

SECURING SECURITY

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Cleaning the Augean stables demanded a Hercules, but his task would seem child's play to anyone trying to clean up the muddle in the law of secured transactions. Yet the draftsmen of Article 9 of the proposed Commercial Code have tried to do just that—bring order and simplicity into this field now marked by chaos and complexity.

Complexity in the law governing security devices stems chiefly from three sources: (1) lack of uniformity among the states; (2) divided control under the federal system; and (3) lack of correlation in the law of any particular jurisdiction.

As to the first, each of the forty-eight states has its own concept of how to resolve the fundamental conflict in goals: Protection of borrowers from overreaching money-lenders versus protection of creditors from prodigals who, having lived beyond their means, seek to evade their obligations. Also, each state has its own peculiar combination of pressure groups, groups more active in this than in other areas of commercial law, and all seeking special legislative concessions.

The significance of the consequent interstate legal variations is great under our credit system in which much of the collateral, as, for example, automobiles, is either movable or in transit. The increase of financing against accounts receivable, accounts which may have arisen from the assignor's sales to persons located in several states, gives prominence to differences in state laws for that kind of financing. And varying state provisions also are important as a hindrance to large finance companies trying to economize by devising standard forms and procedures workable for any of the states in which they take liens.

In some areas of law, differences in state laws can be handled *inter partes* by means of express choice-of-law stipulations. But no such provision in a security agreement would be effective, since it would not bind creditors who had not consented thereto. Consequently there is special need for uniformity in the law of security and it seems obvious that universal acceptance of the Code's Article on Secured Transactions would help meet this need.

Secondly, complexity in secured financing is a consequence of the Federal Government's supremacy in matters of bankruptcy. Since bankruptcy is the crucible in which security is tested, state law is sensitive to the Bankruptcy Act and its interpretations. This was most recently demonstrated when the *Klauder*¹ case's construction of Section 60a brought forth a welter of state statutes dealing with assignments of

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¹ *Corn Exchange National Bank and Trust Co. v. Klauder*, 318 U. S. 434 (1943).

accounts receivable.² Similarly, the draftsmen of the Article on Secured Transactions have had to keep their eyes on the Bankruptcy Act. They have not, however, tried to tamper with that Act directly; unlike some portions of the Code, Article 9 is not being proposed for federal adoption.³

In one or two respects the Code may be difficult to synthesize with the federal law. Thus, the Code's negation of the importance of title⁴ must reckon with Section 70a of the Bankruptcy Act, which confers on the trustee in bankruptcy all the assets to which the bankrupt had "title." And what will be the effect of bankruptcy on the rights after default given by the codifiers? The right to repossess without judicial process, if that can be done without breach of the peace,⁵ might be held to exist against the trustee. However, the Code goes beyond this broad right to repossess and permits the secured lender to dispose of the collateral while leaving it on the debtor's premises.⁶ If this provision should be construed to mean that the lender has sole control over realization on collateral even when it is left in the possession of the trustee in bankruptcy, would not there be something of an innovation? But this question can be better answered elsewhere in the symposium, together with the general question whether the Code would lessen or increase the complexity of secured transactions properly attributable to our federal system.

The third factor resulting in chaos is the absence of integration and order in the statutes and decisions covering secured financing in any particular jurisdiction. Professor Leary, analyzing the law of Pennsylvania, has emphasized the lack of correlation in its law governing security.⁷ He points out how there the rights of bona fide purchasers will vary without apparent reason according to the label a financier selects for the transaction; and the same unintelligible differences are present in regard to landlords' liens, fixtures, and methods and places of recording.

Similarly New York has failed to correlate its factor's lien statute with the law governing mortgages. For instance, a bulk mortgage is subject to elaborate formalities designed to protect creditors against a borrower who intends to give a mortgage and then make off with the proceeds of the mortgage loan.⁸ But apparently these safeguards can be circumvented by the simple expedient of giving a factor's lien instead of a mortgage. Also, in authorizing the factor's lien, did New York intend to apply thereto its traditional mortgage doctrine "that retention of possession by the mortgagor with power of sale for his own benefit is fraudulent as to creditors?"⁹

Such examples of the confusion in the law of particular jurisdictions—what I have termed the third source of chaos in secured financing—could be greatly multi-

² See Pemberton, *Notice Filing for Assignments of Accounts Receivable*, 13 LAW & CONTEMP. PROB. 643 (1948).

³ See May 1950 Draft of the Code §1-105 (Federal Version). Yet the Comment to Section 9-206 speaks of "enactment of this Article by Congress . . ."

⁴ See September Revision (hereafter cited as Revision) §9-202.

⁵ Revision §9-503.

⁶ *Ibid.* Cf. May 1950 Draft, §503.

⁷ Leary, *Our Uncorrelated Chattel Security Law*, 19 PA. BAR ASS'N Q. 295 (1948).

⁸ N. Y. LIEN LAW §230a.

⁹ See Justice Brandeis' speculation in *Benedict v. Ratner*, 268 U. S. 353, 361 n. 11 (1925).

plied. It is the contribution of the Code towards removing this cause of difficulty in the law of secured transactions that I propose to discuss. Does the Code afford a simple, rational, and consistent framework of security that a state can wisely adopt independent of its universal adoption? And do the changes in current law proposed by the codifiers really help secure security or do they create new woes as bad as those we now endure?

I

THE CODE'S STRUCTURE AND APPROACH

Among the chief advantages of the Code are its structure and approach. For one thing, instead of relying on *a priori* concepts, the draftsmen sought to probe the expectations of the business community, an effort facilitated by the length of time available for preparing the Code. And, having found those expectations, the draftsmen tried to express them in words that make sense to businessmen (and consequently perhaps make nonsense to attorneys). To the codifiers it seemed that a financier should be enabled to tell rapidly what his rights would be under a projected loan; under current law by the time those rights are ascertained the loan may well have fallen through.

The effort to obtain clarity and to get out of confusing legalistic ruts caused the codifiers, at least in Article 9, to adopt an approach which can be given the familiar tag "functional." This in turn brought the end of today's multiplicity of security devices and motivated a direction: "This Article applies regardless of the form of the transaction. . . ."¹⁰ The lender can use terms like bailment lease, conditional sale, and chattel mortgage to his heart's content; but under the Code there would be only two security devices—a general lien and a purchase money interest to secure enabling advances—supplemented by some special rules for different types of collateral.¹¹ No room was left for that cherished legal concept "title," so that "each provision . . . applies without regard to who has title to the collateral."¹²

The approach of the codifiers also emphasizes self-operating procedures whereby parties can settle their differences with little reference to a court. For example, under the Uniform Conditional Sales Act it is provided that fixtures can be severed if there is no "material injury" to the realty to which they are attached.¹³ Such injury requires not only the determination of specific facts but also the application of a difficult standard—materiality. Moreover, it seems harsh that if the injury is immaterial, the owner of the realty gets no recompense for such injury as there is, while, if the injury is material, the chattel financier loses all rights in his security regardless of its value in relation to the amount of injury from removal. In 1935 Pennsylvania amended its Conditional Sales Act to provide that personalty can be

¹⁰ Revision §9-102(2).

¹¹ The Comment to Section 9-102 of the May 1950 Draft of the Code has a table of provisions applicable to special types of collateral.

¹² Revision §9-202.

¹³ UNIFORM CONDITIONAL SALES ACT §7.

removed irrespective of damage to realty if a bond is given for damages.¹⁴ The Code, too, gives an absolute right to remove collateral attached to the land if a bond is given for the cost of repairs to the realty, though not for diminution in the value of the land due to the removal.¹⁵ Under this provision—together with the Code's general favor for the self-operating procedure of "cover"¹⁶—instead of dispute as to the materiality of the prospective injury, the only issue, the cost of repairs, can be easily settled by the owner's having the repairs made and submitting the bill to the court.

Clarity and certainty require a liberal sprinkling of hard-and-fast rules. The courts, however, are reluctant to hand down such rules and usually rely on juries to determine whether in a particular case a period of time or form of notice has been "reasonable." In some areas trade associations take up the slack and promulgate a system of private law under which the generality of a standard set by statute or judicial decision is filled in in terms of the conditions in the particular industry. But secured transactions involve the rights of many not subject to the "law-making" of trade or other organizations—persons who, not being parties to the loan agreement, cannot be bound by its clauses. Accordingly, if the needed cut-and-dried rules are to be filled in, it must be by statute. One of the most troublesome litigable questions as to debtors' estates is "tracing"; many an estate has been dissipated in fighting out the factual issues incident to tracing the proceeds of goods subject to a lien. To lessen this problem—and taking a leaf from the Uniform Trust Receipts Act¹⁷—the Code provides a specific rule:

In insolvency proceedings a lender with a perfected security interest has a right to the cash and checking accounts of the debtor equal to the amount of cash proceeds received by the debtor within ten days prior to the institution of such proceedings but no other right to or lien on cash proceeds not subjected to his control before insolvency proceedings are instituted.¹⁸

Problems of "tracing" might have arisen under the provisions of the Code giving special rights to a "purchase money security interest." Disputes would have been inevitable as to whether a loan was actually used to pay the purchase price or merely went into the borrower's checking account, while he pulled cash out of his safe to pay the seller. To bypass such bickering the codifiers wisely drafted a conclusive presumption that if the advances were received ten days before or after the purchase they were in fact an enabling advance creating a purchase money lien.¹⁹ However, some reward is given to the purchase money financier who makes sure that his loan is actually used to pay for the goods, since in a contest between two purchase money interests in the same goods, he will have priority.²⁰

¹⁴ PA. STAT. ANN. tit. 69, §404 (Supp. 1949).

