)	(N=15)	(N=16)
YES	55%	52%	27%	13%
SOMETIMES	36%	22%	46%	37%
NO	9%	26%	27%	50%
TOTAL	100%	100%	100%	100%

We have been unable to determine with certainty the exact cause of this serendipitous correlation; the overlap between Class I lenders and "accounts-first" lenders is neither badly skewed nor linear, thus the phenomenon is not simply a mathematical artifact of the bunching of other variables. One plausible explanation is that among the four types of security listed, accounts and contract rights in the construction industry are the ones most vulnerable to "ephemeralization" when cash flow difficulties (as signaled or caused by tax delinquencies) materialize. However, there were no significant changes in the other accounts-related response patterns (especially Q. 8 (d & e) and Q. 13 (e)) when they were stratified in the same way, as this explanation would have predicted.¹¹⁵ Another, more tempting, guess is that the lender's priority position in accounts vis-a-vis the tax lien is less certain than it is with respect to equipment and personal assets (and possibly inventory) because the latter are normally neither after-acquired property nor assigned *seriatim* as advances are made. But once again there appears to be no *experimentally independent* support in the data for this very plausible supposition. Thus this finding, which tends substantially to support the hypothesis that tax liens

115. As to 8(d) and (e), we would have expected the mean rankings to diverge as the use of accounts as collateral grew more frequent, since the "Ephemeralization" should have been partially a result of the differences in IRS priority in accounts secured and accounts unsecured. As to 13(e), we should have expected the indicated degree of importance to rise, again for the same reasons. (More particularly, collateral other than accounts is seldom acquired by contractor lenders in an "after-acquired" mode.)

matter greatly especially to accounts receivable lenders, must by its context be considered scientifically (though not forensically) a-lop.

While on that question, however, it is interesting to note just how often accounts and contract rights are reported to be high in order of availability: They are first in 17% of all cases, and first or second (typically behind only personal guarantees) in 42%. (We suspect that if the question had been restricted to loans for working capital, so that loans used primarily to finance equipment purchases were excluded, these two figures would have been substantially higher.)¹¹⁶

Questions 12 and 13 inquired into the respondents' willingness to lend into a workout: Question 12 asked, if the contractor were to default on the project because it lacked sufficient funding to complete, would the bank make further advances if doing so would increase the probability of eventual loan repayment?¹¹⁷ *None* of the respondents answered "No." Overall, 65% said "Yes" and 35% said "Sometimes," with the Class I lenders slightly more likely (71%) to say yes than those in Classes II (61%) or III (62%). Question 13 then provided a list of five factors, and asked the respondent to indicate whether, in contemplating such a further advance, each factor would be very important (V), marginally important (M), or irrelevant (I):¹¹⁸

	V	M	I
a) financial condition of contractor	79%	16%	5% (t=100%)
b) proportion of cost already loaned	74%	24%	2% (t=100%)
c) stage of project's completion	85%	13%	2% (t=100%)
d) existence of private competitor to collateral (e.g. surety)	69%	24%	7% (t=100%)
e) existence of public competitor to collateral (e.g., IRS)	74%	21%	5% (t=100%)

(N=61)

116. Questions 4 and 5 referred to "contractor credits," not just working capital credits. Some of our respondents therefore included equipment (and possibly inventory stockpile) loans as well. Equipment loans are not implicated in the present discussion, yet reduced the index of accounts-as-collateral.

