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THE IMPACT OF ARTICLE 9 OF THE UNIFORM COMMERCIAL CODE ON THE CORPORATE INDENTURE

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THE enactment of article 9 of the Uniform Commercial Code[1] will raise many questions for long-term borrowers and lenders and for counsel and other parties who participate in preparing or operating under corporate indentures. These questions will arise under indentures entered into years before anyone thought of the Code, as well as under new indentures. Developed primarily to cope with the problems involved in short-term financing secured by inventory and accounts receivable,[2] the Code's "Secured Transactions" article

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1. The UNIFORM COMMERCIAL CODE is now in effect in Pennsylvania, PA. STAT. ANN. tit. 12A (1954), as amended, Pa. Laws 1959, Act 426, and Massachusetts, MASS. ANN. LAWS ch. 106 (Spec. Supp. 1958), as amended, Mass. Acts 1959, ch. 580. It has also been adopted by Kentucky, Ky. Acts 1958, ch. 77, Connecticut, Conn. Pub. Acts 1959, No. 133, and New Hampshire, to be published as N.H. REV. STAT. ANN. ch. 283A, to become effective in 1960 in Kentucky, and in 1961 in Connecticut and New Hampshire. According to William A. Schnader, an officer of both the American Law Institute and of the Commissioners of Uniform Laws, joint sponsors of the Code, it is being considered by the legislatures or organized study groups of some twenty-two additional states.

The Code is hereinafter cited as UCC; unless otherwise indicated, citations are to the 1958 Official Text with Comments, which supersedes the 1957 Official Text as Amended by 1958 Supplement.

After the 1959 Massachusetts and Pennsylvania amendments referred to above become effective, the Code will be uniform (except for permitted state variations) in Pennsylvania, Massachusetts, Connecticut and New Hampshire. It is expected that the modifications made by the 1958 Supplement will be considered by the Kentucky legislature at an early date.

2. For the emphasis placed by the draftsmen and some of their advisers on problems of short-term financing of inventory, see generally BIRNBAUM, SECURED TRANSACTIONS UNDER THE CODE (1954); Dunham, *Inventory and Accounts Receivable Financing*, 62 HARV. L. REV. 588 (1949); Gilmore & Axelrod, *Chattel Security: I*, 57 YALE L.J. 517

is a lineal descendant of, and clearly influenced by, the newer chattel security statutes[3]—the Uniform Trust Receipts Act,[4] the "Factors Lien Acts,"[5] and the accounts receivable statutes.[6] But article 9 also replaces, almost entirely, the law which has governed the use of personal property in long-term finance —the chattel mortgage, which governed fixtures and other equipment; the pledge, which governed stocks and evidences of indebtedness; and the law (mostly contract law) which controlled the assignment for security of long-term intangibles.[7] Because of the Code's essentially unitary treatment of most security transactions, concepts developed to meet problems of short-term secured finance now control long-term transactions as well.

The problem of greatest immediate importance to the counselor and draftsman is to what extent the Code changes the mechanics which must be utilized to acquire a security interest in the types of collateral more commonly subjected to the lien of the indenture, such as fixtures and equipment, stocks and bonds, long-term contract rights and general intangibles. A more interesting—and from a long range viewpoint, perhaps more important—problem posed by article 9 is the possibility of including under an indenture current assets, such as inventory and accounts, which have traditionally been excluded from the American indenture, though often included under its English and Canadian counterparts. To place these problems in context, a short introduction to the terminology, techniques, and theory of article 9 is first necessary.

ARTICLE 9 IN BRIEF

Article 9 substitutes for the many separate pre-Code bodies of chattel security law a single set of rules which govern most aspects of most transactions[8] by which an interest in personal property is retained or created to

(1948); Gilmore, *Chattel Security: II*, 57 YALE L.J. 761 (1948); Kripke, *Inventory Financing of Hard Goods*, 1956 U. ILL. L.F. 580; Llewellyn, *Problems of Codifying Security Law*, 13 LAW & CONTEMP. PROB. 687 (1948).

3. See Coogan, *Article 9 of the Uniform Commercial Code: Priorities Among Secured Creditors and the "Floating Lien,"* 72 HARV. L. REV. 838 (1959).

4. [Hereinafter cited as UTRA.] The term "security interest" is taken from UTRA § 1; the Code's concepts of "proceeds" (UCC § 9-306), the rights of a "buyer in ordinary course" (UCC §§ 1-201 (37), 9-307), the "purchase-money security interest" in "inventory" and "notice filing" have distinct similarities to corresponding concepts in the UTRA.

