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Security Interests in Chattel Paper*

Joseph H. Leviet†

Chattel paper financing is probably the least known major area of secured transactions law. As the name indicates, chattel paper transactions comprehend all kinds of written agreements where a seller or lessor transfers possession and control of the goods to another while retaining a security interest or a lease interest in the goods. The security or lease interest is embodied in a writing which evidences the debt. This writing constitutes the “chattel paper,” which may consist of a conditional sales contract, a chattel mortgage, a security agreement or a chattel lease, with or without an accompanying negotiable instrument. The chattel paper ordinarily provides that the purchase price or rent for the goods shall be payable in installments over a period of time which may range from a few months, as in the case of certain kinds of computer leases, to many years, if heavy industrial equipment is being purchased on a conditional sales basis. Chattel paper is usually generated by a dealer or manufacturer. The accumulation of such paper creates a “portfolio” of chattel paper. If a substantial amount of his assets are tied up in these medium- and long-term obligations of other persons, the originator of the chattel paper may wish, or may even find it necessary, to raise money by selling this chattel paper or by using it as collateral for a secured loan. Such transactions are referred to as chattel paper financing.

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1. The best discussions of the law of security transactions in chattel paper are in the textbooks, of which the best is G. Gilmore, Security Interests in Personal Property (2 vols. 1965) [hereinafter cited as Gilmore]. Gilmore includes no specific chapter on chattel paper but discusses the problems passim. Chattel paper problems are likewise discussed in P. CooGAN, W. Hogan & D. VAGTS, Secured Transactions Under the Uniform Commercial Code (2 vols. 1969) [hereinafter cited as CooGAN].

2. There has been extensive writing on the equipment lease, most of which centers around the distinction between “true” leases and disguised conditional sales agreements. For present purposes, there is an excellent symposium issue on equipment leasing in 1962 Ill. L.F. 1. See especially, Theiss, Security Aspects of Equipment Leasing, 1962 Ill. L.F. 77. Other useful articles are Comment, Acquisition of Industrial and Commercial Equipment Through Leasing Arrangements, 66 Yale L.J. 751 (1957); Dennon, Financing Chattel Leases, 1 N.Y. Continuing Legal Education 77 (1963); Symposium and Discussion, Getting Down to Earth on Equipment Leasing Transactions, 12 Pract. Law. 9 (1963) (an excellent edited transcript of a program held by the Association of Commercial Finance Attorneys); Riordan & Duffy, Lease Financing: A Discussion of Security and Other Considerations from the Institutional Lender’s Point of View, 24 Bus. L. 763 (1963). For the distinction between “true” equipment leases and others, see 1 Gilmore § 3.6; Hiller, Security Aspects of Chattel Leases in Bankruptcy, 34 Fordham L. Rev. 439 (1966).
Chattel paper financing serves an important economic purpose. Dealers and retailers purchase their inventory from manufacturers and suppliers on relatively short-term credit. Often, in order to sell the same goods to their own customers, they must grant longer terms, thereby creating the "time" obligations embodied in the chattel paper. The dealer or retailer often has no access to secured or bank credit to finance his inventory, nor has he working capital sufficient to carry long-term chattel paper. Even where he does have inventory financing, it may not carry over to financing long-term time sales made by the dealer. Therefore, dealers and retailers often find themselves in a position where the asset upon which they must raise the money necessary to conduct business is their chattel paper, i.e., somebody else's obligation to them. Dealers, retailers, and even manufacturers in many kinds of industries rely upon the chattel paper which they generate for a major source of their financing.

Financing chattel paper is in most cases a profitable business for banks and finance companies. Both capital goods industries—such as computers, machine tools, shoe machinery and construction equipment—and consumer products—including such large industries as automobiles and furniture—rely upon this method. Wherever the ubiquitous leasing company penetrates, it generates chattel paper in the very nature of its business, and by now leasing has found its way into almost every major capital goods industry. The total volume of chattel paper transactions runs into billions of dollars annually and is a substantial source of business to banks, finance companies, and other financial institutions. This article will discuss the major problems in the field of chattel paper financing.

I. The Nature of Chattel Paper Transactions

The creation of a security interest in chattel paper requires at least three parties who take part in two consecutive transactions. In the first transaction, the "Dealer" (a dealer, manufacturer or retailer) transfers the desired goods to the Account Debtor. The Account Debtor executes a security agreement or lease in favor of the Dealer, thereby creating the chattel paper which is to be pledged as security. In some cases, the Account Debtor also gives a promissory note or other negotiable instrument. Once the chattel paper is created in the first level transaction, the Dealer reverses his role. Having been the secured party in the first level transaction, he now sells, pledges or assigns the chattel paper to a Financer (usually a bank or a finance company) and becomes
a debtor in a second level transaction. For convenience throughout this paper, the first level Account Debtor, the Dealer and the Financer, will be referred to in abbreviated form as "A," "D," and "F."

Every chattel paper transaction requires A, D and F, but not all chattel paper transactions are as simple as that described above. The parties to the transaction can vary their relationship by declaring explicitly where the risks of default on the underlying obligation will fall. The assignment from D to F may be with recourse (i.e., where D guarantees collectability of the paper), without recourse, or with limited recourse. So-called assistance agreements, whereby D, as a dealer, promises to resell repossessed equipment or to cooperate in collections, are quite common. At present there is a fashion for first loss arrangements (often called "ultimate net loss" agreements), whereby D agrees to accept a set percentage of a credit loss with any further loss being at F's risk. If the percentage is high enough—and a relatively low percentage usually is adequate since the great majority of all chattel paper is collected without incident—this arrangement will be similar to an assignment with recourse, but it will look much better on D's balance sheet since the contingent liability reported has been kept low.

The method in which A's payments are made varies between transactions. In some cases, F will advise A of the assignment and require direct payment to himself. This is called "direct notification" and is safer because there is less opportunity for collusion between D and A. In other cases, A will make payment to D, who will then remit the proceeds, either in kind or by substituting his own check. Generally speaking, heavy equipment or large single contracts will be put on direct notification. Consumer paper, however, especially that secured by small items, often cannot be handled in the same way because D (here a retail establishment) must keep physical possession of the records and maintain a close supervision over collections. If D is collecting the payments of A, A may be entirely unaware that any transaction has taken place between D and F. F's risk from fraud is thereby increased, for F will have difficulty in tracing, and A will not be able to tell if the same chattel paper has been fraudulently transferred to two different individuals.3

3. One of the reasons for which D may ask that A not be notified is to make the transaction appear to be a security assignment and not a final sale to F. The difference between an assignment as security and a sale will be minimal to F, whose primary interest is in the rate of interest he is getting. To D, however, the tax consequences of a sale may be drastic. If D is truly selling an asset, its chattel paper, then a taxable event has
Some chattel paper transactions are complicated by additional parties. \( D \) may be more than a single party; there are cases in which \( D \) is simply a shorthand reference for several transactions. For instance, there are numerous brokers (sometimes calling themselves leasing companies) who create chattel paper. Such a broker may purchase the goods from \( D \) and resell in his own name to \( A \), who will usually still look to the true dealer for service. The broker then sells the paper so created to \( F \), and the difference between the payment the broker made to \( D \) and the purchase price he received from \( F \) constitutes his compensation. The broker’s assignment to \( F \) will commonly be in the nature of a quitclaim and without recourse. It will contain a bare minimum of warranties—only those needed to transfer the broker’s rights against \( D \). Sometimes there is a double assignment. \( D \) sells goods to \( A \) and then assigns the chattel paper to a broker, either with or without recourse. The broker indorses the paper and assigns it to \( F \). \( F \) then looks principally to \( D \), a mesne assignor, rather than to the broker, the immediate assignor.