117. See questionnaire note 59 *supra*.

118. *Id.*

Question 14 followed-up on these responses by inquiring, generally, when such a further advance would seem reasonable.¹¹⁹ Fifty-six percent of all respondents (N=66) expressed, in more or less general terms, that a calculation of "risk, gain, and loss" would be made, generally relating to whether further loans would generate a higher return than would a "shut-off." Many within that group also mentioned as an important variable, though without much codifiable explanation, the "cause of the default." Another 12% specifically mentioned a "good customer" criterion, which is a blend of "Do we have confidence in the *people*?" and "If we do or might derive other business from him." Eight percent specifically mentioned tax liens *sua sponte*, though this seemingly low figure must be assessed in light of the fact that tax liens had already been patently accounted for in the immediately preceding question. Four percent mentioned other (*e.g.* mechanics') liens as an important factor. But even more interesting is the relatively large number (23%) who specifically pointed out that the decision could rest on the existence or availability of additional collateral/security, some even adding the word "priority" specifically.¹²⁰ Cognitively, therefore, lenders seem to be aware of the risks inherent in lien threats, and report that the priority of tax liens in the borrower-taxpayer's collateral has both a generalized and particular (*i.e.*, workout-advances) impact on their lending policies.

Finally, questions 15 and 16 asked, respectively, what portion of all loans to contractors made on a secured (Q. 15) or unsecured (Q. 16) basis were made "pursuant to commitment" as opposed to being optional future advances:¹²¹

LOANS MADE "PURSUANT TO COMMITMENT"

		% Rs reporting	0% Responses Other Than	0%
			Mean	Median
Q. 15	Secured loans	59% of all Rs.	39% of all loans	20% of all loans
Q. 16	Unsecured loans	73% of all Rs.	39% of all loans	25% of all loans

119. *Id.*

120. The responses were "coded" into these groups by the authors, after the questionnaire results were known.

121. See questionnaire note 59 *supra*.

In assessing these data, all of which are instructive only if the respondents actually act on the basis of their cognitions,¹²² it would do well to keep in mind the hypotheses which we are attempting to establish. Overall, we are suggesting that commercial lenders will be incrementally deterred from making workout or salvage loans to troubled contractors, so long as the IRS as a competitor to the collateral is permitted to have a prior lien in the debtor/taxpayer's receivables. To relate that more specifically to § 6323(c)(1)(A)(ii) [1966] and § 9-301 (4) [1972], we must first establish that the lending policies and methods actually employed implicate the fine structures of those two sections.¹²³

On that latter point, the data seem clear enough. First, most lenders acquire actual notice of tax lien filings very quickly—usually a matter of only a few days. Secondly, *very* few loans to contractors are made on a mandatory rather than optional basis. This finding was exemplified by one respondent who added, “I cannot understand anyone ever making a mandatory commitment to a *contractor!*” Among secured lenders, 59% of the respondents reported that mandatory arrangements are never made. For the group as a whole, only 16% of all their secured loans are made “pursuant to commitment.” That is to say, 84% of all secured financing for contractors is done in a way which the rules of the UCC and IRC make doctrinally relevant.

As to the volume of such financing that is done, it is worth noting that 24 of our 66 respondents had credit commitments to the contracting industry in excess of \$20 million each; 18 had \$5 to 19 million available, and 24 had up to \$5 million.¹²⁴ Because of the way in which our sample was drawn, it is likely that our respondents' figures are somewhat higher than would be true for the population of commercial banks as a whole.¹²⁵ The reader may nevertheless appreciate

122. About which there may sometimes be some doubt . . . As someone once said, a man can tote a big load of theology but live on a small part of it. Three of our respondents made rather interesting comments. One (re Q.3) was, “I do not feel we do a very good job on policing the individual jobs”. And on the question (Q.9) of investigating FIT and FICA payable accounts, one respondent answered: “The answer should, of course, be yes, but sometimes platform skills need constant refinement.” Question 11 asked, are lien filings default conditions in the loan agreements? One respondent replied, “No—but a good idea for the future.” Such slippage between knowledge/attitude and action affects all theorizing about the behavioral results of cognitive states, and cannot easily be quantified within the inquiry methods we have employed.