¹⁵ Revision §9-314(2).

¹⁶ For instance, Section 2-712 of the May 1950 Draft permits "cover" as a remedy if a seller fails to perform.

¹⁷ Section 10(b) (but the right to ten days' proceeds is in addition to, rather than in lieu of, the right to trace).

¹⁸ Revision §9-306(2).

¹⁹ Revision §9-107.

²⁰ Revision §9-313(4).

Another instance of the attempt to remove litigable issues and make the outcome certain is the provision that a lien "continues perfected for a period of four months" if property is brought into another state.²¹ This replaces the Uniform Conditional Sales Act's requirement that refileing occur "within ten days after the seller has received notice of the filing district to which the goods have been removed."²² Thus refileing is made independent of the troublesome question of notice, and there is no longer the anomaly of giving a financier superior rights because he was so careless he never knew his collateral had been taken into another state.

In seeking to bring new order to security, the codifiers have sought to retain only distinctions that are meaningful. Among the most meaningful of distinctions is that drawn between normal commercial financing and the financing of consumer goods transactions—such goods being those "used primarily for personal, family or household purposes."²³ This dichotomy conforms to the Code's basic differentiation of transactions between professionals from those in which non-professionals are involved.²⁴ Moreover, it implicitly acknowledges that consumer financiers are often guilty of "repossession-thinking," the lender seeking to derive unfair profits from fees or forfeitures obtained through repossession. Indeed, the original popularity of the conditional sale is attributed by some to its utility in promoting forfeitures in consumer installment sales. And Maryland, in its statute regulating retail installment sales, found it necessary to prohibit one subtle practice designed to promote consumer defaults and resulting repossessions—the use of a "balloon obligation" under which the unsophisticated buyer is misled by a series of small installments only to be confronted with an unexpectedly large final installment.²⁵

By providing special rules for consumer financing, the Code averts some of the difficulties under the Uniform Conditional Sales Act. The draftsman of that Act, conscious of the abuses associated with the conditional sale in consumer transactions, failed to consider how frequently the conditional sale is used in non-consumer financing; consequently he indiscriminately applied to commercial transactions the safeguards designed to protect retail buyers. The almost-immediate public auctions required by the Act to protect consumers from "rigged" sales wreaked havoc in the context of commercial financing. By preventing the disposition of repossessed collateral in a way that would produce maximum realization on intrinsic value, the Act led to large deficiency judgments against non-consumer debtors.

While the Code segregates consumer transactions, it does not go in for the detailed regulation which characterizes the state statutes.²⁶ No agency or licensing is provided for; there is no outlawing of clauses confessing judgment, waiving tort claims for improper repossessions, assigning wages, or authorizing repossession whenever

²¹ Revision §9-103(2).

²² Section 14.

²³ Revision §9-109(1).

²⁴ Cf. the Comment to Section 2-104 of the May 1950 Draft.

²⁵ MD. ANN. CODE GEN. LAWS art. 83, §118(c) (Cum. Supp. 1947).

²⁶ For a detailed report of developments in state regulation of retail installment sales, see Note, 63 HARV. L. REV. 874 (1950).

the financier feels jittery. Moreover, Secured Transactions are not subject to the same standard of unconscionability the Code applies to Sales.²⁷ Presumably this abstention stems from a desire to avoid controversy that might imperil the Code's passage. And perhaps there is a fear that uncertainty would result under an authority to strike out "unconscionable" clauses, since many judges would probably give "bull-in-a-china-shop" treatment to the clauses of a standard loan agreement.

II

CODE CHANGES IN CURRENT LAW

A. Pledge and Equitable Pledge

Granddaddy of all methods of secured financing is the pledge, in which possession of the collateral is given the lender. Since he holds the collateral the financier is protected against possible dishonesty on the borrower's part. As to the other risk customarily facing a lender, that of the borrower's insolvency, he is also protected, for his possession has given other creditors notice not to rely on the borrower's ownership of the pledged assets and thereby has removed the stigma of a "secret lien." Moreover, if possession is taken concurrently with the loan, it evidences that the transaction was not originally intended to be an unsecured loan with the lender trying to grab a preference as he sees his debtor becoming shaky.

As a basic policy, the Code states that possession of a lender "does not include possession by the debtor even though acting on behalf of the lender."²⁸ Thus it seeks to preclude formalistic procedures under which goods might be "pledged" and almost immediately redelivered to the "pledgor" as agent for the lender-pledgee. However, Section 9-304 creates an exception to this rule, and permits a lender who has possession of instruments, documents, or chattel paper to turn over the collateral and nevertheless retain a perfected lien for twenty-one days. The Uniform Trust Receipts Act similarly gave a period of grace, ten days, in which, despite redelivery of pledged collateral, the lender held a lien valid against creditors.²⁹ But the Trust Receipts Act extended this protection to the redelivery of goods and stated a requirement that redelivery be "for a temporary and limited purpose." Presumably the codifiers omitted this last limitation because they thought it would lead to litigation, and would probably be superfluous since the redelivery of the instruments or documents would normally only be for a limited purpose, like the collection of chattel paper or a "day loan" of securities to a broker.

An outgrowth of the pledge is the "equitable pledge," in which possession is not taken concurrently with the loan but the lender is given authority to take possession later if he so desires. The equitable pledge would include the familiar clause in loan agreements whereby the financier reserves the right to demand more collateral if he feels insecure. And building contracts frequently contain equitable pledges

²⁷ May 1950 Draft §2-302.

²⁸ Revision §9-110 (2).

²⁹ Sec. 3(3).

under which, in case of default on the contractor's part, either owner or surety is given a right to take possession of his materials and equipment in order to finish the job.

In the absence of statute, the after-acquired property clause in a mortgage of inventory also is usually viewed as creating an equitable pledge, under which the mortgagee is entitled to protect his claim of lien by taking possession of the after-acquisitions;³⁰ and the borrower cannot revoke his assent to the mortgagee's entering into possession of the collateral. If the lender is able to take possession of the property before any creditor can attach, he obtains a prior lien. But this lien seems extremely vulnerable, for under Section 60a of the Bankruptcy Act—both before and after its amendment in March 1950—the taking of possession after the pledge will not “relate back” to the original pledge agreement and so will be a “transfer for or on account of an antecedent debt.”

Despite the ostensible abandonment of “relation back,” the doctrine still has some vitality under the Code. For example, the codifiers have authorized an equitable pledge of documents, instruments, and chattel paper effective for twenty-one days.³¹ This differs from the equitable pledge provided by the Trust Receipts Act in respect to period of grace without filing and to not covering goods.³² Also, the codifiers seek partially to sidestep Section 60a by providing that an interest in after-acquired property “is not security for a pre-existing debt or claim” if (a) the interest is claimed by a secured lender and (b) the acquisitions are either in pursuance of the loan agreement or in ordinary course of business.³³ These two restrictions make the Code's provision chiefly applicable to revolving indebtedness agreements which, for most practical purposes, are the same as arrangements under which the goods subject to the lien are sold, the proceeds turned over to the lender, and new advances made almost at once against goods coming in to replenish inventory. Consequently, there can be no charge that the codifiers have called black white, called old value new, in order to defeat the Bankruptcy Act's policy against preferences.

Probably the equitable pledge would suffer a decline under the Code. Much of its current use reflects an attempt to cope with those cases stating that property cannot be mortgaged *in futuro*, and to escape expensive formalities required for a valid mortgage. Since the Code affirms that “except as otherwise provided by law a security agreement is effective according to its terms . . . ,”³⁴ apparently a loan agreement could provide that a lien arise in the future and upon any prescribed contingencies. Instead of having an insecurity clause under which the lender may demand that additional collateral be turned over to him, why not incorporate in the loan agreement provisions for a lien to arise automatically under certain conditions and without need to take possession of the additional collateral? Certainly the expenses

³⁰ Rights under an after-acquired property clause are discussed in Note, 28 ORE. L. REV. 376 (1949).

³¹ Revision §9-304(1).

³² Sec. 3(1).

³³ Revision §9-108(2).

³⁴ Revision §9-201.

and formalities of filing a financial statement under the Code would not be great enough to constitute a serious obstacle to this procedure.