In yet another variation from the simple three-party transaction described above, \( F \) may be a syndicate of several banks or finance companies. Commonly, however, there is a single \( F \) of record who “manages” the account and sells “participations” to the others. Assignments from one \( F \) to another are not uncommon. The existence of any additional party to a chattel paper transaction almost always causes complications, but these problems have rarely been the subject of litigation and are for the most part outside the scope of this article.

II. The Kinds of Chattel Paper; Herein of the Special Case of the “True” Equipment Lease

Section 9-105(1)(b) of the Uniform Commercial Code defines “chattel paper” as follows:

“Chattel paper” means a writing or writings which evidence both a monetary obligation and a security interest in or a lease of specific goods. When a transaction is evidenced both by such a secu-

4. The law of participation has received little attention primarily because financing institutions prefer to work things out among themselves rather than litigate. The lead financing institution is a fiduciary for its participants, but the agreement among the participants usually exculpates the manager for actions taken in good faith. Such agreements are enforceable. See Allied Fin. Corp. v. Duo Factors, Inc., 26 App. Div. 2d 558, 271 N.Y.S.2d 402, aff’d, 19 N.Y.2d 865, 227 N.E.2d 591 (1967).
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...rity agreement or a lease and by an instrument or a series of instruments, the group of writings taken together constitute chattel paper.

All security instruments reflecting an interest in goods are chattel paper as a matter of course. The definition includes all equipment leases, even those which do not, themselves, create a security interest. But while equipment leases are included with conditional sales contracts in the Code's definition of chattel paper, the two forms of financing are not entirely alike. The owner, by assignment, of an equipment lease is not in quite the same position vis-à-vis A, the Account Debtor, as if he were the assignee of a Code conditional sales contract. As we shall see, these differences in treatment create distortions in the second level chattel paper transaction without any rational justification.

Most of the discussion of equipment leases by commentators has centered on the distinction between “true” equipment leases and conditional sales contracts cast in the form of an equipment lease and on the drastic tax and bankruptcy consequences of that difference. If an equipment lease is a disguised conditional sales contract, it will be treated as a security transaction for Code purposes, in bankruptcy, and by the Internal Revenue Service. “True” equipment leases are governed by the law of bailments of personal property and not by the Code. In theory, D owns the property leased to A, and as there is no “security” transaction at all the Code does not apply. There is no requirement that D perfect his security interest in the property leased, for there is no security interest to be perfected. Furthermore, there are no mandatory filing statutes for equipment leases. In the event that A should go bankrupt, his trustee in bankruptcy cannot attack D's position for failure to perfect—a distinct advantage from F's point of view as D's assignee. F, as owner of the property, will be able to reclaim it from the trustee in bankruptcy by turnover proceedings. The provisions of the bankruptcy statutes with respect to security for leases will apply. Similarly, the holder of a lease is probably in a better position than the holder of a security interest in the event of a Chapter X reorganization.

5. See Allen v. Cohen, 310 F.2d 312 (2d Cir. 1962) (Friendly, J.); DeRocha v. Macomber, 330 Mass. 611, 614-15, 116 N.E.2d 139, 142 (1953); 1 GILMORE § 3.6; UNIFORM COMMERCIAL CODE § 1-201(37) [hereinafter cited as UCC].
7. See Hiller, supra note 2.
8. The perceptive reader may notice that that is exactly what the law was for conditional sales contracts before the Code was enacted. This provides yet another reason for saying that there is no distinction between an equipment lease and a security agreement.
9. See In re Yale Express, 370 F.2d 433 (2d Cir. 1965). If the bankrupt owns the
The distinction between true leases and conditional sales contracts also affects the consequences of A's default under the lease. The proper remedy for the holder of a "true" lease is replevin instead of the default procedure laid out in Part 5 of Article 9 of the Code. In those few States where replevin is still encumbered by common law remnants, the equipment lease may have disadvantages. On the other hand, if the Code should be amended in any state so as to include in Article 9 an election of remedies between an action for the debt and a proceeding for repossession of the goods, there would be a substantial advantage in favor of the lease-holder.

In the event that A sells the property out of trust, the holder of a lease interest may be somewhat better off than the holder of a security interest. As we shall see hereafter, a sale by A out of a trust of some categories of goods cuts off D's security interest and passes good title to a bona fide buyer. In theory, the same need not be the case for the lessor-owner of the property sold, although the courts, especially in those states where the Factor's Act has not been repealed by the Code, might find that the owner was estopped by placing the property in the possession of one who could resell. Moreover, since the Code does not apply, its disapproval of Benedict v. Ratner would not necessarily be binding, and a court might well find that the lessor and his assigns were under a duty to maintain dominion or otherwise police the transaction. There is some support for such a position.

In one situation the purchaser of a security agreement may have an advantage over the purchaser of a lease. Where F purchases equipment leases, he takes only an assignor's interest in the equipment lease itself. If F wishes to be secured by an interest in the goods as well, he must obtain a security interest from D and perfect it. A typical example arises when D is leasing computers to A on a three-month basis and F, knowing that such leases are ordinarily renewed, makes an advance that exceeds the balance due on the leases. In this case, F must file a "chattel mortgage" against D in order to perfect his security interest in the inventory of computers which D has rented to A (and probably should also file against D's "contract rights" to cover property, the Bankruptcy or Reorganization Court has jurisdiction, which in Chapter X may include the power to modify liens. On the other hand, if the property is merely leased, a reclamation proceeding by the owner may be available.

10. 288 U.S. 853 (1925) (assignment of accounts receivable as collateral does not create a lien when debtor reserves dominion over the assigned accounts). UCC § 9-205 carefully overrules Benedict v. Ratner and the Official Comment clearly expresses a policy against the rule of that case.

11. See Theiss, supra note 2, at 86-88.
the renewals). If, however, $D$ is buying computers from his supplier on a conditional sales basis, $F$ may very well have a second security interest in the computers themselves. Contrast the situation where $F$ is financing conditional sales contracts generated by $D$. There $F$'s security interest in the property comes with its security interest in the paper, and the additional "chattel mortgage" is not required; $F$, a purchase money buyer of $D$'s conditional sales contracts, need not worry about the security interest of $D$'s suppliers.\textsuperscript{12} The use of conditional sales contracts also avoids all problems of dealing with security for rent, a major cause of complications in the case of equipment leases.\textsuperscript{13}

In terms of chattel paper financing, no reasons seem to exist for differentiating between transactions involving leases and those involving conditional sales contracts. The differences outlined above could be eliminated if all equipment leases for business or commercial purposes which extend over a specific period (perhaps three months or longer) and cover any substantial amount of property (say, $5,000) were brought under the Code.\textsuperscript{14} The lessor would then be required to file in order to enforce his rights against third parties without notice. The rights of the lessor would then be the same as those of a party with a perfected security interest subject to the Code.

Sales contracts and leases are often accompanied by maintenance contracts. In the machinery industry, for example, service and parts contracts often go hand in hand with an agreement to purchase or lease. The two agreements are in practice a single transaction, for no matter what the wording of the sale or lease agreement may be, the buyer or lessee will rarely be willing to make payments on the main agreement when he is not receiving the maintenance which he was promised. One might expect that the maintenance contract would be

\textsuperscript{12}UCC § 9-308, second sentence. Note also that UCC § 2-702, which gives a seller of goods the right to reclaim in the event of insolvency of his buyer, would not apply \textit{vis-à-vis} $F$ if he were a purchaser in the ordinary course of $D$'s business. Under the Code, a lienholder or the holder of a security interest is considered to take by purchase. \textit{Id.} § 1-201(32), -(33).

\textsuperscript{13}Some states require that lease security be deposited in a bank, draw interest, etc., and these statutes often apply to personal property as well as real estate. See, e.g., N.Y. Gen. Oblig. Law § 7-101 (McKinney 1964). Moreover, a lessor's trustee in bankruptcy may always attack the validity of the lessor's receipt of the security, because cash collateral is an "instrument" for which perfection must be made by taking actual possession. See \textit{In re Atlanta Times}, 229 F. Supp. 820 (N.D. Ga. 1966).