123. The full texts of the sections appear at notes 26 and 42 *supra*.

124. On the meaning of “credit commitment” see note 51 *supra*.

125. See note 56 *supra*.

from this the order of magnitude of contractor financing offered by the nation's nearly 15,000 commercial banks.¹²⁶

As to the amount of this financing done on a secured basis, hence the amount potentially governed by Article 9 of the UCC, our respondents as a group (N=61) reported that 61% of all contractor credits were secured.¹²⁷ That mean, however, is deceptive. In fact, 31% of all respondents extended unsecured credit to only 10% (or fewer) of their contractor customers, and 52% extended it to one-quarter of their customers at the most. The security for these advances is often (42% of the time) primarily in accounts and contract rights, though we have reason to suspect that concern with priority in receivables considerably exceeds even this figure.¹²⁸

All of our respondents indicated that under appropriate circumstances a post-default advance might be made. Among the five factors which we suggested to our respondents as being relevant to that decision, the collateral priority of the IRS (1.31)¹²⁹ was insignificantly less important than such obviously critical matters as the financial condition of the contractor (1.26), the proportion of project cost already loaned (1.28), and the state of the project's completion (1.17). In fact, IRS competition was more important, though again by an insignificant amount, than the prior rights of private competitors (1.38), particularly sureties whose prior claims are known to have a measurable disincentive effect.¹³⁰

We do not think it is reasonable to infer from these data that the post-lien-date-plus-45-days priority position of the IRS under § 6323 and § 9-301(4) is typically *the* determinative factor in lenders' decisions to extend waste-reducing post-default optional advances. But it does seem more likely than not that it is *a* measurable factor in a fair number of pertinent cases.

We might iterate at this point the observation that our burden of proof in this inquiry is relatively low. If the choice were between as-

126. Thrift institutions (Sav. & Loans, Building & Loan Societies, etc.) make perhaps the bulk of construction loans, but do not make working capital loans to contractors.

127. See our discussion of bankers' attitudes toward secured and unsecured lending note 51 *supra*.

128. See note 116 *supra*.

129. The numbers in parentheses are indicators of the degree of reported importance, with greater importance represented by lower numbers. They were computed by taking a weighted mean of the responses, with "Very Important" = 1, "Marginally Important" = 2, and "Irrelevant" = 3.

130. See generally *Priorities*, *supra* note 23. See *esp. id.* at 1015-21.

sisting *X* at some cost to *Y*, versus assisting *Y* at some cost to *X*, then—if the costs were agreed to exist—the quantum of evidence necessary to decide which result is superior would have been much higher. That is to say, when there is some cost which we care about in removing a burden from group *X*, we should want to know with considerable confidence that the rule we are about to implement will in fact substantially benefit a substantial number of all *X*'s. There is no such trade-off to be made in the present case, as we have already suggested. The costs of removing a second priority position from commercial lenders have already been labelled salutary (and described as benefits) as a matter of federal governmental policy.¹³¹ The only costs which need be considered now are those of correcting a drafting error in a uniform statute which is still largely unenacted.¹³² In such a case we feel that a lower level of proof of a lower level of benefit is sufficient. Or, in particular, even if a rule change could affect in a socially salutary way only a few members of the putatively affected class, then it is the draftsmen's responsibility to effect that rule change if there would be no relevant or significant costs incurred in doing so. Such is, in our opinion, the present case.

IV

By this point we have accomplished (by our own measure) more or less what we set out to do. We thought, however, that we might append some other sorts of observations to what has so far surely been a dry and very technical exercise.

Shortly after we first noticed this curious statutory misfit, we brought it to the attention of appropriate persons within the NCCUSL and the PEB. We received a very gracious reply,¹³³ which reported that considerable thought had been given to the matter and that our doctrinal conclusions appeared to be sound. The source of the error was given as the Review Committee's having overlooked the fact that the "Real Property, etc." transaction of § 6323(c)(3) does not have the 45-day-or-actual-notice limits which loom so large in the "Commercial Transactions Financing Agreement" of § 6323(c)(2). That error having been made, § 9-301(4) does indeed look far more understandable.¹³⁴

131. See text accompany notes 25-29, and see note 87 *supra*.

132. See note 101 *supra*. See also list of enacting jurisdictions note 2 *supra*.

133. Letter in the authors' files.

134. If all of the superpriority categories *do* have the 45 day limit, then there is no

The replier went on, however, to make other points, all worthy of rejoinder here:

1) *In most (c)(3) transactions the lenders make commitments to lend, thereby protecting their advances anyway under a combination of (c)(1)(B), (c)(2), and § 9-301(4) plus, maybe, 9-312(7) and 9-105(k).*¹³⁵

While this may be true of the (c)(3)(A)(i) transaction (*construction lending*), our findings demonstrate that it is typically not true for the (c)(3)(A)(ii) (*contractor lending*). As to the relative volume of business done under each heading, consider who physically builds real property improvements: The construction lender gives money to the developer, but the *contractor* lenders support the specialty contractors who do the work on virtually every improvement project.¹³⁶

2) *Most construction loan agreements are made with the owner of the real estate, secured by a mortgage lien, and of course Article 9 does not apply to them.* True, but we demur, since we are not concerned with construction loans. The error the Committee made was therefore not simply neglecting the no-notice and no-limit character of (c)(3) transactions, but also that of not seeing that the IRC exemptions come in the two very distinct modes previously referred to.¹³⁷

3) *Only a few transactions will be left out.* First, if misperceptions numbers 1) and 2) had not been made, the "few" would have swelled considerably. But even so, this is hardly sufficient reason to

need to continue perfection under § 6323(c)(1)(B) for any longer than that period of time. Hence, if the draftsmen's view had been correct, their solution would have been sufficient.

135. UCC § 9-312(7) [1972 Revision]:

If future advances are made while a security interest is perfected by filing or the taking of possession, the security interest has the same priority for the purposes of subsection (5) with respect to the future advances as it does with respect to the first advance. If a commitment is made before or while the security interest is so perfected, the security interest has the same priority with respect to advances made pursuant thereto. In other cases a perfected security interest has priority from the date the advance is made.

UCC § 9-105(k) [1972 Revision]:

An advance is made "pursuant to commitment" if the secured party has bound himself to make it, whether or not a subsequent event of default or other event not within his control has relieved or may relieve him from his obligation.

136. Over the last 30 years a considerable evolution has taken place in building construction—notably in the emergence of the "Specialty Contractor," usually operating as a subcontractor and further defined as one who does most of the work himself . . . Today, in many instances, the general building contractor [or contractor-developer] will perform less than 20% of the construction work, and sometimes none at all.

Bristow, *supra* note 23, at 28.

137. See text accompanying note 19 *supra*.

dismiss the thought of correcting the error. While it is true that legislation cannot always be scathed for not curing every evil it might have cured, it seems to us that draftsmen of uniform codes, especially commercial codes, have a greater responsibility in this direction than is ordinarily the case. The Code, if successful, makes the law among the states uniform—"semi-permanently" so. Errors are therefore ubiquitous, and coordinated corrections are politically onerous. Moreover, it is probably the case that uniform legislation is treated by some state legislatures with more deference (and less critical care) than is the home-grown variety.¹³⁸ Not only do the uniform bills bear the imprimatur of distinguished scholarly draftsmen and elite institutions, they also deflect some scrutiny in the name of uniformity. Therefore, draftsmen of uniform legislation in our opinion have greater responsibilities both to be "right" within the realm of their work, and to care more about a few left-out cases than local legislators do—especially when the distributive costs of corrections are trivial, and when the existing federal law has already marked the paths to be followed.

4) *Even if the error had been spotted, nothing might have been done anyway. A correction might so complicate the subsection that it would become unintelligible to everyone.* This is partly convincing and partly not. We tried our hand at drafting § 9-301(4) so that it would cover the (c)(3) transactions yet retain the 45-day and notice rules for state lien creditors. It was possible, but it was a mess.¹³⁹ To ask "What are commercial lawyers for, after all?" is not a complete answer, especially if one believes (as we do) that the people (e.g., bankers) who are daily governed by a rule should be able to discern what it means without paying seers' fees.

But there is another way to solve the problem—*viz.*, chop off the last half of § 9-301(4) [1972] so that it reads "A person who becomes a lien creditor while a security interest is perfected takes subject to

138. To be sure, the legislative commissions of some states (New York and California, for example) peruse NCCUSL drafts as carefully as they do their own, perhaps even more so. Nevertheless, in many states the inquiry may tend to be perfunctory in the face of arguments based on the virtues of uniformity, the aegis of the legislation, and the actions of other states.