5. *E.g.*, N.Y. PERS. PROP. LAW § 45. On factors' lien acts see generally Fechteler, *The Factors' Lien Statutes*, Bus. Law., April 1956, p. 60; Moore & Kupfer, *Factor's Liens and Accounts Receivable—Current Developments*, 12 BUS. LAW. 482 (1957).

6. *E.g.*, CAL. CIV. CODE ANN. §§ 3017-29 (Supp.).

7. See generally Gilmore & Axelrod, *supra* note 2, at 521-22, 530-41; Comment, 67 YALE L.J. 847 (1958).

8. Article 9 does not replace regulatory statutes such as usury laws, retail installment sales acts, and the small loans laws, UCC §§ 9-201, 9-203(2); UCC § 9-101 comment. UCC § 9-104 contains a list of transactions excluded from the operation of article 9. Many are not relevant to the corporate indenture—*e.g.*, the assignment of wages or the transfer

secure an obligation. This "Secured Transactions" article generally deemphasizes differences in rules and results based on the form of security device used.[9] It merges the law governing pledges, chattel mortgages, conditional sales, trust receipts, "factor's liens," assignments of accounts receivable, and leases for security. Its rules are the same whether the indebtedness be due in a month or in twenty years. The agreement is, in each case, called a "security agreement."[10] The interest created in the "collateral"[11] is a "security inter-

of a claim arising out of a tort. Perhaps the most important is the exclusion of security interests subject to "any statute of the United States such as the Ship Mortgage Act, 1920," UCC § 9-104(a). But note that the exclusion applies only to the extent the federal statute governs the rights of the parties to and third parties affected by the transaction. In some cases it is difficult to determine whether a federal statute is intended to be self-contained or whether it is a filing statute only, in which case provisions of the Code other than the filing provisions (UCC § 9-302) will apply. See Federal Copyright Act, 17 U.S.C. §§ 28-30 (1958); Republic Pictures Corp. v. Security-First Nat'l Bank, 197 F.2d 767 (9th Cir. 1952) (action to foreclose copyright mortgage must be brought in state court). *But cf. In re* Leslie-Judge Co., 272 Fed. 886 (2d Cir. 1921). Even assuming that the federal act is more than a recording act, some literary rights not covered by the Copyright Act might be covered as "general intangibles" under article 9. The federal laws governing the assignment of patents, 35 U.S.C. § 261 (1952), and trademarks, 60 Stat. 431 (1946), 15 U.S.C. § 1060 (1958), are quite similar to the provisions of the Copyright Act.

For federal provisions regarding security interests in aircraft, see Civil Aeronautics Act of 1949, 62 Stat. 494, as amended, 49 U.S.C. § 523 (1952). See also Adkins & Billyou, *Developments in Commercial Aircraft Equipment Financing*, 13 Bus. Law. 199 (1958).

A questionable exclusion from the operation of article 9 is an "equipment trust of railway rolling stock." UCC § 9-104(e). Here the result turns on the form of the security device, which is contrary to the Code's general philosophy. Is an equipment trust of a streetcar or a trackless trolley covered by article 9 or is it excluded? Is a device which has some characteristics of a conditional sale and some characteristics of an equipment trust included or excluded? In this connection, see 66 Stat. 724, 49 U.S.C. § 20(c) (1952), on secured transactions involving interstate railroads. If there is a good reason for excluding certain railroad obligations, the test applied should be a better one than that provided by § 9-104(e). As far as the indenture draftsman is concerned, the safe procedure when in doubt would seem to be to comply with any other law that might be applicable as well as with article 9 on the chance that the device might be held to be something other than an equipment trust. On railroad financing generally, see Adkins & Billyou, *Current Developments in Railroad Equipment Financing*, 12 Bus. Law. 207 (1957).

9. See UCC § 9-101 comment. See generally Coogan, *supra* note 3, at 840-46.

10. UCC § 9-105(1)(h).

11. "Collateral" is defined in UCC § 9-105(1)(c) as "property subject to a security interest." Collateral is divided and sub-divided into defined categories by §§ 9-105, 9-106 and 9-109. In general, the importance of these definitions has been over-stressed in the literature on article 9. The definitions are convenient in discussing the economic differences between kinds of collateral, but legal distinctions based on the Code categories of collateral are minor. Originally the rights of a "buyer in ordinary course" were tied to inventory. See UCC § 9-307(1) (1952). While collateral sold to a "buyer in ordinary course" would usually be inventory, the provisions of the present § 9-307 might now be applicable to a debtor who regularly sold his used equipment—*e.g.*, a taxi or a trucking company which maintained a used car lot. Conversely, § 9-307 would appear not to protect

est";[12] the secured creditor is the "secured party";[13] and the obligor is the "debtor."[14] A single agreement may now be used to cover a transaction which under pre-Code law could have been created only by the use of, for example, a combination of a chattel mortgage, a trust receipt, and an assignment of accounts receivable—or a number of each of these devices.