\textsuperscript{14}Cf. Henson, "Proceeds" under the Uniform Commercial Code, 65 Colum. L. Rev. 292, 294 n.14 (1965); Note, 49 Cornell L.Q. 672 (1964). The writer knows of no instance in which the present law has been defended as making a reasonable distinction for security purposes. It is sometimes claimed that a distinction for tax purposes makes economic sense, but nobody has ever given a reason for excusing filing except to say that such is the present law. There is a trend toward treating equipment leases as if they were covered by the Code for warranty and like purposes.
considered a part of the chattel paper generated by the transaction, i.e., a part of the security agreement with which it is inseparably connected. The Code is to the contrary.\(^\text{15}\) This is not without reason, for the entire thrust and purpose of the Code's treatment of security in chattel paper is to assimilate it to a "commercial specialty," i.e., a negotiable instrument. A maintenance agreement assumes that the duty of the seller of the goods will continue into the future, even if it only involves sending a man around to examine the engine or to program the computer. The transaction is not yet concluded, and chattel paper financing is inapposite.

The Code contains one specific method by which chattel paper which is to be financed can be made to assume the qualities of a negotiable instrument. Section 9-206 permits a buyer to agree that he will not assert against an assignee any claim or defense which he may have against the "seller" and states that such an agreement is enforceable by any assignee for value, in good faith, and without notice of a claim or defense, except for those defenses which might be asserted against a holder in due course of a negotiable instrument. Where a negotiable instrument is given as part of the transaction, the Code implies an agreement of this kind. Where both an agreement and a note exist, the Code provides that the two "taken together constitute chattel paper."\(^\text{16}\) Therefore, if \(F\) fails to take possession of the note—even if the instrument never gets into the hands of any person with a claim vis-à-vis \(F\)—there is a possibility that \(F\) will be held to have failed to perfect his security interest.\(^\text{17}\)

III. Protecting the Security Interest in Chattel Paper Against Other Interests

The natural enemies of the holder of a security interest in chattel paper are

1. Landlords, mortgagees, persons who have maintained or improved the collateral (such as repairmen or warehousemen), and taxing authorities—all persons who may establish liens on the collateral itself;
2. The Account Debtor himself;
3. \(D's\) other creditors, including the Trustee in Bankruptcy who represents all creditors;

\(^{15}\) Because the party obligated to maintain has neither a security interest nor a retained leasehold, the Code's definition of chattel paper is not applicable.

\(^{16}\) UCC § 9-105(b).

\(^{17}\) See Kripke, Practice Commentary, N.Y. U.C.C. 360 (McKinney 1964) (commentary in § 9-105).
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4. Bona fide purchasers for value of the equipment which forms the security;
5. Other purchasers of the same chattel paper.

A. Other Classes of Lienors

Most of the persons falling into the first class—tax authorities, landlords, mortgagees, warehousemen, repairmen, and the like—derive their liens from sources other than the Uniform Commercial Code. In such cases, the priority problem presented by their position vis-à-vis F is a conflict between F’s Code security interest and their non-Code liens. The only Code provision germane is Section 9-310, which is intended to protect laborers, warehousemen, repairmen and the like. It provides that where a person “furnishes services or material in the ordinary course of his business with respect to goods subject to a security interest,” his lien takes priority over all perfected security interests in the goods themselves. The reason for 9-310 is, of course, that such lienors have enhanced or protected the value of the collateral and, thus, no one is prejudiced by their priority.\(^{18}\)

In a number of states, landlords have a preferred lien position or a right of distraint on all property located on their premises, even if the goods are not affixed to the realty.\(^{19}\) Where the state statute provides for cutting off the landlord’s lien by timely notice, D can protect himself by informing the landlord that the equipment is about to be or has been delivered to A’s premises. In other cases, D should obtain the landlord’s consent before delivering the collateral to A’s premises. If the goods are to be affixed to the realty, the fee owner’s consent is almost always needed, but such transactions are not normally suitable for chattel paper financing. The mortgagee’s consent may also be necessary where his lien extends to personal property under the terms of the mortgage or the local real estate law.

Taxing authorities may also claim liens. Federal taxes are not a significant problem if D has properly perfected his security interest against A. In such a case, D will have a valid defense against subsequent Internal Revenue claims against A’s property, and F will take D’s position by assignment. State and local taxes raise more interesting questions. Many states, including California, Massachusetts and other important commercial jurisdictions, have personal property taxes which

\(^{18}\) *See generally* Comment, *Nonconsensual Liens Under Article 9, 76 Yale L.J. 1649* (1967).

\(^{19}\) *CCH Secured Transactions Guide* (4 vols. 1969) has the applicable State law at § 340 under the law of each state.
place an annual impost upon all of the taxpayer's personal property. Ordinarily, the security agreement between $A$ and $D$ will require $A$ to keep the property free and clear of all liens and to pay all taxes. If, however, $A$ is unable to pay the tax or for some other reason does not do so, and $D$ has assigned to $F$, an out-of-state lender not doing business in the jurisdiction, some difficult legal problems can arise. Does the state have power to tax $F$'s property? If $F$ is forced to repossess the collateral (and if $A$ cannot pay its taxes, it probably cannot pay its finance charges either), is $F$ “doing business” under local law? If $F$ must qualify in the state, can the state impose payment of the taxes as a precondition to the suit? If $F$ is a national bank, as will often be the case, will the above questions be answered in the same manner according to federal law?

B. The Account Debtor

$F$'s interests may be prejudiced where the Account Debtor has defenses or claims that can be asserted against $F$ arising out of $A$'s transactions with $D$, the person with whom he contracted. Further claims may arise where the transaction between $A$ and $D$, the first level transaction, is subject to state or federal regulation.

Generally speaking, business transactions at the first level provide few complications when they become the subject of chattel paper financing. It is, in fact, not uncommon for $D$ to bring his prospective account debtor to $F$'s attention in advance of the transaction in order to have $A$'s credit “checked” and to discover in advance whether $F$ is even interested in financing the transaction. $A$ often knows which finance company or bank is going to be buying the chattel paper well in advance of his consummation of the first level transaction. In a sense $A$ is taking a loan from $F$ in order to acquire the equipment from $D$. In many cases $D$ and $A$ will use a printed form prepared by $F$ which says on its face that it will be assigned to $F$ and has on the reverse a form of assignment from $D$ to $F$.


A very different situation is presented where consumer goods provide the subject matter of the first level transaction. $D$ and $F$ in such transactions rarely deal at arm's length. $A$ does not know that he will be dealing with a financing agency; he only knows that he is dealing with a store. The occurrence of fraud in such transactions has prompted a great deal of regulation over the last ten years, and the flow of such regulation seems to be accelerating at present. Many states have Retail Installment Contract laws, which bear directly on the consumer goods first level transaction. A Federal Truth-in-Lending law has recently become effective, and the Federal Reserve Board has promulgated Regulation Z, which requires consumer credit cost disclosure.

The interaction between the regulation of first level consumer credit—essentially the sale from the store to the buyer—and the second level chattel paper security transaction—a pledge of the paper by the store to a bank or finance company—is likely to present financing institutions with some novel problems. The financing institution cannot safely ignore the legislative regulation of the first level transaction because as an assignee, it cannot have rights greater than the rights of its assignor. On the other hand, the financing institution is not a party to the first level transaction and does not wish to become over-involved in its customer's business. The tension resulting from these pressures has not been resolved.

The Code is of little relevance here, for it was prepared in such a way as to avoid conflict with retail installment regulation. Although Section 9-206, discussed above, permits the inclusion of provisions in the first level agreement which would cut off $A$'s defenses vis-à-vis $F$, the section is drafted to allow an exemption for consumer goods transactions. Where such a statutory exemption has been made, $A$ may defend against $F$ regardless of the language of the first level agreement or the existence of a negotiable instrument.