139. Although it would be linguistically quite simple to add a new subsection specifically excepting "Real Property, etc." loans from the operation of existing subsection 4, the political result of catering *expressly* to a particular segment of the economy would be a Hell-raiser. But even more importantly, such a temporally and substantively particularistic provision in a semi-permanent Code would be just plain silly. See generally Gilmore, *On Statutory Obsolescence*, 39 U. COLO. L. REV. 461 (1967). See *esp. id.* at 464.

the security interest.” Or, if someone insists, we could add, “to the extent that it secures advances made pursuant to an agreement entered into before he became a lien creditor, whether the advances were optional or mandatory.”¹⁴⁰ Such surgery would have the effect of protecting the post-45-day optional advance of a contractor’s financier, at the expense of the post-45-day rights of the creditor armed with a judicial lien.¹⁴¹ Even that is not strictly correct, since the lender will be protected vis-a-vis tax liens, while the state law creditor will merely lose some of his already dubious security only to holders of optional-future-advance security interests who continue granting credit more than 45 days after the state-law (judicial) lien arises.¹⁴² Perhaps the draftsmen thought the 45 days was a fair compromise, though their real motivation and concern was for the tax lien problem—the problems of state lien creditors “are not very great” anyway.¹⁴³ Furthermore, even under § 9-301(4) [1972] *as it stands* the lien creditor loses out both when advances beyond the 45 days are mandatory rather than optional,¹⁴⁴ and when optional advances are made within 45 days after the lien has attached.

Yet it is, after all, possible to identify this as a tradeoff of economic values:¹⁴⁵ Is it more important to preserve this “not very great” degree of protection for the state-law-lien creditor against state-law-perfected secured parties? Or is it more important to avoid the

140. The added phrase would accomplish two purposes. First, it would limit the damage which an Article 9 creditor could do to a lien creditor, by not allowing *new* (i.e. *post-lien*) agreements, just new-but-already-contracted-for advances. Second, it would make clear that “perfection” for this purpose *includes* perfection of optional and not-yet-made advances as against a lien creditor. As to the need for this implication see note 41 *supra*.

141. That is to say, the post-lien secured party could “feed” and thus fatten the security interest in the lien property by making further advances.

142. “Dubious,” because *as drafted* mandatory advances can already undercut the lienholder’s claim. See § 9-301(4), and note the disjunctive “or” between the 45 day/knowledge limit and the “commitment” language. Moreover, to the extent that the interest would be “fattened” by post-lien advances, notice that the increase in the security interest will not exceed the increase in the common debtor’s assets provided by the advance.

143. See UCC § 9-301 [1972 version], Comment 7.

144. See note 142 *supra*.

145. There are, really, two possible tradeoffs. One would be correction by detailed drafting versus the costs (in lawyers’ time) which complexity would create. See text accompanying notes 138-43 *supra*. The other is this, between lien creditors and tax-lien-free contractor lenders. There is, in another way, a third: *guessing* about either of the first two versus *inquiring* about them. See text accompanying notes 146-48 *infra*.

“waste” which comes from endangering, to the degree 9-301(4) presently does, the 45-days-post-tax-lien optional advances of the contractor’s financier? Even if the draftsmen saw the choice in that light (which they did not), how should they know? While as statutory draftsmen they are of course allowed (indeed, encouraged) to make distributive policy choices, they can’t even begin to do so unless they can “know” the ultimate social location and magnitude of the effects of their choices.¹⁴⁶ But when we consider the nature (and expense) of an inquiry into the diffuse economic roles played by state-law judicial liens *only* as they are ever so slightly involved in this articulation of a potential trade-off, we must pause to wonder whether trying to know such things would be a judicious use of scarce research resources.