In most adopting states, the Code will make it substantially easier to cover property acquired by the debtor after the security agreement is made. Two factors produce this result. First, the public notice required to perfect a non-possessory security interest in nearly all personal property may be met by "notice filing." In contradistinction to systems that require a detailed list of collateral,[15] the Code requires only that the instrument to be filed give gen-

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a buyer of leather from the inventory of a manufacturer "engaged in the business" of selling shoes and not leather.

The most tangible forms of collateral are "goods," defined in UCC § 9-105(1)(f) and subdivided by UCC § 9-109 into "consumer goods" (bought for personal, family or household use); "equipment" (bought for use in a business); "inventory" (goods bought for resale, plus raw materials, work in process or materials consumed in a business); and "farm products" (the "inventory" of a farmer, but only so long as it is in the possession of a farmer).

Intangibles which are represented by pieces of paper are classified by degrees of negotiability or seminegotiability—"instruments" (stocks, bonds, notes), UCC § 9-105(1)-(g); "documents" (bill of lading, warehouse receipt), UCC § 9-105(1)(e); "chattel paper" (a new term, exemplified by a conditional sale contract with or without a note, assigned by the dealer to the financier), UCC § 9-105(1)(b). Pure intangibles are divided somewhat artificially into accounts, contract rights, and general intangibles. UCC § 9-106. Note that the term "contract right" is narrowly defined to include only rights to receive money, and that "account" is limited to the right to receive payment for goods sold or leased. Since the difference between the two is important only for purposes of § 9-318 (modification of executory contract), *query* the wisdom of using common terms in so restricted a meaning. It is somewhat confusing to discover that the right of an industrial company to compel a natural gas company to supply natural gas under a contract is not a "contract right" but a "general intangible" in the Code's categories of collateral. This last mentioned category is a convenient catch-all which includes any species of personal property not included in the other definitions and not excluded by § 9-104. Literary property is a general intangible; so is an expectancy.

Not all categories of collateral are relevant to long-term commercial financing. By definition "consumer goods" become such only when purchased for personal, household, or family use. "Chattel paper" and "documents of title" (*e.g.*, warehouse receipts, bills of lading) are not likely to be used in connection with corporate indentures or other instruments of long-term finance.

12. A security interest is "an interest in personal property or fixtures which secures payment or performance of an obligation." UCC § 1-201(37). This important term is more fully defined in the same section.

13. UCC § 9-105(1)(i).

14. UCC § 9-105(1)(d).

15. See, *e.g.*, the detailed requirements of the English Bills of Sale Act, 1878, 41 & 42 Vict. c. 31, as amended, Amendment Act, 1882, 45 & 46 Vict. c. 43. Sections 4 and 5 require an inventory of goods of which the mortgagor was at the time of execution of the bill of sale the "true owner." These technical requirements seem to have been deliberately imposed to discourage non-possessory security interests in personal property.

eral notice that one of the signing parties has given, or may in the future give, to the other a "security interest" in a class or classes of property which the former then owns, or may in the future acquire, to secure indebtedness that may at the time be outstanding, or may later be incurred.[16] Second, the Code abolishes the necessity for an "independent intervening act" after the debtor acquires an interest in the collateral, except in the rare case where public notice is given by an act which can not be performed until the debtor acquires the collateral—for example, a surrender of possession of the collateral or notation of the security interest on a certificate of title.[17]

Other Code provisions allow the parties to agree that the debtor may exercise over the collateral a degree of "dominion" or "control" not permitted under the pre-Code law of many states. Article 9 rejects the dominion rule of *Benedict v. Ratner*,[18] the pre-*Benedict* "free-handed mortgage"[19] cases upon which it is based, and the post-*Benedict* cases which probably have extended the doctrine of both.[20] Thus, in theory, a Code creditor might, by a single agreement and a single filing, subject all his debtor's assets, present and future, to a valid security interest, yet leave the debtor free to use these assets in any manner agreeable to the parties.[21]

Additionally, a single set of rules determines when a security interest is "perfected"[22]—*i.e.*, generally protected against third party claimants. Perfec-

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See WALDOCK, MORTGAGES 89-93 (2d ed. 1950), for an account of the tightening up brought about by the 1882 amendment. It is not unlikely that these English acts and their predecessors influenced American legislatures and courts.

16. UCC § 9-402. Note that the Code also allows the parties to include in their agreement future advances whether required or optional. UCC § 9-204(5). Contrast the requirement of UTRA § 14, that a trust receipt secure only the advance made to purchase the goods covered by the receipt.