The experience to date with Truth-in-Lending for consumer goods, even when coupled with a limitation on the finance rate that $D$ may

22. The scope of the Retail Installment Sales acts varies; in many states they apply to all nonbusiness retail sales, in others only to automobiles. All such laws prescribe the form of agreement to some extent. Others expressly prohibit certain practices deemed unconscionable. A number of such statutes impose maximum ceilings on finance charges. The applicable statutes for each state may be found in the CCH Consumer Credit Guide (2 vols. 1969).

23. Pub. L. No. 90-321 (May 29, 1968), 82 Stat. 146. See Felsenfeld, Uniform, Uniformed and Unitary Laws Regulating Consumer Credit, 37 Fordham L. Rev. 208 (1968). In Felsenfeld's view the Federal Truth-in-Lending Act, the various state laws already in effect such as the Retail Installment Credit acts and the proposed Uniform Consumer Credit Code all overlap.
charge $A$, has been less than satisfactory, particularly where the poor are concerned. Insofar as the statutes simply require disclosure, poor people tend to accept the disclosure and buy the goods. They often cannot buy at all except on credit and cannot get credit anywhere except in the store where they actually buy. Regulation of the amount by which $D$’s finance charge may exceed the cash price is meaningless where $D$’s sales are almost all on credit, for the cash price can be set arbitrarily to hide excessive financing charges. The abuses most complained of—shoddy merchandise, misrepresentations by the seller, lack of maintenance and repair facilities, highbinding salesmanship, exorbitant prices, unfair collection procedures—are not remedied by regulation of this nature except insofar as the Federal Truth-in-Lending Act contains a provision limiting garnishments.²⁴

The failure of consumer protection laws has led to the suggestion that financer $F$’s should be made to police retailer $D$’s. Usually it is proposed to force $F$ to police $D$ by restricting $F$’s rights in chattel paper transactions whenever $D$’s conduct has been fraudulent or dishonest. Since $F$ is usually a very solid citizen—a bank or a finance company—and $D$ may be a shaky retailer of furniture, television sets, clothing or the like in a ghetto area, the idea is not without its attractions to the legislature, not the least of which is that it puts the work and expense of regulating credit sales on someone other than the public. For much the same reasons, the banks and finance companies are less impressed. They would much rather lend money to their customers without getting involved in their business or their morals. With considerable force and not a little reason, the financial institutions point out that they simply are not in the business of operating or policing their customer’s enterprises. Furthermore, they observe that this will only make financing harder to get, thereby driving up ghetto prices, while at the same time, all sorts of nonghetto enterprises will be unnecessarily hurt. In fact the number of reputable lenders advancing against consumer paper has greatly diminished in recent years.

Despite these arguments, some legislation in this area seems politically inevitable. Since the Code follows present commercial practices—a point of honor with its draftsmen—it may be unfeasible to adjust new legislation to the Code’s model of consumer goods chattel paper financing. The Code anticipates that the financing of chattel paper arising from the sale of consumer goods will ordinarily take the form

²⁴. *Id.* tit. III.
of a loan agreement between $D$ and $F$ under which $F$ will advance monies to $D$ to be secured by a pledge of $D$'s chattel paper. The chattel paper need not be delivered to $F$ but may remain in $D$'s possession, properly stamped to show that it has been pledged to $F$. $D$ will effect collections on the paper. $F$ may make an audit from time to time but will have no direct control nor any supervision of either the sales made by $D$ to generate the paper or of $D$'s procedures to obtain collection. Any change that would place responsibility on $F$ would necessarily distort the above transaction. While the dislocation of established commercial procedures is not a valid reason for avoiding changes in law that will benefit the public, the legislature ought to make such changes as are necessary in such a manner that the commercial feasibility of financing consumer paper is maintained.

The crucial question to be considered is what new obligations are to be placed upon $F$. The first signs of legislative regulation seem to indicate that chattel paper lenders will be required to register in order to do business. The sanction for failure to supervise the borrower is the withdrawal of the lender's license. Registration provisions are contained in a number of Retail Installment Credit acts already enacted. The proposed Uniform Consumer Credit Code (Draft No. 6)\(^{25}\) contains provisions requiring the licensing of all persons who purchase consumer chattel paper, except regulated financial institutions. These provisions are controversial. The exemption for regulated financial institutions suggests that the direction of the proposed regulation would be toward assimilating all consumer paper lenders to those lending institutions already subject to public audit. Such regulation cannot effectively provide adequate consumer protection. It is most unlikely that any regulatory agency will have the personnel available to permit any audit in depth of the records of licensees. Assuming, however, that careful audits are conducted, what will the auditor find? The real complaints, such as overcharging, forced selling, shoddy goods, and abuse of process in collection, will not appear in any records which the auditor sees. They will probably not appear in $D$'s records and, certainly, not in $F$'s records. Furthermore, the rule-making machinery of most administrative agencies is so cumbersome and the requirements for revoking a license so onerous that except in the most extreme cases, the public is likely to receive little benefit from such regulation.

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The absence of regulation need not mean that lenders will not be responsible for acts of their borrowers under all circumstances. Historically a lender has rarely been held liable for acts of his borrower, no matter how objectionable the practices may have been, except where the lender had an equity, was a principal-in-fact, or was engaged in a joint venture. A recent decision of the California Supreme Court, however, indicates the possible beginning of a common law doctrine holding a lender liable for the acts and practices of his borrower where the lender becomes too closely implicated in his borrower's business. In Connor v. Great Western Savings and Loan Association, Chief Justice Traynor, speaking for a narrow majority of a closely divided court, found that a savings and loan association which had no equity interest at all in its borrower could be held responsible for its borrower's negligence to third parties.

The facts in Connor are unusual, but the very existence of the holding is of great significance. Defendant savings and loan association lent the sum of about $3,000,000 to a real estate developer. The developer himself put less than $50,000 into the business—a "thin equity" situation reminiscent of that in which the corporate veil is pierced. The investment certainly was much more than a prudent regulated lender of any kind should have made and, at best, was of questionable legality. The developer built on adobe soil, common in Southern California. Adobe soil expands greatly after a heavy rainfall with disastrous effects upon foundations—a fact that a developer or savings and loan association in Southern California might fairly be expected to know. Although a special building technique for foundations in adobe soil exists, the developer negligently failed to employ it, and the foundations sank. The owners of the homes sued the savings and loan association, apparently on the theory of a joint venture. A majority of the California Supreme Court held the complaint stated a cause of action for a direct suit against the lender. Mr. Justice Traynor's approach is reminiscent of MacPherson v. Buick, for he found that, on the pleadings at least, the lender could, and reasonably should, have anticipated the risk of injury to the plaintiffs and that it was under an affirmative duty to exercise reasonable care to protect them.

Connor is a significant decision certain to generate much comment and controversy. It is too early to guess at its importance, except to remark that it proves that the common law has lost neither its generative

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26. 73 Cal. Rptr. 369, 447 P.2d 609 (Sup. Ct. 1968).
27. 217 N.Y. 382, 111 N.E. 1050 (1916).
Power nor its quality of unpredictability. It would not be a very great extension of Connor to hold F legally responsible to A where F is too closely implicated in misconduct by D. Connor certainly sharpens F's dilemma: if he remains too distant from D and keeps all transactions on a formal basis (which, incidentally, is bad practice for a bank and suicidal for a finance company), he runs the risk of being held liable for D's practices which he should have known about but which did not come to his attention. On the other hand, if the lender does follow the account too closely, he may become liable under Connor. Certainly it would be to the public benefit for financers to accept this risk and to follow their borrowers closely for abuses, but what is F to do when it discovers the abuse and lacks the power—or, frankly, the desire—to do something to cure it? There are no pat answers, and financing consumer paper is not likely to be a dull occupation in the near future.