B. Field Warehousing

Field warehousing is really only another form of pledge—warehouse receipts being pledged instead of the goods.³⁵ Frequently the warehousing is rather artificial. The warehouseman may be a corporation organized solely to facilitate the particular loan; the employees of the warehouseman may be employees of the borrower who have been bonded in connection with the warehousing operation; the only goods the warehouseman will receive will be those of the borrower; and the "warehouse" is merely a segregated area of the borrower's plant. The whole point of this involved set up is to permit advances against collateral which the borrower must have accessible in order to carry on his operations and which, because it is changing form due to processing, cannot be handled in many jurisdictions under other types of security arrangements. Also, field warehousing permits the property in the warehouse to be repossessed and sold by the lender without reference to a bankruptcy court. And recordation and acknowledgment of the lien are unnecessary.

Already field warehousing seems to be in eclipse,³⁶ presumably due to its high cost and, in my opinion, to the increasing availability of factor's liens which can frequently play the role for which field warehousing was designed. Under the Code there would be even less reason to use it. Since the codifiers treat warehouse receipts in conjunction with field warehousing as creating a nonpossessory security interest, filing is required;³⁷ nor does the pledgee of the receipts have superior rights in case of default. Also, the Code's provision for a general lien, which can attach to after-acquired property and follow the collateral as it is processed, undercuts the need for field warehousing. Probably if the Code is enacted, field warehousing will be resorted to only if the lender thinks his loan is especially risky and wishes to police the borrower by having his own representative as "warehouseman" on the borrower's premises and in possession of the collateral.

C. Purchase Money Mortgages, Conditional Sales, and Trust Receipts

Almost as ancient as the pledge is the chattel mortgage in which, instead of possession, the lender relies on recordation to give notice of the existence of his lien. Next on the scene was the conditional sale, whose *raison d'être* apparently was its freedom from the controls equity had placed on the chattel mortgage. Originally the conditional sale was the rival of the purchase money mortgage; today, after transformation by statutes, it looks in many states more and more like the twin. For instance, North Carolina provides that conditional sales are to be "registered in the same manner, for the same fees, and with the same legal effect as

³⁵ Legal aspects of field warehousing are examined in Birnbaum, *Form and Substance in Field Warehousing*, 13 LAW & CONTEMP. PROB. 579 (1948).

³⁶ See Koch, *Economic Aspects of Inventory and Receivables Financing*, 13 LAW & CONTEMP. PROB. 566, 572 (1948).

³⁷ Revision §9-305(2).

is provided for chattel mortgages."³⁸ And Texas states more bluntly that conditional sales contracts "shall be held to be chattel mortgages."³⁹ Illinois is one of the few states in which the conditional sale retains its common law vigor.⁴⁰

In line with the tendency for conditional sales to become indistinguishable from purchase money mortgages, the codifiers wisely have swallowed up both in the "purchase money security interest." This new security interest responds to the function the parties intended the loan to play—an enabling advance for the purchase of goods. Also, it disregards what Judge Hand, dissenting in *In re Lake's Laundry*, termed the "barren distinction, though indubitably true, that title does not pass upon a conditional sale."⁴¹ That same case held that while both mortgagee and conditional vendee were "creditors" for bankruptcy purposes under Section 77B of the Bankruptcy Act—and presumably under Chapter X—the conditional seller does not have to enter the reorganization and may repossess his collateral because the borrower never got "title." Other cases have utilized this "barren distinction" in deciding that conditional sellers are not subject to the after-acquired property clause in a prior lien given by the conditional vendee, but that a seller who takes a purchase money mortgage is subordinate to the earlier lien.⁴² Anyone who distrusts "conceptualism" and to whom the emphasis on "title" is anathema will shed few tears that the Code leaves no place for decisions like these.

The trust receipt is something of a Johnny-come-lately among security devices, gaining most of its popularity in the last thirty years. It is the converse of the conditional sale in that no seller can use it; but, like the conditional sale, the trust receipt at common law depended for its validity on a finding as to the location of title. Thus, numerous cases enunciate the requirement that title move directly from the seller to the third party financier; if there was the slightest slip and—however instantaneously—title went to the buyer, the transaction was considered a disguised chattel mortgage demanding the orthodox foreclosure formalities, and was usually held invalid for lack of recordation.⁴³ Under the Code all these common law subtleties are forgotten and the trust receipt, too, is lumped in the purchase money security interest.

Indeed, the handling of the trust receipt in the Uniform Trust Receipts Act and the theory of new value and enabling advances introduced in that Act served as a model in framing the Code's purchase money security interest. In the May 1949 draft of the Code there was even a tendency to overparticularize in terms of the patterns of trust receipts financing; that draft required that, for a purchase money

³⁸ N. C. GEN. STAT. ANN. §47-23 (1943).

³⁹ TEX. REV. CIV. STAT. ANN. art. 5489 (1941).

⁴⁰ See, e.g., *Sherer-Gillett Co. v. Long*, 318 Ill. 432, 149 N. E. 225 (1925).

⁴¹ 79 F. 2d 326, 328 (1935), *cert. denied*, 296 U. S. 622 (1935).

⁴² E.g., *Diana Paper Co. v. Wheeler-Green Electric Co.*, 228 App. Div. 577, 240 N. Y. Supp. 108 (4th Dep't 1930).

⁴³ E.g., *McLeod Nash Motors v. Commercial Credit Trust*, 187 Minn. 452, 246 N. W. 17 (1932); *Armstrong v. Greenwich Motors Corp.*, 116 Conn. 487, 165 Atl. 598 (1933); *In re Schuttig*, 1 F. 2d 443 (D. N. J. 1924).

interest, each unit of inventory be identified and a release price be provided for the discharge of that portion of the obligation secured by each unit.⁴⁴ As implied in the official comment for the draft, this requirement conformed to the practice of itemization and setting forth release price per unit in the trust receipting of automobiles and other durable goods. But the requirement was a straitjacket. Itemization would have been too expensive for goods of low unit cost and without unit serial numbers; it would have been impractical where the goods were sold by measure rather than by unit. Accordingly, this provision was deleted, since the purchase money security interest was not designed solely for high cost durable goods but for any transaction in which new value is advanced for the purchase of goods.

D. Factor's Liens

In recent years over twenty states have adopted factor's lien statutes, for the most part modeled on the New York law.⁴⁵ In these statutes "factor" no longer means a middleman engaged in marketing but is a word of art denoting any persons "who advance money on goods consigned to and/or pledged with them."⁴⁶ Probably the phrase "advance . . . on" would be held to imply that the factor must make an advance concurrently with the taking of the lien, so that the factor's lien could not be used to create a preference in favor of a previously unsecured creditor.

In addition to being apparently restricted to new value transactions, the factor's lien is sometimes subjected to restrictions on the type of goods it can cover. For example, Maryland permits it for "merchandise," which it defines as "any personal property intended for sale" but not including "fixtures or other trade or manufacturing equipment";⁴⁷ under this statute it would seem that raw materials or goods in process could not be factored. Missouri, on the other hand, equates "merchandise" with "chattels intended for sale in the same or a different form," and adds that the borrower need not be engaged in manufacturing.⁴⁸ In Virginia and West Virginia seemingly only manufacturers can be financed by factor's liens;⁴⁹ in Michigan and North Carolina only manufacturers and processors.⁵⁰ Texas states that a factor's lien "shall not apply to any stock of goods, wares or merchandise daily exposed to sale at retail in the regular course of business."⁵¹

The Code takes the "continuing general lien" provided by factor's lien laws as the model for its own general lien. But such a lien can be given to secure an antecedent debt—though, of course, subject to the Bulk Transfer Article—and any kind of goods can be covered. The codifiers also dispense with the "conspicuous signs" that some statutes require to be maintained on the premises where the goods are

⁴⁴ Sec. 7-302.

⁴⁵ A table of the provisions of these statutes appears in Silverman, *Factoring: Its Legal Aspects and Economic Justification*, 13 LAW & CONTEMP. PROB. 593, 602-603 (1948).

⁴⁶ See, e.g., N. Y. PERS. PROP. LAW §45.

⁴⁷ MD. ANN. CODE GEN. LAW art. 2, §21-28 (Cum. Supp. 1947).

⁴⁸ Mo. LAWS 1945, S. B. 75 (6).

⁴⁹ W. VA. CODE ANN. §3946(17) (1949); VA. CODE §55-143 (1950).

⁵⁰ Mich. LAWS 1947, P. S. 180; N. C. GEN. STAT. ANN. §44-70 (Supp. 1949).

⁵¹ TEX. REV. CIV. STAT. ANN. art. 5506(c)(10) (Supp. 1949).

located; and they fill in the gap appearing in several statutes as to whether a lien attaches to the proceeds arising from the sale of factored goods. Moreover, the Code carefully delineates the rights of the lender upon default; these are usually ignored in the statutes dealing with factor's liens, Minnesota and Vermont apparently being unique in providing that the factor's lien may be foreclosed or redemption made in the same manner as for chattel mortgages.⁵² Viewed generally, the Code seems to reflect more careful draftsmanship than any of the factor's lien laws.