17. See UCC §§ 9-204, 9-303, 9-302(3)(b).

18. 268 U.S. 353 (1925). *Benedict* involved an assignment of accounts receivable with the assignor retaining freedom to collect the accounts without being required to turn proceeds over to the secured party or to substitute new collateral. Purporting to apply New York law, the Supreme Court held the lien invalid against the debtor's trustee in bankruptcy. See note 126 *infra* for a discussion of possible rationalizations of this rule. The "repealing" section of the Code is § 9-205. See generally UCC § 9-205 comment.

19. See, *e.g.*, Griswold v. Sheldon, 4 N.Y. 581 (1851). On the "freehanded mortgage" doctrine, see generally 2 GLENN, FRAUDULENT CONVEYANCES & PREFERENCES §§ 582-94 (rev. ed. 1940). Not all of the freehanded mortgage cases antedate *Benedict*. See, *e.g.*, Bussert v. Quinlan, 267 F.2d 219 (10th Cir. 1959), applying Kansas law. *Benedict* was not cited.

20. See, *e.g.*, Lee v. State Bank & Trust Co., 54 F.2d 518 (2d Cir. 1931), discussed in note 126 *infra*.

21. "Might" is emphasized because (1) the lien on newly acquired assets may be subordinate to a prior purchase-money security interest, UCC §§ 9-312(3)-(4); (2) a security interest in certain collateral (*e.g.*, negotiable bonds) may be perfected only through possession, UCC § 9-304(1), and the debtor might fail to make delivery; and (3) the Code as adopted in a particular state may require an act other than filing as to a particular type of collateral (*e.g.*, notation of the interest on a certificate of title, UCC § 9-302(3)(b).

22. UCC § 9-303 (interest perfected when it attaches and other prescribed steps taken).

tion occurs upon the happening of whatever may be the last of four events: (i) the reaching of an agreement, which must be in writing to be enforceable even between the parties, unless evidenced by delivery of possession of the collateral;[23] (ii) the acquisition by the debtor of "rights in the collateral";[24] (iii) the giving of "value,"[25] which usually means the making of an advance by a lender or the supplying of goods by a merchant, or in either case, the undertaking of an obligation to perform these acts;[26] and (iv) the giving of public notice, ordinarily accomplished through filing or a change of possession.[27] Note that although these steps may be taken in any order, no security interest is perfected in the collateral involved until the last of the four steps has been taken. And since by definition a security interest must secure an "obligation,"[28] the interest must also be measured as of any given time by the obligations which are at that time outstanding.

While perfection of all security interests is governed by one set of rules, it by no means follows that each perfected security interest is of the same quality—*i.e.*, gives the same degree of protection against third parties. The word "perfected" must not be too closely associated with the word "perfect" as ordinarily used.[29] A "perfected security interest" is *generally* protected against unsecured creditors including those who later seek by legal process to acquire a lien on the collateral, against the debtor's trustee in bankruptcy, and against all others except certain "purchasers."[30] But the quality of the security interest may vary according to the nature of the collateral, the amount of control the debtor is permitted to exercise over the collateral, the nature of the transaction, and the time and method by which public notice is given. As examples, a perfected security interest in goods will be lost if the property is sold to a "buyer in the ordinary course of business."[31] And if the debtor

23. UCC § 9-204(1) (agreement prerequisite to "attaching" of security interest); UCC § 9-203 (when security interest enforceable).

24. UCC § 9-204.

25. UCC § 9-204.

26. UCC § 1-201(44).

27. UCC §§ 9-302 (filing), 9-305 (possession).

28. UCC § 1-201(37).

29. Although a word of art under the Code, "perfected" is not directly defined therein. It is negatively defined by § 9-301, listing persons who can disregard an *un*perfected security interest. Comment 1 to that section says:

> As in Section 60 of the Federal Bankruptcy Act, the term "perfected" is used to describe a security interest in personal property which cannot be defeated in insolvency proceedings or in general by creditors. A security interest is "perfected" when the secured party has taken whatever steps are necessary to give him such an interest. These steps are explained in . . . sections (9-302 through 9-306).

Since even some perfected security interests (*e.g.*, one perfected within four months of bankruptcy securing an antecedent debt due to a holder who knows the debtor is insolvent) can be defeated in bankruptcy, the phrase "in general" should precede the phrase "cannot be defeated."