While the courts fix the parameters of Connor, the wisdom of requiring the registration of lenders seems questionable. A better course of action would be to give the persons actually injured by D substantial rights of action and to make behavior that is sufficiently outrageous a violation of the criminal laws. The false advertising statutes which have been proposed and, in a few cases, adopted\textsuperscript{28} partially implement this proposal. Encouraging class actions and similar representative suits\textsuperscript{29} against offenders would be advisable; both private parties and public agencies should be granted the right to bring representative actions. For example, where a store is selling by false advertising, anyone induced by such advertising to purchase merchandise should be granted an action on behalf of himself and all others similarly affected. Broad injunctions running in favor of the public could be made mandatory in appropriate cases. Bad trade practices can be prohibited. For example, if certain kinds of door-to-door selling regularly produce fraudulent results, then the practice ought to be made a misdemeanor. Perhaps the criminal laws ought to be changed

\textsuperscript{28} See Dole, Merchant and Consumer Protection; The Uniform Deceptive Trade Practices Act, 76 YALE L.J. 485 (1967). The Federal Trade Commission has jurisdiction to enjoin false advertising in certain instances but as a practical matter is unlikely to enjoin minor instances. The state attorney general may have jurisdiction in such instances.

\textsuperscript{29} The proposed Uniform Consumer Credit Code gives the Administrator the right to seek injunctions against fraudulent and unconscionable conduct in Section 6.111, but the section quoted in Jordan & Warren, supra note 25, at n.102, is quite narrow and is restricted to injuries caused "primarily because the transactions involved are credit transactions." The Uniform Consumer Code gives no wide offensive powers to any private party; chiefly it follows the pattern of the usury laws and requires a forfeiture for unconscionability. Jordan & Warren, supra note 25, at 427-428. This is really unnecessary; the courts can get to that point simply by using the unconscionability provisions of UCC § 2-302.
where appropriate so as to give private persons the right to force a public agency to initiate legal action. The history of the enforcement of housing ordinances suggests that the public must not entrust enforcement to a small overworked official staff. Private parties could be allowed to sue for an injunction on behalf of the public if criminal prosecution is not initiated. Appropriate provisions for attorney's fees should be included in the statutes for the practical purpose of encouraging lawyers practicing in the ghetto areas to bring such lawsuits.

Public regulation alone is most unlikely to be successful in this area. A small glimpse at history is instructive. The forms of market and mercantile regulation in the Elizabethan and Jacobean periods are now historical curiosities, while the action of deceit and the equity procedure for rescission introduced at about the same time not only survive, changed to suit the needs of the times, but have living issue in the Texas Gulf Sulphur decision and SEC Rule 10b-5.

C. The Dealer’s Other Creditors—Perfection by Possession or Filing; Stamping the Chattel Paper

The transaction by which D assigns his chattel paper, his secured rights, to F is itself a security transaction. If F has a perfected security interest in the paper so sold, F is a secured creditor, who, fraud aside, is protected from any attempt by D’s creditors to treat his advance as a mere unsecured loan. To protect his rights, F must insure that the appropriate procedures have been followed to perfect his security interest in the chattel paper and, if necessary, the proceeds from that paper.

The Uniform Commercial Code authorizes two different means of perfecting a security interest—(1) taking possession of the collateral and (2) filing a Financing Statement (Form UCC-1) with the appropriate registry office. Both are available for chattel paper. Section 9-304(1) permits perfection of a security interest in chattel paper by filing, and Section 9-305 permits perfection “by taking possession of the collateral.” If F has perfected his security interest, either by filing or by taking possession, he will be protected against a claim by D’s creditors or trustee in bankruptcy that he is only an unsecured creditor.

Possession, the first method of perfecting a security interest in chattel paper provided by the Code requires F to take physical possession of the paper. Where the chattel paper generated by a trans-

action between A and D consists of more than one document, potential problems of perfecting by possession arise. By Section 9-105(b), chattel paper may consist of a security agreement or equipment lease alone, or the document plus a negotiable instrument. In transactions where a negotiable instrument is given, there is a risk that D will discount the note to one financer and sell the security interest to another. In this case, the holder of the note will have a cause of action *vis-a-vis* A, and the holder of the security agreement will have only a worthless piece of paper. His only claim will be against D for fraud.

A related risk occurs when A executes several copies of the same security agreement (but does not execute a note), and D then assigns one copy to each of several financers—a classic case of double financing. Plainly the holder of the original security agreement takes priority over all holders of mere copies. But what happens where both financers take copies or where A has executed duplicate originals at D's request? If D has filed the original as a financing statement with the appropriate registry office, there will only be copies. The problem has not been presented to the courts for determination.

Perfecting security by possession raises further difficulties as soon as F does not take possession itself but appoints another as his agent. Where the agent or custodian is an independent third person having no relationship to D, there can be no objection. However, a practice exists in some segments of the finance industry of appointing an employee of D as "custodian" or "agent" of F for the purpose of taking possession of the paper, under an agreement providing for nominal consideration. An allied practice is for F to lease from D those filing cabinets in D's office which contain the paper. In both instances, the transaction is more formal than real; the "custodian" continues to be an employee of D, and D continues to have control over his own files. Sections 9-205 and 9-305 (especially Official Comment 2) make it evident that a person controlled by his debtor cannot be an agent for a secured party. Therefore, insofar as such devices are intended to have more than a psychological effect, they are useless. The Code's prejudice against *Benedict v. Ratner* has not relaxed the common law requirements of possession. 31

F's perfected security interest in the chattel paper does not, without further action, give him a perfected interest in the proceeds of that paper. Proceeds are an entirely different class of collateral under the

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31. UCG § 9-205, Comment 6.
Code; if $F$ does not have a secured interest in the proceeds and the paper has been converted into proceeds—say by the sale of the goods covered thereby—the proceeds will go into a fund for the general creditors despite $F$'s preferred position with regard to the chattel paper. For ten days after receipt by the debtor, proceeds are automatically perfected. After the expiration of the ten days, however, a perfected security interest in the proceeds can only be obtained by filing.\(^{32}\) Where $F$ has perfected his security in the chattel paper by filing a financing statement, he need only check the proceeds box on the form to secure his interest in the proceeds. Such a filing against proceeds, however, can produce the very problem it was meant to prevent. This odd result arises from the language of Official Comment 3 to Section 9-306: “A claim to proceeds in a filed financing statement might be considered as impliedly authorizing sale or other disposition of the collateral, depending on the circumstances of the parties, the nature of the collateral, the course of dealing of the parties and the usage of trade.” With all due respect, the Comment is wrong.\(^{33}\) If $F$ does not file against “proceeds,” he loses all rights to those proceeds in the event that $D$ disposes of the collateral. The only reason for $F$ to file against proceeds would be to protect himself against the very act which the Code now implies he may tacitly have authorized. Luckily, the wording of the Comment is indefinite. It refers to custom, understanding of the trade, and other considerations. In the absence of specific trade considerations to the contrary, $F$'s chances of avoiding loss seem greatest if he files against the proceeds.

In practice, the choice between taking actual possession and filing as a means of perfecting the security interest is related to the character of the goods which form the basis of the security. The Code differentiates between equipment, inventory, and consumer goods.\(^{34}\) For practical reasons, it is often difficult or inconvenient for $F$ to take physical possession of consumer chattel paper which must remain in $D$'s hands as administrator of the contract for collection. Where $F$ buys consumer paper, he will ordinarily file a financing statement on Form UCC-1 against $D$ and stamp the paper to show that it has been assigned. If nonconsumer goods or large consumer items, such as auto-

\(^{32}\) UCC § 9-306(3).

\(^{33}\) The odd thing about this Official Comment is that it is utterly unnecessary. The problem is already covered in the statute itself, for UCC § 9-306(2) says that a security interest continues in collateral notwithstanding sale, etc., by the debtor “unless his action was authorized by the secured party in the security agreement or otherwise.” (Emphasis added.)