E. Accounts Receivable

In addition to inventory and equipment, most manufacturers and merchants have another asset, their receivables. These receivables can arise on open account or can represent obligations secured by conditional sales or chattel mortgages. In the latter case delivery of the security agreement customarily accompanies the transfer of the receivable; and, deferring to this business custom, several states⁵³ and the draftsmen of the new Code have set up special rules for assigning this "chattel paper."⁵⁴ But whether chattel paper or open account, his receivables are frequently a businessman's most liquid asset, one against which he often seeks to obtain cash.

Originally in the Code, financing against this asset was assimilated to inventory financing, an "inventory lien" being provided for both tangibles and receivables. The rationale of this assimilation was the opinion that in the minds of the business community receivables merge with inventory in a fundamental "working assets" concept. However, while receivables resemble inventory in constituting quick assets, the codifiers found that in many respects receivables financing raises distinct problems requiring separate treatment. For one thing unlike other loan arrangements the assignment of receivables is interpreted in some business circles as being almost a confession of insolvency. Consequently many a borrower would feel reluctance even to finance against his receivables, much less to have on public record a notice that he is doing so.

The intangibility of accounts in itself raises different problems. It opens up vistas of fraud—fake invoices, duplicate assignments, improper collections by the assignor, trumped-up accounts, and the like—and demands a larger amount of policing than would be necessary for normal inventory financing. And where are the receivables located for purposes of perfecting the assignment? For chattel paper common sense would dictate that the location of the "paper" determine the applicable law. For other receivables traditional doctrine, at least, would refer to the place where the account arose or where payment is to be made. But these contacts may well be so diversified or so fortuitous as to be unserviceable. Another possibility would center on the assignor's place of business, where it is argued his creditors will

⁵² MINN. STAT. ANN. §514.86 (Supp. 1949); VT. STAT. §2746 (1947). Note, 34 MINN. L. REV. 119 (1950) discusses the Minnesota Factor's Lien Law.

⁵³ E.g., CAL. CIV. CODE §955 (1949); N. J. STAT. ANN. §17: 16B-6(d) (Supp. 1949).

⁵⁴ For instance, an assignment of chattel paper can be perfected by delivery without filing. See Revision §§9-105(b)-9-302(b), 9-308.

be most likely to search the record for assignments. The Code, refining this latter approach to take account of the case where the assignor has branches in several states, provides: "For the purposes of this Article (a) accounts or contracts rights are located in this state if the office of the assignor where he keeps his records of the accounts or contract rights is located in this state. . . ."⁵⁵ Thus, in the normal situation filing will only have to be done in a single state which can be easily determined on the basis of a test understandable to any businessman.

Unlike inventory financing, receivables financing involves someone other than the borrower or lender—the account debtor; this can create difficulties. In the first place, the value of the accounts assigned depends on the credit of the assignor's customers; to evaluate that credit requires careful investigation, which adds to the cost of receivables financing and discourages some financiers from entering the field. Also, the attitudes of these customers may be important. If notification of the assignment is given the customers, will they know whom to pay? Will they misinterpret the assignment as a mark of the seller's financial desperation? If the payments are to be made at the assignee's place of business, will the assignor be losing a merchandising opportunity because his customers do not have to come to his store to make their payments?

One of the chief problems of receivables financing concerns realization on the collateral, and arises from the rights of the account debtor. At first glance the position of the assignee of accounts would seem to be excellent in regard to realization. He does not have to worry about storing or selling repossessed goods. He must only avoid improper dunning of the debtor and decide when to compromise claims. But there is one snag—the possibility that the value of the receivables may be diminished due to claims arising from the underlying transaction which created the account. The risk is not inconsiderable, for a seller about to default on his obligations may try to save some money by cutting corners on his goods, and may thereby give rise to claims of fraud or breach of warranty. Also, the assignor's default will frequently coincide with a falling market in his industry, and this in turn may lead buyers to give goods unusually close scrutiny in the hope of finding a minute nonconformity on the basis of which they can reject or rescind.

Under present law the financier can to some extent segregate himself from the original sales transaction. If a mortgage and note are used by the seller and then assigned to the lender, defenses are cut off on the note and under the traditional rule that a note "imparts negotiability" to the mortgage securing it, the financier can even repossess without regard to the buyer's equities. The chief deterrent is the possibility that the relation of the seller and the finance company will seem so intimate as to persuade judge or jury that the financier is not a holder in due course. If instead of a mortgage a conditional sale is used, the seller may seek to procure assignability free of defenses by: (1) contemporaneous execution of a promissory note; (2) the drafting of the contract itself as a promissory note; or (3) the in-

⁵⁵ Revision §9-103(1).

sertion of a "cut-off clause" in the conditional sales contract.⁵⁶ Under either the first or second technique, negotiability is not imparted to the security. A recent New York decision dealt with the third and indicated that while a cut-off clause might be effective to waive a breach of warranty, it did not suffice to create an estoppel to defend on the ground of fraud.⁵⁷

Efforts to cut off the defenses of account debtors have received several statutory rebuffs. Illinois provides, "All notes secured by chattel mortgages shall state upon their face that they are secured," or the mortgage shall be void; and secured notes are made non-negotiable.⁵⁸ Maryland protects its consumers from the hardships of negotiability by requiring in its Retail Installment Sales Act that a note in connection with an installment sale shall refer thereto,⁵⁹ and be subject to all defenses, while Pennsylvania's Motor Vehicle Sales Finance Act states:

No installment sale contract shall require or entail the execution of any note or series of notes by the buyer which, when separately negotiated, will cut off as to third parties any right of action or defense which the buyer may have against the original seller.⁶⁰

For consumers' sales the Code also accepts the policy of not permitting negotiability. But there is an exception in cases where a negotiable instrument, given as part of the transaction and not referring to the security agreement, is negotiated to a holder in due course who seeks to proceed solely on the instrument and not to enforce the security agreement.⁶¹ This concession to negotiability may seem wise; yet to lessen possible harsh effects on consumers, would it not be desirable to require, subject to penalty, that a negotiable instrument in a consumer sale refer to any security agreement?

For non-consumer secured transactions, the Code gives full effect to "cut-off clauses."⁶² The argument in favor of allowing negotiability by contract is analogous to that for making the issuer of a letter of credit independent of defenses or counter-claims arising out of the underlying sales transactions. According to this argument, a financier against accounts receivable lacks the expertise for determining whether the goods conform to the minute specifications of the sales contracts from which the accounts arose; and under the Code, unless they conform in every particular, they can be rejected.⁶³ Therefore the financier can lend against receivables at reasonable rates only if he is free from all concern with the initial sale. Irrespective of acceptance of this argument, it seems desirable that the law as to conditional sales and purchase money mortgages should be sufficiently harmonized so that if defenses can

⁵⁶ See Note, 57 YALE L. J. 1414 (1948).

⁵⁷ *Manhattan Co. v. Monogram Associates, Inc.*, 276 App. Div. 766, 92 N. Y. S. 2d 579 (2d Dep't 1949).

⁵⁸ ILL. STAT. ANN. §83.35 (1935).

⁵⁹ MD. ANN. CODE GEN. LAWS art. 83, §134 (Cum. Supp. 1947).

⁶⁰ PA. STAT. ANN. tit. 69, §615(G) (Supp. 1949).

⁶¹ Revision §9-208(1).

⁶² Revision §9-208(2).

⁶³ May 1950 Draft §2-601.

be cut-off under one, they can equally be cut-off under the other, and vice versa. The Code does remove any distinction.

III

SOME INNOVATIONS UNDER THE CODE

A. After-Acquired Property

One of the chief purposes of the codifiers in the Article on Secured Transactions was to authorize a "floating charge" like that used by English financiers. In its most usual form such a charge is part of an agreement to keep outstanding a loan which will represent a certain proportion of the borrower's inventory. As items are acquired, processed, and later sold, the charge covers them at all times while they are in the borrower's hands, even though no pledge or mortgage is entered into subsequent to the original loan agreement.

Perhaps the closest thing to the "floating charge" in American law is the factor's lien. But under most factor's lien statutes there is a question whether after-acquired property must be formally pledged or consigned. Rhode Island and South Carolina seem explicitly to require these evidentiary formalities, for they speak of the factor's lien as covering goods described "from time to time in written statements identifying such merchandise."⁶⁴ New York in its statute refers to a general lien "upon all goods and merchandise from time to time consigned to or pledged with" the factor.⁶⁵ In states where factor's liens are not permitted, after-acquired property can be covered fairly well by an arrangement under which the borrower executes new mortgages or trust receipts as inventory comes in to replace what has been sold; or if "field warehousing" is being used, the warehouse receipts are pledged as the goods are acquired and turned over to the warehouse.

The Uniform Chattel Mortgage Act also attempted to establish "floating charges," but the Act was not adopted in full by any state.⁶⁶ However, several states have followed the Chattel Mortgage Act in providing that after-acquired property can, under some circumstances, be covered by a mortgage. Georgia permits a mortgage or bill of sale to cover a stock of goods, or inventory of merchandise (which includes materials, goods in process, and finished goods) "or other things in bulk but changing in specifics"; the lien is lost as to all articles disposed of but attaches to purchases made to take their place, and when expressly so stipulated in the mortgage, to other after-acquired additions to the original stock.⁶⁷ Kentucky lets the chattel mortgage "include replacements of any mortgaged property therein described."⁶⁸ Maine provides: "A chattel mortgage shall constitute a valid lien on property described in the mortgage to be purchased with the proceeds of the loan secured thereby, and on

⁶⁴ R. I. PUBLIC LAWS 1938, c. 2568(1); S. C. CODE ANN. §8785 (1942).