30. The terms "purchase" and "purchaser" are broadly defined in UCC §§ 1-201 (32)-(33).

31. UCC § 9-307.

is allowed to deal with collateral without accountability to the secured party, the security interest in the "proceeds" received on a sale may be lost, either because the proceeds have been disposed of or, even if not disposed of, are no longer "identifiable."[32] Further, a perfected security interest may be or become subordinate to another perfected security interest under the Code's rather elaborate rules determining priorities as between persons claiming a security interest in the same collateral, and it might be subordinate to some special statutory lien.[33] The two most important of these rules are the one which generally gives priority to the secured party who is the first to file when both security interests are perfected through filing,[34] and the rule which gives highest priority to a party who enabled the debtor to acquire the goods, —the holder of a "purchase money security interest"—even though the latter is perfected through a later filing.[35] In addition to the varying quality of different security interests under the Code itself, different kinds of security interests may possess differing degrees of vulnerability to attack under various segments of non-Code law, including state fraudulent conveyance law, state and federal statutes giving high priority to government claims, and the national Bankruptcy Act.

With the general outlines of the Code in mind, we shall now turn to a discussion of some of the specific problems involved in its application to long-term finance.

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32. UCC § 9-306.

33. UCC §§ 9-312 (priorities among secured creditors), 9-310 (Statutory liens). See generally Coogan, *supra* note 3, at 855-72; Note, 68 YALE L.J. 751 (1959).

34. UCC § 9-312(5)(a).

35. UCC §§ 9-312(3)-(4). The concept of the "purchase-money security interest" is an important one. UCC § 9-107 defines it as an interest "(a) taken or retained by the seller of the collateral to secure all or part of its price; or (b) taken by a person who . . . gives value to enable the debtor to acquire rights in or the use of collateral if such value is in fact so used." Under § 9-312(3), priority is given to the inventory purchase-money man only if in advance of the time the debtor gets possession of the collateral the purchase-money man (i) gives notice to anyone known to have a security interest in that kind of collateral and to anyone who, prior to the filing of the purchase money interest, has filed a "financing statement" (see UCC § 9-402) claiming that kind of collateral, and (ii) perfects his own security interest. As to any kind of collateral other than inventory, no such notice is required and perfection may be completed within ten days after the debtor gets the collateral. UCC § 9-312(4). Note that the priority given by both § 9-312(3) and § 9-312(4) relates only to the "same collateral." When the inventory is converted into accounts the purchase-money priority does not follow it, and the other priority rules (probably § 9-312 (5)(a) ("first to file" priority)) will control. In the 1957 Official Text (as originally adopted in Massachusetts), § 9-312(4) had no ten-day grace period and required perfection at the time the debtor received possession. There were also differences in the wording of §§ 9-312(3) and 9-312(5)(a) which made it doubtful whether the "first to file" priority rule applied to a purchase-money interest which had not satisfied the requirements for a purchase-money priority. Changes recommended by the Massachusetts sponsors were adopted in Massachusetts in 1958 and 1959. Mass. Acts 1958, ch. 542; Mass Acts 1959, ch. 580. These changes are now incorporated into the 1958 Official Text.

WHEN ARTICLE 9 APPLIES

Probably the first problem to be faced by counsel for long-term borrowers and lenders is to determine when article 9 applies. It is clear, of course, that a post-Code indenture will be governed by the Code if it creates a security interest in any kind of personal property other than the minor types excluded by section 9-104. But many new transactions under old indentures must also comply with the Code.

A Hypothetical Problem for Counsel

At this point, it will be helpful to introduce a hypothetical case, to be used throughout the Article. Assume the following facts: About a year before the Code became effective in the applicable state, Modern Metal Products Company sold 3,000,000 dollars principal amount of its first mortgage bonds. The bonds are secured by assets typically covered by a general mortgage on an industrial plant: real estate (with which we are not concerned), large hydraulic presses affixed to the realty, metal treating and bending equipment, gas and electric welding equipment, electric motors, small tools of all sorts, motor trucks, fork lift trucks, and tractors. The collateral also includes one hundred per cent of the stock of Metal Products' sales subsidiary, notes representing advances made by Metal Products to its subsidiary from time to time, and Metal Products' rights, under a long term contract, to purchase natural gas at what now appears to be an advantageous price. Under the state's pre-Code law, no lien good against third parties can be created by an after-acquired property clause until a supplemental indenture has been executed and filed after the debtor has acquired the new collateral. The indenture requires Metal Products to take, at least once each year, whatever action is necessary to bring under the indenture property of the same types originally covered which has been acquired since the execution of the indenture or of the latest supplemental.

Covering After-Acquired Property

The date on which supplementals have been executed in past years is approaching. Counsel for the indenture trustee must decide whether after adoption of the Code the after-acquired property clause in the pre-Code indenture will, without any further act, bring under the lien of the indenture property acquired since the last supplemental and make applicable the Code's rules as to after-acquired property for all subsequent acquisitions. If some action is necessary after adoption of the Code he also must decide whether it is necessary to execute and file a new supplemental reaffirming the grant of after-acquired property or whether the filing of a simple financing statement will be sufficient.