\(^{34}\) These terms are defined in UCC § 9-109.
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Mobiles or trailers, are the subject matter of the transaction, \( F \) will usually take physical possession of the paper. Where \( F \) is in possession of the paper, \( D \) may prevent \( F \) from filing the assignment.

Official Comment No. 2 to Section 9-308 suggests that where chattel paper is left in the originator’s possession, \( F \) may protect his interest by stamping the chattel paper with a legend indicating that he has taken a security interest in it. This will protect \( F \) against a subsequent claim by a financer that he took possession innocently and without knowledge of the prior assignment to \( F \). Stamping itself is neither possession nor filing, and therefore does not perfect a security interest in the event of a bankruptcy. \( F \) should file as well as stamp. Since stamping is not in itself a method of perfection, a financer who files first will take priority, other things being equal, over one who files later and stamps. If the second financer wishes to take advantage of the preference accorded physical possession, he must take possession. Stamping is a shield against subsequent possession by others, not a sword to strike down prior filings. Stamping creates some interesting problems. If \( D \)—presumably with fraudulent intent—removes the stamp, thereby altering the chattel paper, and resells the altered paper to an innocent purchaser for value, who then has priority? It would appear, by analogy to the forgery of a negotiable instrument,\(^{35}\) that the innocent purchaser would take priority. Furthermore, the first \( F \) could have taken physical possession of the paper but did not, and although himself innocent thereby made the fraud possible.

D. Bona Fide Purchasers of the Collateral

\( F \)'s security interest in the chattel paper includes not only \( A \)'s promise to pay (with possible recourse to \( D \)) but also by definition an interest in the rights of \( D \) to the collateral which secures the first level transaction. Almost every security agreement requires the debtor to retain possession of the collateral and to keep it fully insured and free and clear of all liens and encumbrances. While the vast majority of all debtors do keep these agreements, so great is the volume of security transactions that unauthorized sales by \( A \) in violation of the security agreement present a significant problem. In those cases where \( A \) disposes of goods in violation of the security agreement, he is said to have sold them “out of trust.” If the purchase is made in good faith and for value, the purchaser may contest \( F \)'s claim to the goods since both

\(^{35}\) Gruntal v. National Surety Co., 254 N.Y. 468, 173 N.E. 682 (1930); UCC § 3-419.
F and the purchaser have taken bona fide interests in the property for value.

Under the Code the rights of the parties in the event of an out of trust sale depend on whether the goods sold are classified as consumer goods, inventory, or equipment. In the case of consumer goods, Section 9-307(2) provides that a buyer who purchases goods for value, for his personal, household, or family use, takes free and clear of a security interest unless a financing statement has been filed. If a financing statement has, in fact, been filed, the interest of the secured party is paramount. While the Code affords the holders of secured interests this means of protection against out of trust sales, it is often not exercised. By Section 9-302(1)(d), it is not necessary to file in order to perfect D's security interest against other lienors claiming the same goods as security. Thus even if D does not file against A and is thus not protected against an out of trust sale for value, he has a "perfected" security interest and is protected against A's trustee in bankruptcy. Consequently, in practice, it is relatively rare for secured parties to file for consumer goods except in the case of "big ticket" items such as automobiles, tractors and boats.

In the case of "equipment," the interest of the secured party continues in the event of a resale unless there is some waiver or consent to the sale. On the other hand, there is no protection for the holder of a secured interest upon "inventory" in the event of resale in the ordinary course of the debtor's business. Even in cases where the person who purchases the inventory knows that the security interest exists, his rights to the goods will be paramount. Since the only reason that inventory is acquired by a going business is for resale, it is reasonable to assume that some provision has been made in the security agreement for the sale of the goods. Only in the rare case of a bulk sale or an obvious fraud might another rule be applied. Of course, no sensible bank, finance company or lender will knowingly engage in chattel paper financing of inventory or consumer goods on the same basis as it would for equipment, unless it can protect itself or there are excellent business reasons for doing so. Where chattel paper is purchased without F's lending officer being aware that he is buying inventory paper because the fact was concealed and the lending officer finds out the fact afterwards, he will immediately suspect fraud and move to protect himself.

36. 2 Gilmore § 27.1.
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The three classes into which the Code divides collateral are reasonably discrete. Only one difficulty occurs with any degree of frequency—A may acquire items for use either as inventory or equipment. This situation is common to dealers in construction equipment who resell items to the trade (inventory) and who also maintain a rental fleet (equipment). Suppose that D sells A a machine to be placed in A's rental fleet and files against A, and that A sells the machine to a customer and thereby treats it as inventory. The most sensible solution to this problem is to place the risk of loss on D and F, who, by putting the equipment into the hands of a person in the trade who appears able to pass good title, made the transaction possible. A practical solution to this problem on the part of the lender is to require A to separate his operations into two different companies with separate sets of books and operations and to police A's transactions. Few lenders seem willing to accept this responsibility; most are more likely simply to accept the risks involved.

E. Other Purchasers of the Same Chattel Paper—Priority Problems

Let us now consider the situation where two parties claim security interests in the same chattel paper or in the proceeds of such chattel paper. It is worthwhile to spell out the various instances in which different classes of security interest may conflict by claiming the same collateral:

1. Two security interests in the same chattel paper.
2. A security interest in chattel paper versus a security interest in the proceeds of chattel paper.
3. A security interest in chattel paper versus a security interest in the proceeds of inventory.
4. A security interest in the proceeds of chattel paper versus a security interest in inventory.
5. A security interest in the proceeds of chattel paper versus a security interest in the proceeds of inventory.
6. A security interest in the proceeds of chattel paper versus a security interest in an account.
7. Two security interests in the proceeds of the same chattel paper.

Conflicts between financers arise because it is not uncommon for D to pledge his chattel paper with several financers or to pledge inventory with one financer (who will then have rights in the proceeds) while pledging chattel paper arising out of the sale of that inventory with another financer. As Gilmore points out, chattel paper financing is profitable to banks and finance companies while inventory financing is less
profitable and usually carries a higher risk. If a single $F$ contracts to finance all of the chattel paper and inventory of $D$, conflicts such as above cannot arise unless $D$, in an attempt to obtain better terms or services, breaches his contract. Where neither the financing of $D$'s inventory nor his chattel paper is tied to a single $F$, it is entirely common for $D$, happily polygamous, to place paper with a number of $F$'s who compete against each other in terms, services, and rates. As soon as there is a multiplicity of $F$'s, the risk of inadvertent conflict between their rights increases as do the opportunities for $D$ to engage in fraud. Some of the finer horror stories of fraud told among commercial counsel involve chattel paper; the most famous recent case is that of Billie Sol Estes. For all the combinations and permutations set forth the author has no hope that he has covered all the possibilities of fraud. The Chairman of the Securities and Exchange Commission, who, by virtue of his position, is always an authority on fraud, once sighed in an opinion that fraud was like Cleopatra—age could not wither nor custom stale its infinite variety.37

For the purposes of this discussion we shall call the two financers holding adverse security interests in the same collateral “$F-1$” and “$F-2$.”