⁶⁵ N. Y. PERS. PROP. LAW §45. *In re Comet Textile Co.*, 15 F. Supp. 963 (S. D. N. Y. 1936), *aff'd*, 91 F. 2d 1008 (2d Cir. 1937) held that periodic pledges were not required by the statute.

⁶⁶ See Draftsman's Note to Section 17 of that Act.

⁶⁷ GA. CODE ANN. §67-103 (Supp. 1947).

⁶⁸ KY. REV. STAT. §382-610 (1948). *Cf.* IND. ANN. STAT. §51-505 (Supp. 1949) ("Replacements").

substitutions for or replacements of property described in the mortgage, when acquired by the mortgagor.”⁶⁹ Mississippi authorizes an after-acquired property clause, but not for merchandise.⁷⁰ Louisiana permits a mortgage of movables and certain “masses or assemblages,” which include “stocks of inventoried merchandise or other things in bulk, but changing in specifics”; as to this inventory, the lien shifts from items sold to things replacing them and to after-acquired inventory.⁷¹ California has a strange conglomeration of statutes. According to one:

Title acquired by the mortgagor subsequent to the execution of the mortgage inures to the mortgagee as security for the debt in like manner as if acquired before the execution.⁷²

It seems likely, however, that this provision was not intended to authorize the use of after-acquired property clauses, but merely to deal with an estoppel by deed situation where the mortgagor's title, defective at the time of executing the mortgage, was later perfected by him. This interpretation is reenforced by the existence of a different section of the California Civil Code, which seems more applicable to after-acquired property clauses, and states:

An agreement may be made to create a lien upon property not yet acquired by the party agreeing to give the lien, or not yet in existence.⁷³

Even though these two sections have been construed together to authorize after-acquired property clauses in a mortgage,⁷⁴ their significance is diminished by California's prohibition of mortgages upon “the stock in trade of a merchant.”⁷⁵

Statutes like these reflect the businessman's viewpoint toward inventory. He knows his inventory is changing as to individual items; yet he thinks of it as a unit. Indeed, the notion that to some extent inventory has a constancy which makes it resemble a fixed asset underlies the accountant's theory of a “base stock” inventory. Since they view their inventory as an unchanging whole—though with changing parts—most businessmen feel that the law is unduly complicated when it requires that, in a loan against inventory, a series of new pledges or mortgages be executed as new goods stream in to replace old. In the businessman's mind, the collateral has never really changed.

⁶⁹ ME. REV. STAT. c. 164, §9 (1944). Cf. CONN. REV. GEN. STAT. §7278 (1949). (After-acquired property clause validated as to machinery of a “manufacturing or mechanical establishment” as to “any after-acquired property forming a part of the establishment” or any substitutions “of like nature to the property included in such mortgage.”)

⁷⁰ MISS. CODE ANN. §851 (1942). (Mortgage “on all the chattels of a named class or classes (not including merchandise) (described or limited as to locality) owned at the time of the execution of the instrument and on such property of like kind as may be acquired during a stated period not to exceed twelve months . . .” shall be a valid lien.) Cf. DEL. REV. CODE §3371(c) (1935) (chattels “of the same class”). New Jersey authorizes after-acquired property clauses to the extent of excusing recordation of individual mortgages if there is filing of a preliminary statement. N. J. REV. STAT. §46: 28-5.1 (1933). Cf. N. Y. LIEN LAW §230-(c) (chattel mortgages by auto dealers).

⁷¹ LA. GEN. STAT. §5022.1 (Cum. Supp. 1949).

⁷² CAL. CIV. CODE §2930 (1949).

⁷³ *Id.* §2883.

⁷⁴ *Bank of California v. McCoy*, 69 P. 2d 1013 (1937), *rev'd on other grounds*, 72 P. 2d 923 (1937); *Mason v. Citizens Nat'l Trust & Sav. Bank*, 71 F. 2d 246 (9th Cir. 1934).

⁷⁵ CAL. CIV. CODE §2955 (1949).

The Code takes the same approach and protects after-acquired property clauses that will embrace collateral "acquired under a contract of purchase made within a reasonable time after the making of the security agreement and pursuant thereto," or "acquired by the debtor in ordinary course."⁷⁶ A series of pledges or mortgages—irrespective of the recording of such mortgages—are not required in order to have the security interest cover incoming goods; though they tend to identify the goods constituting the collateral, such mortgages or pledges would be an overly expensive formality. Also, unlike some of the statutes, the Code has no implied or expressed condition that the new goods be replacements of or substitutions for collateral which has been disposed of. Such a condition, while theoretically justified, might produce too much litigation as to what is a "replacement." Accordingly under the Code most financiers would include in their loan agreement some catch-all clause to the effect that: "Financier's lien shall extend to *all* property hereafter acquired by the debtor."

One change should be noted in the September Revision of the Code. Formerly, in fixing priorities among conflicting security interests, the codifiers provided that an interest attaching after a financing statement has been filed takes priority from the time of its filing.⁷⁷

This provision is now omitted and it is stated

a secured lender who has a perfected security interest and who acquires rights in after-acquired collateral under a term in the security agreement takes priority as to such rights from the time when his security interest was originally perfected . . .⁷⁸

A security interest is perfected when "it attaches if filing is required and filing occurs before the security interest attaches."⁷⁹ However, a security interest cannot attach until "value is given and the debtor has rights in the collateral."⁸⁰

Taken together, these provisions seem to indicate that, despite having filed a financing statement, a lender can lose his priority unless he gives "value" before another financier both files and gives value. While "value" includes "an consideration sufficient to support a simple contract,"⁸¹ would not most courts construe "value is given" to mean not the promise to loan but the actual advancing of funds? After all, it was not the promise but the loan that the borrower bargained for. Another ambiguous situation is involved if lenders *A* and *B* both advance money solely on the security of goods to be acquired later. If either or both are purchase money security interests, their priorities are provided for.⁸² But if neither is a purchase money interest—perhaps because the advance was made more than 10 days before acquisition of the property and because other funds were used for such acquisition—apparently the security will be prorated. The interest of each was "originally perfected" at the

⁷⁶ Revision §9-108(2).

⁷⁸ Revision §9-313(1).

⁸⁰ Revision §9-203(1).

⁸² Revision §9-313(3)(4).

⁷⁷ May 1950 Draft §9-312(1).

⁷⁹ Revision §9-303(1)(b).

⁸¹ Revision §9-108(1)(6).

time the after-acquired goods came into the debtor's hands. There is nothing to indicate any priority between them. In view of the two situations discussed, I feel it would be wise to restore the provision under which priority is to be determined by time of filing, save for purchase money liens.

The Code's leniency towards after-acquired property clauses creates a danger of overreaching by the lender. It was a similar danger that induced the North Dakota legislature to provide:

Any mortgage of personal property containing a printed or a written description or designation of property such as "all other property owned by the mortgagor" or language of like effect as a part of the printed or written form shall be void and of no effect as to the property covered by such language.⁸³

The Code does at least have two limitations that lessen the possibility of borrowers' reducing themselves to virtual peonage by giving a security interest in all their subsequent acquisitions or work products.⁸⁴ Consumer goods do not come within the scope of the after-acquired property clause unless obtained "within ten days after the secured lender gives value." Similarly no security interest attaches to crops planted or grown more than one year after the loan agreement is made, unless the interest is given in conjunction with a lease or land-purchase contract, in which case the use of the land would seem to be new value, being extended concurrently with the attaching of the lien.

In permitting an automatic lien on after-acquired property, the Code presents a possibility that one lender will get a stranglehold on the borrower. For example, assume that in connection with a loan lender *A* files a notice of financing which purports to cover after-acquired property. Later *B*, contemplating a loan to the borrower, sees *A*'s notice on record. He cannot be sure whether the collateral he plans to loan against is covered by *A*'s notice, which having already been filed, would give priority over any loan under a notice of financing now filed by *B*. *B* will scarcely wish to take a second lien when *A* would have sole control as to realization on the collateral. The upshot of all this is that *B* may decide against the planned transaction; and if he does, *A*, shielded from competition, can extort higher interest from the borrower.

Several provisions of the Code seek to eliminate the possibility of a monopoly produced by use of the after-acquired property clause. For one thing, the borrower can obtain a statement of termination of financing to cancel the effect of obsolete notices of financing that might otherwise be a cloud over projected loans.⁸⁵ Also, by reason of the priority given a purchase money financier over a lien under an after-acquired property clause, a borrower may be able to obtain enabling advances from other than the original lender. But the prospective purchase money financier faces several problems. If inventory is to be the collateral, this financier must give

⁸³ N. D. REV. CODE §35-0402 (1943).