This raises a question as to what is a "transaction" which brings the Code into play. While section 9-102 provides that article 9 applies "to any transaction . . . which is intended to create a security interest," section 10-102(2) states that

> transactions validly entered into before the effective date . . . and the rights, duties and interests flowing from them remain valid thereafter and may be terminated, completed, consummated or enforced as required or permitted by any statute or other law amended or repealed by this act as though such repeal or amendment had not occurred.

Although use of the word "may" in section 10-102(2) might appear to indicate some power in the parties to elect whether the Code or pre-Code law will govern, this is not a permissible construction; pre-Code law must continue to control all pre-Code transactions not superseded by later acts.[36] Thus, as to indebtedness outstanding on the date the Code became effective and property then covered by this pre-Code indenture, pre-Code law would continue to govern the enforcement of the indenture and the collection of the debt. The Code would not apply until a "transaction . . . intended to create a security interest" took place after the effective date of the Code in that state.

At the least, a Code filing must be made to protect future transfers of property. By hypothesis, the old law of the state would not subject after-acquired property to the indenture lien without a new recording; in general, a nonpossessory security interest cannot be perfected under the Code without filing. Arguably, after enactment of the Code, filing of a financing statement in the skeleton form permitted by section 9-402 would automatically pull all property acquired since the last supplemental, as well as all property to be acquired in the future, under the lien of the indenture. Upon such filing, all other conditions precedent to the creation and perfection of a security interest (as set out in sections 9-204 and 9-302) are met: (i) There is an agreement in existence (the old indenture); (ii) "value" has been given (when the old loan was made); and (iii) the debtor has "rights in the collateral." While a secured party who has to make this argument should be able to convince a court of his security interest's validity, it would not seem wise to rely on an untested theory when substantial rights are involved. As a result, lawyers for indenture trustees and other secured parties will probably insist upon the execution of a supplemental on or after the effective date of the Code, which contains granting language adequate to pick up all property acquired by the debtor since its last effective grant under the pre-Code indenture, and which

36. Since the rule of the section covers a variety of activities (*i.e.*, termination, consummation, or enforcement of pre-Code transactions), "may" is clearly a more appropriate word than "shall" or some similar word which might otherwise have been used to negate any reading of the section as permitting an election of law. The practical problems raised by giving the parties a right to elect their law would be considerable and an election mechanism would have been provided had the draftsman intended to permit such election. Of course, if parties whose relationship is presently governed by pre-Code law elect to have all of their relationships governed by the Code, they should use language which expresses that intent and go through a regrant of the collateral.

repeats the grant of all property to be acquired thereafter. Such an execution is clearly a transaction "intended to create a security interest" which brings article 9 fully into play as to the new property so conveyed and property thereafter acquired. But it should be emphasized that execution of a supplemental indenture which does no more than bring in new property or create new debt does not simply by referring to the original indenture bring under article 9 all bonds delivered prior to the effective date of the Code or control the property theretofore subjected to the indenture, in so far as the old property secures old debt.[37]

Issuance of New Debt

Modern Metals' indenture is "open-ended"—*i.e.*, it permits issuance of additional bonds against additional collateral under prescribed conditions. Suppose that Modern Metals had acquired sufficient "additional property" to permit the issue under the terms of the indenture of another 500,000 dollars of bonds. Would the issue of new debt be a "transaction" bringing the new bonds under the Code? Section 9-204(1) seems fairly clear in recognizing that separable security interests arise as each new lot of collateral comes under the indenture.[38] Separable security interests may likewise come into existence when the shoe is on the other foot—when it is the amount of the indebtedness secured by the mortgage which is increased.[39] It would appear, therefore, that article 9 would be applicable to the new property and the new debt, but only to the new property and the new debt.

This raises the question of whether two bodies of law can control rights under the same indenture. The possible conflict may be pointed up by arbitrarily assuming the existence of some remedial rights, derived from pre-Code law, which are available under the indenture as to security interests created prior to the Code, but which are not permitted under the Code. (The assumption could be made in the opposite form, of course.) If new indebtedness has been created by the supplemental, the trustee, in so far as he represents the new bondholders, would then have lesser rights than he has as representative of the old bondholders. Further, he may have different rights with respect to new property than he has with respect to the old.