1. **Conflicts between secured parties claiming an interest in the same chattel paper**

As we have seen, overlapping claims of interest by two parties in the same collateral may arise from fraudulent double financing by $D$ or from negligence where $F$ does not adequately police the loan.38 In all cases, the Code allows perfection of a security interest in chattel paper either by filing or by taking possession of the paper. By either means, a security interest which is perfected takes priority over one which is not. When

38. Financers will usually protect themselves from fraud or destruction of security by requiring proper documentation of the transaction from $D$. $F$ will usually demand that $D$ deliver to it (1) the original chattel paper, including any negotiable instruments, or proof of its existence if it is to be left with $D$ for collection; (2) proper assignments of the chattel paper; (3) proof that $A$ has accepted the goods (this may be $D$'s invoice to $A$, but in a substantial deal, a careful lender will require a “Delivery and Installation Certificate” in which $A$ acknowledges receipt and installation of the goods and states that they are satisfactory); (4) insurance on the goods as required; and (5) evidence that $D$ has filed a financing statement against $A$ on Form UCC-1 with all appropriate filing officers as required by the Code. $F$ may also file an assignment of this financing statement on Form UCC-3 which will show that the original interest in the goods has been assigned from $D$ to $F$. This is not required to perfect $F$'s security interest in the paper vis-à-vis $D$ and, in fact, will not substitute for a direct filing by $F$ against $D$ or for the physical possession of the chattel paper. Form UCC-3, however, will protect $F$ against collusion between $D$ and $A$ where $D$ releases the original filing against $A$. Whether or not $F$ files Form UCC-3 depends on the size of the transaction, and the estimate of the risk of collusion between $D$ and $A$.
both security interests are perfected, it becomes necessary to work out an order of priorities. Section 9-308, which contains the Code’s priority plan, gives preference to the holder of a security interest in chattel paper perfected by possession over the holder of a security interest in the same paper perfected by filing, provided that the possessor has (a) given “new value,” (b) taken possession in the ordinary course of his business, and (c) did not have knowledge that the specific paper was subject to a security interest at the time he took possession. “Knowledge” is defined in Section 1-201(25) as actual knowledge, not merely constructive notice. Accordingly, the buyer of chattel paper who intends to take possession does well not to search the records, another example of the Code’s propensity for the “Rule of the Pure Heart and Empty Head.”39 By implication, of course, the holder of a security interest perfected by filing takes priority over the holder of a possessory interest if the possessor did not advance “new value,” bought outside the ordinary course of his business, or had actual knowledge.

The reader will observe that where both F-1 and F-2 satisfy Section 9-308, F-2, who is later in time, prevails. As we shall see, this preference for the later “purchase money” security interest runs throughout this area, a notable reversal of the usual situation where priority goes to the party first in time. The underlying theory adopted by the Code draftsmen was that the new value put in by the holder of the second interest created a fund which could be applied to the payment of outstanding obligations, including that of F-1.40 F-1 might well object that since this problem usually arises out of fraudulent double financing, it is likely to gain little practical advantage from the new value introduced by F-2. Although F-1 is admittedly entitled to the proceeds received from F-2, identification of those proceeds, a necessity if F-1 is to maintain its security interest, is usually impossible. The draftsmen of the Code would certainly reply that if F-1 had watched his debtor, he would have been able to identify the proceeds received. This is not always a reasonable assumption; it is folk wisdom among bankers that “if a borrower is going to cheat you, you can’t stop him.” Though somewhat unfair from F-1’s point of view, the rule seems quite just from F-2’s vantage. F-2 has enriched the estate with his payment. Why should F-1 be allowed to gain at his expense? The

40. The history of the purchase money priority may be found in Gilmore, The Purchase Money Priority, 76 Harv. L. Rev. 1333 (1963). It is astonishing how rarely the courts have articulated the reasons for this rule, or, for that matter, any priority rule.
general preference of the Code in this area for the later contributor of new funds runs directly against the natural propensity of all commercial law to favor the first interest to be perfected.

Where the two security interests both take by filing, the party first to file wins. The reason for this is obvious; there is no excuse for not searching when one intends to rely upon a filing.

Where both parties claim by possession, the party with the original chattel paper should prevail. The problems which exist where two parties claim by possession and both hold originals or copies are more difficult to solve. For its decision, a court could rely upon several possible lines of distinction: (i) simple priority in time—which financer first took possession of the paper; (ii) the existence of a negotiable instrument—if A had executed a negotiable instrument in addition to the two security agreements, the F holding possession of the note will claim priority; (iii) filing—one F may have filed against D as an additional measure; (iv) notice to A—one F may have given notice to A and, perhaps, required direct payment; and (v) diligence—the possibility of a fraud may have come to the attention of one of the F's but not the other. A fair priority scheme where both individuals were in possession might be the following:

First Priority: The holder of a negotiable instrument would take priority over all other F's in the absence of fraud to which he was a party.42

Second Priority: If either party had reason to suspect double financing but failed to verify such suspicion, he would be subordinate to all holders of perfected securities who had no reason to suspect double financing.

Third Priority: Any F who filed against chattel paper would take priority on a notice basis, over all F's who thereafter bought chattel paper covered by the filing. Otherwise, filing by F's would be disregarded as among perfected security interests.

Fourth Priority: Any F who is collecting directly from A would take priority over all F's who have permitted D to retain control over collections.

Residual Priority: Whichever F purchased first in time would take priority.

2. A security interest in chattel paper versus a security interest in the proceeds of chattel paper

This problem, which is of a rather esoteric nature, can arise in the

41. UCC § 9-312(5)(a).
42. This would seem mandated by UCC § 9-309.
following manner. D sells to F-1 chattel paper covering his sale of a tractor to an account debtor, A-1. A-1 returns the tractor to D, who accepts the return and cancels the debt which A-1 owes to him. The obligation which forms the basis of the original chattel paper no longer exists. D then sells or leases the tractor to A-2, another account debtor, thereby creating another piece of chattel paper. D “finances” this transaction by selling the second piece of chattel paper to F-2 who perfects his security interest, presumably by possession. This transaction is similar to double financing and is almost certainly a violation of the agreement between D and F-1. Practices of this nature do occur, however, especially in the construction trades and other businesses where returns are common. Both F-1 and F-2 now claim a priority interest in the chattel paper. F-2’s right is grounded in his purchase of the paper from D for value, while F-1’s right, presuming he has filed against proceeds, is based on the fact that the new chattel paper resulted from the disposal of his security. The dispute is then between F-2 as holder of the chattel paper and F-1 as holder of a security interest in the proceeds of chattel paper.

The Code is anything but clear as to which financer prevails. Section 9-308, which should have covered this problem, does not do so. The rational solution would be to treat this as a dispute between two holders of a security interest in the same chattel paper and to give F-2 preference if he has advanced new value, does not have actual knowledge, and has purchased in the ordinary course of his business. As in the case of overlapping security, F-2’s new value has improved the financial position of D and created a fund from which F-1 might draw. One may fairly assume on the basis of Section 9-308 that this is what the draftsmen of the Code intended.

But the Code places obstacles in the path of this simple, commercially reasonable conclusion. Compounding the difficulties created by the omission of this problem from Section 9-308, the draftsmen, in dealing with returned goods under Section 9-306(5)(b) provided only that the holder of chattel paper should take priority if he were entitled to priority under Section 9-308, a road sign that points nowhere. With no special provisions for priority to cover this case, we are left to the catch-all priority provision of the Code, Section 9-312(5)(b), which assigns priorities in the order in which the interests were perfected. Since F-1 perfected earlier in time than F-2, this provision would give priority to F-1. Thus technical interpretation leads to an uncommercial result.

Karl Llewellyn always preached the wisdom of finding a technical
solution to a technical impasse; he believed in untying knots in the law rather than in cutting them. One may suggest two technical solutions. Section 9-307(1) provides that when a purchaser buys from a seller in the regular course of the seller’s business, such a purchaser takes free and clear of any security interest created by the seller regardless of whether the purchaser knew of the security interest or whether the security interest was perfected. Purchase is defined by the Code to include taking by lien or security interest. The requirements in Sections 9-307 and 9-308 that the transaction be in the regular course of business are not identical; Section 9-307 requires the sale to be in the regular course of D’s business while Section 9-308 requires the transaction to be in the regular course of F’s business. The discrepancy, however narrow, leads to a satisfactory result. If the sale of the chattel paper to F-2 is sufficiently unusual, F-2 should be on notice of possible difficulty and charged with accepting the risks involved in proceeding with the transaction.