⁸⁴ Revision §9-203(3).

⁸⁵ Revision §9-405.

notice to any lender who has made a prior filing, the notice to "describe the inventory."⁸⁶ Since such notification must be given *before* the debtor receives the collateral, in many instances it may be difficult to give much of a description. Whether the financier obtains priority will probably depend on how broadly the courts construe the Code's provision that any description is sufficient "whether or not it is specific if it reasonably identifies the thing described."⁸⁷

If the goods subject to a purchase money security interest are processed or sold, will the lien on the finished product or on the proceeds take the same priority as the lien on the raw goods? Formerly the Code's definition of the "purchase money security interest" spoke of an interest which *originally* was taken to secure an enabling advance.⁸⁸ The omission of "originally" in the September Revision may indicate an intent to confine the priority to the collateral in the condition in which it entered the borrower's hands. Also, if there are two purchase money security interests, can the equity in one be applied to secure the other? For instance, suppose the lender makes two enabling advances, *A* and *B*, in each case taking a purchase money lien; then the borrower defaults. If the value of the goods purchased with advance *A* is in excess of that advance, can the excess be applied to secure loan *B*; and, if so, will the excess have the priority of a purchase money interest?

B. Future Advances

Analogous to the after-acquired property clause is a clause stating that a lien secures all future advances. The former seeks to bring new property under the lien; the latter seeks to include new extensions of credit within the lien. The priority given future advances under the Code is another aspect of facilitating a "floating charge."⁸⁹

Unless these advances are treated as if they were made contemporaneously with the filing of the original notice, it becomes necessary for the financier to look at the record before making the advance in order to see whether another lender has filed a notice and made a loan which would come in ahead in regard to the collateral. Yet it is quite possible that the future advance may have been envisaged at the time of the initial agreement between lender and borrower; indeed, the lender may be obligated to make the advance. Or, perhaps the advance was part of a revolving indebtedness arrangement to keep the outstanding loan at a certain per cent of inventory, and was made necessary by a prior, temporary reduction in the borrower's inventory. In situations like these, the filing of a statement that the advance has actually been made in accord with the previously filed basic loan agreement would add little to the notice given by the original filing.

In the absence of statute, the rules covering future advances under a mortgage or other lien seem to be rather confused.⁹⁰ Apparently if the advances are obligatory

⁸⁶ Revision §9-313(3)(b).

⁸⁷ Revision §9-110(1).

⁸⁸ May 1950 Draft §9-107.

⁸⁹ Revision §9-313(1).

⁹⁰ Discussed in Waldo, *Effect of After Acquired Liens Upon Mortgages for Future Advances*, 22 FLA. L. J. 58 (1948).

they obtain the priority of the original recordation and do not require any subsequent execution of a mortgage. Of course, in the normal loan agreement where the lender inserts a host of escape clauses, it would be difficult to tell whether a particular advance is obligatory, for the lender, hiding behind these clauses, could usually avoid lending if he thought it inadvisable. When the making of advances is optional, the courts have swayed between two rules: (1) that the first lienec must search title and see whether anyone else has filed in the interval since his original filing; or (2) that in the absence of actual notice of a lien obtained in this interval, the lender can make an advance with the assurance that the loan will be treated as if made when he first recorded.

Several statutes now deal with future advances. For example, California provides that if a mortgage states a maximum for future advances, it shall be a lien as to such amount of the same "rank, effect, status and standing" as if the money had been loaned initially.⁹¹ Hawaii adopts the distinction as to whether the lender was under a duty to make the future advances: if so, the advances take the priority of the original mortgage; if not, they create a lien only as to mortgages subsequent to the time the advances are made.⁹² Maryland is rather harsh with future advances;⁹³ no mortgage to secure future advances will be given effect unless the amount of the prospective future advances and the times when they will be made are set forth. Moreover, the lien attaches only from the time an advance is made. The only exception to these provisions is in cases where the advances are to be made at the mortgagee's option and in the aggregate do not exceed \$500.00. The Uniform Chattel Mortgage Act directed itself chiefly to the problem of providing notice when an advance had actually been made and stated that, except in the case of a revolving indebtedness, each advance under a mortgage to secure future advances must be evidenced on the record in order to be effective against third parties.⁹⁴

The protection given future advances by the Code is not subject to any of the restrictions provided by these statutes. But would it not have been wise to require that a maximum for future advances be stated in the loan agreement, especially where there is not a revolving indebtedness? Otherwise a lender, about to take second lien, can never be sure whether subsequently a prior lienec whose statement of financing has been filed will make new advances to the borrower—advances that will further subordinate the second lien. Since the Code demands no particularization, the second lender can never be sure whether the first filing refers to only a "small potatoes" loan arrangement, or to a "big deal." Moreover, statement of a maximum will scarcely create undue interference with a loan, for a maximum can be set that will give plenty of margin for any contemplated advances.

While the Code provides for a statement of the termination of financing, this statement is only required if no advances have been made under the financing state-

⁹¹ CAL. CIV. CODE §2975 (1941). Cf. DEL. REV. CODE §3373(d) (1935).

⁹² Hawaii Session Laws 1939, c. 148A.

⁹³ MD. ANN. CODE GEN. LAWS art. 66, §2 (Cum. Supp. 1947).

⁹⁴ Sec. 19.

ment or after the discharge of the obligation secured.⁹⁵ Thus, to be entitled to such a statement, the borrower must pay off his loan to the first financier; otherwise he cannot get on record anything to preclude the possibility of further advances by the first financier that will take priority under the original financing statement. Of course, an agreement by the borrower with the second financier that he will seek no further advances from the prior lender does no good; that lender not having joined in the agreement, he will not be estopped from claiming priority if in fact he makes a further advance. Perhaps in dealing with this situation the codifiers might authorize in certain circumstances the filing of a notice, concurrent with written notice to the lienee, stating that the borrower does not intend to request any future advances; after this notice the original financier would have priority only as to the aggregate indebtedness up to that time.

C. Filing and Notice

To facilitate easy security and floating charges the codifiers have very lenient provisions for notice filing. For one thing, central filing is adopted, the lender being required to file only at the state capital rather than in the various counties where the goods may be located.⁹⁶ Moreover, the notice required is itself so meager as to give little more than an indication that some sort of security transaction has been entered into between lender and borrower. Unlike the recordation of a deed to real estate, the filing is not designed to give detailed information to be used in showing title, but only to suggest that some assets will not be available to satisfy claims, existing or prospective, against the debtor. Further information is to be obtained by creditors and prospective lenders under their own steam.

A procedure provided by the Code can be utilized in getting this information. A large creditor or prospective lender can exercise his economic leverage to compel the debtor to submit a list of collateral to the first financier with a request that it be approved or corrected. If "the security agreement or any other record kept by the secured lender identifies the collateral," the first lender must comply with the request. The penalty is liability for "any losses suffered by the debtor" due to an unreasonable failure to reply, and loss of lien as against persons "misled" by his failure.⁹⁷ It seems the codifiers might have been wiser to eliminate entirely the question of who was "misled." Also, perhaps a similar New Jersey law⁹⁸ may be more direct in permitting any person to demand disclosure by the financier whether he has a lien on described chattels; after all, under the Code the debtor will usually be submitting his list of collateral at the behest of someone else. On the other hand, the financier might in New Jersey find he is running a costly information service.

To supplement the vague information obtained from a filed notice of financing, some creditors or prospective lenders may be able to get a look at the borrower's

⁹⁵ Revision §9-405.

⁹⁶ Revision §9-401(1)(a). Subject to some exceptions stated in Revision §9-401(1)(b).

⁹⁷ Revision §9-406.

⁹⁸ N. J. REV. STAT. §46:28-5.1 (1937).

most recent balance sheet. Of course, the chance of seeing this balance sheet will probably depend on the economic pressure said creditor or lender can bring to bear. And even then, that balance sheet may be several months old and may have been altered. Moreover, disclosure in balance sheets is not always complete; sometimes it is difficult to ascertain from them which debts are secured and by what.

One of the chief beneficiaries of the Code might well be the credit agencies. The minimal notice the Code requires plus the defects in alternative ways of securing credit information may lead many creditors and lenders to lean even more heavily than today on Dun & Bradstreet. Perhaps such enhanced importance for these credit agencies would be only an aspect of increased specialization, but it should be noted that in some sections of the country, there is probably less tradition of relying on credit agencies than in others. Will these sections wish to adopt a Code under which an individual cannot go to the courthouse and get facts on which to base a reasonable, independent judgment whether to loan money?

For consumer sales, however, there is probably general agreement that the Code has done well to eliminate filing of liens.⁹⁹ The cost of recordation is usually high in proportion to the value of the security—indeed, so high that many finance companies prefer to take the risk of not recording. Also Merchants Associations and Better Business Bureaus funnel adequate credit information about consumers through a semi-public agency. But it is interesting that New York in its Conditional Sales Act has done an exact about-face. It requires no filing of conditional sales for resale, but in all other sales, including consumer sales, filing must take place.