37. Similarly, a filing under the Code which does no more than record the existence of a pre-Code transaction will not bring the Code into play as to that transaction. For example, if under the old law a chattel mortgage must be refiled every five years, and the period expires after the effective date of the Code, it will probably be necessary to do the filing in the Code system. A similar situation could occur if an old chattel mortgage and the debt it secures were assigned to a new holdee. The fact that, at least to the filing clerks, the old chattel mortgage records are a closed book, should not mean that such a Code filing would bring the full force of the Code into operation. Not only has no "transaction" occurred, but the creation of the Code filing system is for these purposes probably best characterized as a mere amendment to the old chattel mortgage system.

38. See Coogan, *supra* note 3, at 867-68.

39. See *id.* at 868.

Even assuming that the Code does work this change, the problems presented by this variation in rights are not truly serious. Basically, such increases or decreases in the trustee's remedies are no different from those produced by any other change in the law which might have occurred during the life of the bonds.[40] The corporate indenture typically runs for ten, fifteen, twenty, or more years; the bondholder must be presumed to have taken his bonds with the knowledge that, as to property to be conveyed in the future under the after-acquired property clause in his mortgage, his rights might be more or less than his rights to property conveyed contemporaneously with or prior to the original issue. He must also be presumed to know that the issuance of new bonds at some future date, if such action is permitted by his indenture, might as a practical matter increase or decrease the value of his security.

In our hypothetical indenture, as is nearly always the case, the old bondholders are protected by provisions spelling out the terms on which new bonds can be issued. These provisions require the delivery of an officer's certificate setting forth the value of available additional property and the delivery of an "opinion of counsel," stating in a prescribed form that the issue of new bonds comes within the terms of the indenture. If these evidences that the rights contracted for in the indenture are being protected can be given, the old bondholder would have no right to object, even if the Code should in some way decrease available remedies. This is true even though, as a practical matter, the trustee may be in effect restricted to the lesser of his two sets of rights, since he may not be able to apply one set of rights to new property or debt and another set to old. Nor should the usual opinion that the new bonds will be "equally and ratably secured with the old" be difficult for counsel to give, since our indenture, like most open-ended ones, provides that once new bonds are issued they become entitled to their pro rata share of any distribution thereafter made, without any attempt to trace which proceeds result from the exercise of the trustee's rights as representative of the old bondholders, and which from his exercise of rights as representative of the new.

What To File

Assuming that counsel for the indenture trustee decides to have a supplemental executed, he must then determine what the indenture must contain and what to file in order to obtain the protection of the Code. This problem is not unique, since identical filing requirements must be met by draftsmen of all post-Code indentures.

For probably the first time in American law, the Code permits the use of "notice filing," popularized principally by the Uniform Trust Receipts Act, in long-term finance. A filed document which meets the minimum standards of section 9-402 need only give notice to third parties that one who is or may

40. See, *e.g.*, Wright v. Vinton Branch of Mountain Trust Bank, 300 U.S. 440 (1937); Norman v. Baltimore & O.R.R., 294 U.S. 240 (1935).

become a secured party may be claiming a security interest in some or all items of an indicated type of collateral.[41] These requirements can be met simply by filing a statement which contains the names, signatures, and addresses of the parties, and which "indicates the types" of collateral covered.[42]

No doubt exists of notice filing's general effectiveness in short-term secured finance. When many repeat transactions, each of short duration, are involved, the advantages of covering all transactions through a single, simple instrument, for instance, one which indicates that "automobiles" are being financed, are obvious. But the advantages of using such highly abbreviated descriptions do not necessarily follow when an indenture is involved. Since borrowing transactions occur only once every several years instead of several per week or day as in short term finance, any burden imposed by the filing system is necessarily reduced in importance. Secondly, while a short term transaction typically involves only one type of collateral, an indenture generally covers collateral of many types or classes and their mere enumeration may require as much as several pages of concentrated text, even when the general types are quite broadly indicated. Normally several paragraphs are then required to exclude from the lien of the indenture certain sub-types not intended to be covered. Both the inclusions and exclusions must be read together to determine what collateral is covered. In addition, the granting clauses of a corporate indenture usually represent the agreement of the parties in its most carefully thought out and well structured form. Often both history and practice are reflected in its choice of phrase, reducing the possibility of a misunderstanding as to the types or items of collateral included and excluded. In

41. See UCC § 9-402, comment 2. Under UTRA the parties need to file once a year a "Statement of Trust Receipt Financing" which gives the names of the parties and a statement indicating that they intend to enter into trust receipt transactions with respect to a type of collateral such as "cotton, wool, automobiles." UTRA § 13(2). But the unfiled trust receipt must give a fairly specific designation of the collateral. UTRA § 2(1) (b) (i). Compare the sample trust receipt and financing statement set out in HONNOLD, CASES ON SALES AND SALES FINANCING 473-74 (1954). Presumably a prospective creditor seeing a financing statement will consult with the parties to determine exactly what items of collateral are covered.