That, in turn, prompts our two final queries: First, now that the draftsmen can know what the present study has uncovered, would it be more or less responsible for them to act on our suggestion without expending large additional sums to explore empirically the potential perturbations in these tiny pertinent corners of state judicial lien law? And second, if we answer the first question negatively, has it been a judicious expenditure of scarce academic resources for us to have essayed our criticisms in this way? The former question, a matter of what social scientists refer to as “taste” in the selection of subjects for study, has already been discussed in the relevant literature.¹⁴⁷ The latter, however, does need periodically to be raised.¹⁴⁸

146. Or at least enough to facilitate the making of those distributive-effect guesses which it is legislators’ duty to make.

147. See, e.g., Kalven, *The Quest for the Middle Range: Empirical Inquiry and Legal Policy*, in *LAW IN A CHANGING AMERICA* 58 (G. Hazard ed. 1968); Hazard, *Limitations on Uses of Behavioral Science in the Law*, 19 *CASE WES. L. REV.* 71 (1967).

With respect to commercial codes in particular, one of the more intriguing statements has been that by Professor Gilmore:

We overrate the results that can be achieved by hiring a team of specialists and having a survey made. The bigger the problem to be investigated, the longer the survey takes, the more it costs and the more doubtful the results. The task of a statute like the Code is to state basic principles under which business transactions can be carried out. This task does not require a scientific knowledge of each business fact—even if such knowledge were conceivably available which it is not. ‘Science’ performs miracles; we worship the controlled experiment of the laboratory man and think that salvation lies in applying his methods to everything we do. What we get, outside the laboratory, is an illusion of certainty. In the drafting of statutes a draftsman who is aware of the possibility of human error and walks cautiously is infinitely to be preferred to a pseudo-scientist who knows he has the truth. I am not an

But, we are told, navel-gazing (perhaps especially navel-gazing about the proper functions and standards of academic legal research) is better done at some remove from one's own most recent work. This, then, for another time.

advocate of happy ignorance. What was needed—and achieved—in the drafting of the Code was a good working knowledge of the facts of business life. Gilmore, *The Uniform Commercial Code: A Reply to Professor Beutel*, 61 YALE L.J. 364, 365-66 (1952).

Perhaps needless to say, there is an area—the boundaries of which we cannot define—in which we disagree with Professor Gilmore, even though we share his aversion to the seductions of science and to its possibility—when *misused*—of eclipsing by the weight of its popular charm other epistemological avenues. The core of the area of disagreement is that “scientific” inquiry should not be disclaimed a priori in the deliberations of even sensitive and cautious draftsmen. We can suggest, perhaps incautiously, one example. “Lien creditors” do not fare very well in the UCC. Their rights are compromised in § 9-301(4), as we have indicated, and in § 2-702 (as amended in 1966). The 1972 comments to § 9-301(4) describe the lien creditor problem as being “not very great.” How do the draftsmen know that? In particular, we might ask *who* would know that? The A.L.I. is rather a prestigious body, with a membership which may be skewed to overrepresent the leaders of the bar, and through them, more or less, their clients. Article 9 law is largely bankers’ law, and is the concern of bank counsel. “Lien” law is the concern of trade creditors and their counsel, who are involved in *commercial collections*. We would like to know whether collection work is distributed more heavily among those segments of the bar which are underrepresented in the A.L.I., and whether the draftsmen are really in a position to know how important “lien law” really is. See J. CARLIN, *LAWYERS ON THEIR OWN* 114 (1962): “Many lawyers look down upon this kind of work, sharing the view . . . that the collections lawyer handles ‘garbage.’” The “collection lawyer” is, generally, a member of that segment of the bar (*i.e.*, the “solo”) at some remove from its centers of power and influence. *Id.* at 173-76.

The rights of lien creditors, therefore, is one illustration of an issue which in our opinion is fit for the tools of survey sampling. The results would not dictate the law; they might only show us how it could be improved. Policy must remain the domain of people, but facts can be the nonexclusive domain of science.

148. One of the very best introspective discussions of legal research generally, even though not focussed upon the uses of empirical studies in particular, is Dworkin, *Legal Research*, 102 DAEDALUS 53 (Spring, 1973).