An alternative technical solution may be available under Section 9-312(4), the general purchase money priority provision. That section gives priority to a perfected purchase money lien over all conflicting security interests in the same collateral and could be interpreted to favor a financer who, though later in time, advanced new value to D and accepted the chattel paper as security. As we shall see, this solution could also be applicable to other problems which arise in this area.

3. A security interest in chattel paper versus a security interest in the proceeds of inventory

This problem is specifically covered in the second sentence of Section 9-308, which provides that a purchaser of chattel paper who gives new value and takes possession of the paper in the ordinary course of his business has priority over a claim for proceeds of inventory, even where the chattel paper financer has actual knowledge of the pre-existing inventory lien. According to the Official Comment to Section 9-308, this priority was established in order to encourage the financing of chattel paper out of inventory.44

4. A security interest in the proceeds of chattel paper versus a security interest in inventory

This problem arises as in the previous case, when goods are returned to D by A, the account debtor, and held in inventory by D. F-2, an in-

43. UCC § 1-201(35).
44. UCC § 9-308, Comment 2. See discussion in Felsenfeld, supra note 39, at 265-68.
Security Interests in Chattel Paper

inventory lender, then lends against the goods, presumably on the basis of some kind of regular inventory financing. F-2 may have given new value, and, in any case, has acted in complete innocence. Thus, we reach a situation where both F-1 and F-2 have acted innocently, given new value, and perfected their respective security interests. This problem also is specifically covered by Section 9-306 (5), which provides that the holder of the security interest in the inventory takes priority. This result is consistent with the general rule that the purchase money security interest later in time receives priority where both parties act innocently. Note also that here as in all transactions in which goods are returned, the financer of the first chattel paper could have protected himself by collecting directly from A.

5. A security interest in chattel paper versus a security interest in the proceeds of inventory

6. A security interest in chattel paper versus a security interest in accounts

These situations arise in substantially the same manner as did situation (4). D sells goods to A-1 and sells the chattel paper thereby created to F-I. A-1 returns the goods to D. While in inventory, the goods are advanced against by F-2. The goods are then sold by D to A-2, a new account debtor. The final sale will result in the creation either of an account (as defined in Section 9-106) or of new chattel paper, depending on whether or not D has retained a security interest. For purposes of analysis, let us assume the simplest transaction where D does not re-finance the chattel paper generated as a result of the sale to A-2. D will then have possession of the new chattel paper, and both F-I and F-2 will claim it as the proceeds of their respective interests in chattel paper and inventory.

This situation is not covered by Section 9-308. Similarly, Section 9-306(5), which sets forth the rules for priorities in returned merchandise, is silent on rights in the proceeds of such goods.

The problem presented by two perfected purchase money security interests in the same collateral is whether to follow Section 9-312(5)(b) or Section 9-312(4). Section 9-312(5)(b) relies on the sequence of filing and, unless another rule specifically applies, gives priority to the first party to perfect its secured interest; the section expressly states that it applies to purchase money security interests not otherwise disposed of. Section 9-312(4) would seem to favor the party whose interest arose last, on the theory that his payment constituted a fund from which
the first party could be paid. However, this rule has not been codified and the Official Comments are silent. Technically, the Code would appear to favor F-1. In the entire Code, however, there are no significant instances (with a single possible exception which has not been resolved45) in which a later purchase money interest is subordinated to an earlier one. It would seem to make better commercial sense to turn these repeated instances into a rule. Rather than depend on a meaningless sequence of time, the Code would then prevent the unreasonable consequences of making F-1 both the recipient of the money paid by F-2 and a superior lienor.

7. Two conflicting security interests, both arising out of proceeds in chattel paper

This situation is similar in principle to (5) and (6). A purchase money security interest will take priority over a nonpurchase money security interest, and as between two purchase money interests—here a rare case—priority will follow the rule which the courts elect to apply to fact situations (5) and (6).

IV. Summary and Conclusion

The present distinction between "true" equipment leases and Code security agreements is illogical in cases where the lease covers a substantial amount of equipment for more than a short period. Such leases are financing devices. No reason exists for not treating lessees like sellers in other financial transactions. All equipment leases for a period of more than three months involving equipment to be used for commercial purposes where the lease provides for rent in excess of $5,000 should be made subject to the Uniform Commercial Code.

The Code distinguishes between the classes of chattel paper arising out of transactions involving consumer goods, inventory and equipment. The Code rules turn on these distinctions. To date, few borderline cases have arisen. The statutory distinctions reflect functional differences and are working well.

45. By inadvertence, the drafters of the Code omitted any determination of which interest should prevail in the event of a controversy between the holder of a security interest in the proceeds of inventory and the holder of a security interest in accounts generated by the sale of such inventory. The argument in the text assumes the holder of the interest in the accounts would prevail. See Kripke, Priorities Between Claimants to Accounts as Proceeds of Inventory and Related Problems, 41 N.Y.U.L. Rev. 687, 709-19 (1966). Contra, Henson, Priorities Under the Uniform Commercial Code, 41 Notre Dame Law. 425, 428-32 (1966).
Chattel paper arising out of the sale of consumer goods is an area in which strain upon the Code is beginning to appear. The draftsmen of the Code looked to the commercial practice in existence at the time of writing for the pattern of norms to be followed. They left room for consumer rights legislation by stating that the Code would subordinate itself to specific legislation governing retail installment sales and by permitting an exemption to the "commercial specialty" rule for consumer paper. The draftsmen did not foresee any developments whereby \( F \) would be made to police the dealers from whom he bought paper. There is now at least a strong possibility that legislation of this type will be passed. In such a case, the best course of action to follow would be to add a separate section to Article 9 which would establish a new pattern of perfection for consumer goods chattel paper or, preferably, to add a section which would put precisely stated obligations upon \( F \). Licensing laws for financers are undesirable. The procedure required would be slow and cumbersome, and would complicate the flow of commerce between the states by raising questions of jurisdiction and the power to regulate. At the same time the consumer would not have a direct interest in the regulation but would have to rely upon an industry-oriented agency to correct misfeasance. The best solution to the problem is to grant consumers direct rights against abuses by dealers and financers (if financers are to be involved), or to regulate \( D \)'s directly. Representative actions and class actions should be used for such purposes. Both public agencies and private parties directly injured should have standing to bring these actions; practice acts should be amended accordingly. In the meantime, common law development, whose future course cannot be predicted, has begun.

The provisions of the Code dealing with the financing of equipment chattel paper appear to be working relatively well, although they are not free from difficulty. The Code emphasizes the rights of a person who takes physical possession of chattel paper and assimilates his position to that of the holder of a negotiable instrument. So long as we are discussing \( A \)'s obligations to make payment, few difficulties are presented by such an arrangement. Problems do arise as to who is entitled to equipment which is sold out of trust by \( A \). Problems of priority between secured parties also exist. The Code is not clear on a number of priority questions and to date there is little case law. Many such problems are negotiated out of court by the institutional lenders concerned. To date, these priority problems are not so numerous as to require a substantial reworking of the Code in this area; case law can be trusted to make what changes are necessary. If changes are to be made,
Section 9-308 should more explicitly set forth the general principle that where two security interests in the same collateral both represent advances of new funds made in good faith, the interest later in time should take priority, except where a specific provision of the Code mandates another result. Perhaps some of these changes could be made by amending the Official Comments, as opposed to changing the statute itself.

Apart from bad credit decisions, the main threat to financers of equipment chattel paper is fraud. Physical possession of the chattel paper can eliminate these problems in many cases. Notifying the account debtor or collecting directly from him will eliminate many others. In interpreting the Code, the Courts should give preference, so far as may be fair, to those financers who have used notification financing. A lender who engages in non-notification financing and omits to institute controls over his debtor has in effect made the fraud possible and, as against another innocent party, has little equity on his side.

In general, the problems arising in chattel paper financing are not serious and can be handled within the scope of the Code. The real changes which are needed are those in the field of consumer chattel paper, which are outside the scope of classic commercial law. To date, the Code is working well.