Besides letting unsecured creditors know that certain assets are unavailable for their claims, a filed financing statement has other functions. First, it plays an evidentiary role in giving some proof that the transaction was intended from the beginning to be secured, and was not an unsecured loan trumped-up into a claim of security when the borrower is about to go broke. Even the Code's loose requirement of notice has value for this function.

Also some statutes seek to use public notice as a means for letting creditors know that the debtor is seeking to create preferences, so that bankruptcy proceedings can be instituted within four months after the transfer. For example, New Jersey requires chattel mortgages presented for recordation to be accompanied by a detailed affidavit of consideration which shows whether or not new value is being given.¹⁰⁰ Indeed, in New Jersey even when recordation of the mortgage is not required, the affidavit of consideration must be executed. Michigan in similar fashion provides:

Every mortgage or conveyance intended to operate as a mortgage of the whole or any part of a stock of merchandise or fixtures or merchandise and fixtures, pertaining to the conducting of any said business which shall hereafter be made for a past consideration other than the purchase price of the property mortgaged without notice to the creditors of

⁹⁹ Revision §9-302(d).

¹⁰⁰ N. J. REV. STAT. §46:28-5 (1937); *cf.* Sec. 46: 28-5.1, construed in *Bruck v. Credit Corp.*, 3 N. J. 401, 70 A. 2d 496 (1950).

the mortgagor as herein provided, shall be void against said creditors not so notified.¹⁰¹

While many Bulk Transfer Acts are limited to bulk sales and seek chiefly to insure that the Transferor will not sell for cash and "skip" with the proceeds, others extend their notice requirement to bulk mortgages in order that creditors can be tipped off to attempted preferences.¹⁰² The Bulk Transfer Article of the Code has this effect; it requires notice to creditors of any transfer "not in the ordinary course of the transferor's business of a major part of the materials, supplies, merchandise or other inventory of an enterprise subject to this Article or of so much thereof that what remains together with the transferor's other assets exclusive of the consideration received for the transfer, is inadequate capital for the regular conduct of his business."¹⁰³

D. Power of Sale and Right to Proceeds

In order to carry on his business, the borrower who avails himself of inventory financing desires some right to dispose of the goods when they are ready for sale. Yet the common law took a very dim view of a power to sell given the mortgagor of a stock of goods.¹⁰⁴ In states following the New York view the mortgage was fraudulent as a matter of law unless all proceeds resulting from the exercise of the power of sale were applied rigorously to reducing the mortgage debt. Texas wrote this view into its statutes providing:

Every mortgage, deed of trust, or other form of lien attempted to be given by the owner of any stock of goods, wares or merchandise daily exposed to sale, in parcels, in the regular course of business of such merchandise, and contemplating a continuance of the possession of said goods by said owner, shall be deemed fraudulent and void; provided that this Article shall not apply to farm products when offered for sale by the producer; and further provided that this Article shall not apply to any mortgage, deed or trust or other form of lien given to secure the purchase price of any such goods, wares or merchandise, except as to all retail sales made in good faith in the regular course of business.¹⁰⁵

¹⁰¹ MICH. COMP. LAWS §9548 (Cum. Supp. 1945).

¹⁰² A table of Bulk Transfer Acts appears at page 24101 of 3 COH CONDITIONAL SALE CHATTEL MORTGAGE REPORTER. See, e.g., LA. GEN. STAT. ANN. §§9037-9045 (1939) ("The transfer in bulk and otherwise than in the ordinary course of trade and in the regular and usual prosecution of the business of the transferor, of any portion or the whole of a stock of merchandise . . ."). The words "sale or disposal" in the Kansas Bulk Sales Act were construed as including a bulk mortgage. *Linn County Bank v. Davis*, 103 Kan. 672, 175 Pac. 972 (1918). But cf. *Aristo Hosiery Co. v. Ramsbottom*, 46 R. I. 505, 129 Atl. 503 (1925) (chattel mortgage is not a "transfer" even though Rhode Island is a "title theory" state).

¹⁰³ May 1950 Draft §10-102(1).

¹⁰⁴ Varying treatments of the power of sale and the duty of accounting thereunder are set forth in Note, 28 ORE. L. REV. 376 (1949).

¹⁰⁵ TEX. REV. CIV. STAT. ANN. art. 4000 (Supp. 1950). Cf. IND. ANN. STAT. §51-506 (Supp. 1949) (Right to sell or exchange "if the proceeds of such sale or exchange are applied upon the mortgage debt or subjected to the lien of said mortgage, or are used solely for the purpose of paying the expenses of cultivating, harvesting, preparing for market, processing, marketing or otherwise preserving or rendering merchantable or salable the remaining property covered by said mortgage . . ."); MAINE REV. STAT. c. 164, §§2, 8 (1944) (A power of sales does not affect the validity of the mortgage but "no consent given by the mortgagee of personal property to the mortgagor for the sale or exchange of the mortgaged personal property shall be valid or be used in evidence in civil process unless in writing and signed by

Apparently under this statute the very existence of the power of sale, irrespective of any accounting required of the mortgagor, voids the lien. Some states follow Texas in relaxing the restrictions on a mortgage of inventory if the mortgage is for the purchase price of the goods; others permit the mortgagor, in accounting for proceeds, to deduct expenses necessary to the immediate sale—which of course does not include overhead—or a sum necessary for the replenishment of inventory.

One way to rationalize the New York requirement of accounting is on the theory that the accounting for proceeds of sale attests the good faith of the mortgage. Without this requirement a mortgage to some friend or relative could be put on record to stave off creditors, and yet the "mortgagor" would be in the same position as before, being able to use the proceeds in whatever way he wished. The accounting for proceeds helps show the transaction was not a sham. Of course, where the mortgage is for the purchase price the demonstration of good faith by accounting is superfluous and can be dispensed with.

However, the feeling has spread that sham transactions and preferences can be better eliminated by Bulk Transfer Acts than by continuing the requirement of accounting for proceeds. The requirement is felt to be especially harsh in that a lender who fails to police the proceeds loses not only his lien on those proceeds but also a lien on any of the original collateral that has not been disposed of. Moreover, procedures for accounting often have turned into a lot of hocus-pocus that run up expenses without producing any appreciable benefit. For example, under one arrangement for "accounting," if a bank is the financier, proceeds are deposited in a special account to the bank's credit; contemporaneously with each deposit a check on the special account is drawn in favor of the borrower and deposited in his personal account.¹⁰⁶ Another set up involves deposits in a special account from which withdrawals are made if the bank's agent countersigns the withdrawal request; this procedure resisted attack in one case even though the agent apparently countersigned habitually and rather automatically.¹⁰⁷ Almost the only ones who benefit from "accounting" in this form are banks; they receive a financing edge over other lenders, since they have better facilities for entering these evasive arrangements.

Perhaps the chief objection to the requirement of accounting by the borrower derives from its having been carried to absurd lengths in the cases following *Benedict v. Ratner*.¹⁰⁸ Some courts have felt the requirement negated any permission for a borrower with a power of sale to make any adjustments with his customers, however desirable commercially. For example, he could not be allowed to accept returns of goods, else the lien would fall.

the mortgagee or his assigns"). Cf. N. M. STAT. ANN. §63-514 (1941); N. H. REV. LAWS c. 262, §19 (1942); WIS. STAT. §241-14 (1947), prescribing so many formalities that in [1947] WIS. L. REV. 453 it is pointed out the statute is almost useless and should either be eliminated or greatly relaxed.

¹⁰⁶ Monumental Shoe Mfg. Co., 14 F. 2d 549 (D. Md. 1926).

¹⁰⁷ Ford v. C. E. Wilson & Co., 129 F. 2d 614 (2d Cir. 1942). Note, 24 N. Y. U. L. REV. 598 (1949), describes various arrangements for circumventing "accounting" requirements.

¹⁰⁸ 268 U. S. 353 (1925).

The arguments against accounting have produced steady statutory sniping. For instance the Uniform Trust Receipts Act takes the view that complete loss of lien is too severe a penalty for failure to "police" the borrower; it provides merely that if, during the ten days after the entruster obtains knowledge of proceeds, there is no demand for accounting, his lien on those proceeds is waived.¹⁰⁹ Presumably the knowledge that the borrower-trustee has power to sell or is selling the goods in regular course would imply a knowledge that proceeds of some sort are being created. And so in most instances the Act would seem to afford nothing more than a ten day period of grace in which to go after proceeds or lose all claim thereto. Incidentally, since trust receipts are confined chiefly to enabling advances, for purposes of "accounting" they would come within the same policy exception as mortgages for the purchase price.

New York in passing its Factor's Lien Law relaxed the rigid rule that a borrower could not accept returns or grant credit, allowances, or adjustments to purchasers.¹¹⁰ The Uniform Chattel Mortgage Act went even further towards removing the requirement that the lender police. After stating that the mortgage is not invalid because there is no duty to account for proceeds, the Act provides: "there shall be a presumption against any provision for accounting for the proceeds of any disposition of the subject matter."¹¹¹ Wyoming seems to adopt the contrary presumption with its provision that while it shall be lawful for a mortgagor to sell without accounting, "unless permission is expressly given otherwise in the mortgage, the mortgagor shall pay over to the mortgagee all moneys received from the sale of any part of the mortgaged property aforesaid."¹¹²

The Code follows the trend of these statutes lessening the rigors of accounting. It abolishes any presumption of fraud by reason of the borrower's power to make adjustments or accept¹¹³ returns. Not until the September Revision, however, did the codifiers say explicitly whether returned goods are proceeds or merely the original collateral.¹¹⁴ The Code gives a ten day period of grace during which a perfected lien follows "proceeds," in this respect accepting the policy of the Trust Receipts Act but removing the qualification therein as to knowledge of proceeds.¹¹⁵ Such a qualification only adds a litigable issue and tends to reward a lender who fails to keep track of his collateral. Most important, the Code permits indefinite extension of the lien on proceeds if there is included in the original notice of financing a statement that the lien covers proceeds.¹¹⁶ The chief deterrent to inclusion of such a statement would be that it automatically creates a power of sale in the borrower.¹¹⁷ Yet, as to inventory, a limitation on the borrower's power of sale is

¹⁰⁹ Sec. 10(c).

¹¹⁰ N. Y. PERS. PROP. LAW §45.

¹¹¹ Sec. 18.

¹¹² WYO. COMP. STAT. ANN. §59-114 (1945).

¹¹³ Revision §9-207.

¹¹⁴ Revision §9-306(4). *Bloch v. Mill Factors Corporation*, 119 F. 2d 536 (2d Cir. 1941).

¹¹⁵ Revision §9-306(1).

¹¹⁶ Revision §9-306(1)(a).

¹¹⁷ Revision §9-307(2).

of little value anyway, since even knowledge thereof does not lessen the ability of a buyer in ordinary course to cut off the security interest.¹¹⁸

In the provisions concerning the automatic lien on proceeds the codifiers seem to be seeking a compromise which will promote whatever policing of collateral is especially desirable socially but will not require expensive formalities. Cash represents the ultimate in liquidity. If cash proceeds are allowed to accumulate in the borrower's hands, his creditors may be deceived as to his condition. Moreover, the borrower may yield to the temptation to take a protracted trip to Mexico with these cash proceeds. The Code's provision giving a lien on cash proceeds only for the ten days preceding insolvency—though it was probably directed chiefly towards eliminating litigation about "tracing"—has the desirable result of prodding the lender to police cash. Accounts receivable are also liquid; but the notice given by the borrower's original financing statement claiming a lien on proceeds serves to destroy their liquidity. Thus, the dangers of misleading creditors and of fraud on the lender are taken care of by the requirement of the initial notice. It would be unduly formalistic to follow some factor's lien statutes in demanding that the financier obtain periodic assignments of accounts arising from the sale of liened goods.¹¹⁹ Chattel paper involves an intermediate situation. Obviously it does not have the liquidity of cash. But the "thrust" of the Code is towards making chattel paper very similar to negotiable instruments, accentuating possession and eliminating any need for an assignee to search records for a prior interest in the paper. Accordingly, though the inventory lien covers chattel paper arising from the sale thereof, the Code furnishes a pressure for the lender to police; otherwise his interest may be cut off by a subsequent assignee of the chattel paper—even one who knows that there is a security interest in inventory and that this interest extends to the proceeds of the inventory.¹²⁰ The only way for the financier to protect his lien is either to obtain possession of the chattel paper or have noted on the paper the existence of his interest.

A strong objection can be taken that the automatic lien on accounts provided by the Code (very much like the protection given the secured lender as to after-acquired property and future advances) tends to tie the borrower to a single financier. Even if the inventory lien covers only a small amount of inventory it will be difficult, to an extent depending on the manner in which the borrower keeps his books, to tell whether the accounts about to be assigned derive from the sale of such inventory and are therefore subject to the lien. The prospective financier against receivables may well be uncertain of the value of his collateral when he sees an inventory financier's notice purporting to cover all the proceeds. Consequently if the borrower needs extra cash because of an emergency, he may have to get it from the original inventory financier or not at all. This poses two difficulties. The first lender, having the borrower over a barrel, may extort a high financing fee; or the lender may be

¹¹⁸ Revision §9-307(1).

¹¹⁹ N. Y. PERS. PROP. LAW §45 seems to require these assignments unless the account debtor is notified.

¹²⁰ Revision §9-308(2).

an institution which does not engage in receivables financing. If the latter is the case, probably the borrower's accounts existing at the time of the initial loan were not relied on by the financier as security. And now the borrower can get no money against the accounts which replaced those earlier receivables. The consequence is his receivables have brought him no cash.

Perhaps this whole problem is unrealistic. Not too much multiple financing goes on, there usually being established a rapport between a businessman and some particular financing institution. Moreover, many lenders finance the inventory chiefly as a basis for getting the borrower's receivables financing on which higher profits are to be made. This seems especially true in the durable goods industries where inventory is financed under "floor plans" at exceedingly low rates in order that the lender can get a chance to handle the high profit consumer paper. These financing facts of life persuade me to defer to the judgment of the codifiers in permitting an automatic lien on proceeds.

IV

CONCLUSION

If enacted, the proposed Commercial Code will revolutionize the law of security. The certainty and the simplicity it affords are indeed desirable ends. As to its liberalization of security, the nature and the desirability of the results seem indeterminate. I will only try to suggest some of the possible consequences for our economy.

Presumably the availability of easy security, the better protection afforded the secured financier, will enable him to offer credit more freely and on better terms, and to take as collateral things which before were unacceptable. With more credit accessible demands for goods might be heightened among merchants whose expansion is now thwarted by the difficulty of securing funds. A precedent is afforded in the history of the automobile industry. There manufacturers required cash for their goods, but many dealers had no cash. Yet the dealers needed large inventories in order properly to display and sell the goods. The development of the trust receipt helped provide an escape from this *empasse* for it afforded an easy security device for financing autos while they were in transit from manufacturer to dealer, and subsequently while they were in the dealer's show room. The trust receipt was the corner-stone for "floor planning," which, in turn, stoked large-scale automobile distribution, the necessary auxiliary to mass production.

The availability of easy security may also aid in halting the increasing trend towards concentration in production and distribution. An entrepreneur can get money in two ways: by equity financing or by loans. For small concerns the cost of the former is prohibitive since the proportionate cost of floating the issue varies inversely with the size of the issue.¹²¹ Moreover, in placing a stock issue the "little fellow" will usually not possess the advantageous contacts with investment bankers afforded the

¹²¹ See Adelman, *Integration and the Antitrust Laws*, 63 HARV. L. REV. 27, 33 (1949).

"big boys" through interlocking directorates and social connections. As for loans, small firms must rely on secured financing. The Code, by tending to reduce the cost of secured financing and by making it feasible for financiers to loan against broader categories of collateral, opens up new vistas of financing for small concerns, and thus reduces the pressure on them to go out of business or be merged with large outfits.

After careful examination of the Code, the fundamental question in my mind is this: If it is so easy to be a secured creditor and the rights of the secured creditor are so strong, who is going to be an unsecured creditor? Today they are the sellers. Yet the few formalities required under the Code will induce most sellers to obtain purchase-money security interests. Many small creditors will be sheltered by materialmen's liens. Consequently the easy security of the Code and especially the right to after-acquired property and to proceeds may not avail financing institutions as much as some believe, for under the Code many will take a lien for whom today it represents too much trouble and expense.

Cash sales may well become more common under the Code.¹²² Because of the probability that the buyer's assets will be encumbered by secured liens, the amount of which will be difficult to detect, many sellers now selling on open credit will feel it is too dangerous to continue doing so. Some, instead of taking a purchase-money lien, may decide to sell only for cash. Also, a pressure towards cash sales may develop from the other side; many a buyer will seek to obtain a loan against incoming inventory in order to take up the cash discount offered by sellers. The effect of these developments would be the destruction of receivables financing except for the financing of consumer sales, in which chattel paper is normally taken.

If this pattern of cash sales evolves under which the purchase will be financed by a loan to the borrower from some professional lending institution instead of on credit extended by the seller, greater specialization will result—credit being concentrated in the hands of professional financiers. Yet would these institutions be able to evaluate as well as the seller the conditions in the buyer's industry, which determine the value of the collateral and to large degree the prospect of the buyer's insolvency? Of course the centralization of credit in lending institutions would make the economy more subject to governmental regulation. And perhaps it would give a more conservative cast to the economy, the conservatism of bankers being famous.

Broad imponderables like these require the combined wisdom of lawyers, economists, and political scientists. In a realm more closely associated with law, it can be confidently asserted that as a legislative endeavor the Code's Article on Secured Transactions is excellent. In draftsmanship it is, like the well-known soap, 99.44 per cent pure; and, even if not adopted in toto, the Code, with its consistent and well-articulated goals, should be a model for any state desiring to bring order out of the chaos in its law of secured financing.

¹²² Cf. Dunham, *Inventory and Accounts Financing*, 62 HARV. L. REV. 588, 613-15 (1949).