The Code's requirements to to the description of the collateral in the security agreement are less demanding, but the analogy between the requirements of the two acts is clear. *Query* if the Code provides an adequate mechanism for enabling interested parties to determine what amount of debt may be protected or what collateral is covered under a given filing. While information can be demanded by the debtor under UCC § 9-208, there is no comparable provision for requests from those who are not parties to the agreement. And, even if it be assumed that the debtor who wants further credit will request information for the benefit of prospective lenders, an honest answer complying with § 9-208 need not disclose the possibility of future advances being made under a present agreement or advances being made under a future agreement, which advances will take priority from the date of original filing under UCC § 9-312(5) (a).

42. UCC § 9-402. This section sets out a sample form of financing statement. It should be emphasized that use of this form is not mandatory and that anything which gives the required information may serve as the financing statement.

view of all these considerations, any attempt to abstract these granting clauses into an abbreviated description in a financing statement will probably be extremely time consuming, thus nullifying one advantage that the shorter form may appear to have.

And any attempt at abbreviation may result in a description either overly broad or not sufficiently inclusive. Counsel for the bondholders will readily understand the disadvantages of having underdescribed his collateral in the financing statement. On the other hand, counsel for the borrowing corporation must be careful not to permit a description so broad that it hampers his client's future legitimate credit needs. Since the lender looks primarily to income from the debtor's operation as the normal source of repayment, and only secondarily to his collateral, the lender's interest as well may be harmed by an overbroad financing statement, if it has this result.

The Metal Products indenture in which the collateral covered includes "motor trucks, fork lift trucks, and tractors" will serve as an illustration of the dangers of overcoverage. If the parties succumb to the temptation to abbreviate this description in a separate financing statement, they might use the generic term "motor vehicles," which would no doubt satisfy the filing requirements but might well lead to trouble. Assume that Metal Products maintains a fleet of passenger cars for its salesmen. Traditionally, it has paid cash for new models in the fall and then used these cars as security for short-term bank borrowings in the spring when inventories are high and cash is low. When Metal Products seeks its customary spring loan, bank counsel must now tell his client that it cannot safely finance on the former basis as long as the indenture financing statement covering "motor vehicles" is on file, even though the bank has satisfied itself that the indenture does not now cover passenger cars. The bank must assume that at some future time the indenture might be amended to include passenger cars and if any were included the lien of the indenture would take priority over the security interest of the bank because of the first-to-file priority rule.[43] If the bonds were all held by a single individual and the relationship between the bondholder and Metal Products were a normal one, the execution of a simple amendment to the financing statement or of a specific subordination agreement[44] would provide easy solutions. But if the bondholders are numerous and the trustee under the indenture is not given specific authority to amend the financing statement, the considerable, if not impossible, physical task of getting consents from the bondholders may make it impossible for Metal Products to continue to use its passenger cars as security in short-term financing. Such a result, intended by no one and probably benefiting no one, can be avoided by the filing of a description which corresponds exactly to the granting clauses in the indenture.[45]

43. UCC § 9-312(5)(a).

44. Subordination agreements are expressly authorized by UCC § 9-316.

45. In practice, the parties can often so arrange their dealing that a purchase-money priority under UCC § 9-312 would probably avoid problems similar to the one discussed

In many cases the easiest way to carry out the intent of the parties is to file as the financing statement a signed copy of the security agreement. Almost of necessity, the collateral will be "indicated by types," rather than "described by items." So far as description of the collateral is concerned, it would therefore seem quite unnecessary to file any of the past or future supplementals unless a particular supplemental changes the types of property covered.[46] Nor need the entire indenture be filed. The important thing is that the description in whatever is filed as the financing statement should neither overindicate nor underindicate the types of collateral. A simple mechanical method is to file a separate financing statement which contains the signatures and addresses of the parties, to which there is physically attached either a copy of the indenture (preferably one not signed) or a copy of the granting clauses.[47] If any real

in text. The basic point, however, remains valid. Assets claimed under an overly broad financing statement are not readily available for obtaining secured or unsecured credit, regardless of the intent of the original secured creditor. Even though releasing collateral unintentionally claimed in a financing statement may seem like the kind of formal act which the trustee should be able to consent to without action by the bondholders, few typical indentures would permit it. This would be a surrender of a right which could be construed as one of value to the bondholders—the right to discourage any other lender, secured or unsecured, from extending credit in direct or indirect reliance on collateral covered by the financing statement but not by the indenture.

46. Further filing would be advisable if the name or address of either of the parties changed; a searcher of the files might otherwise claim that he could not obtain the information since the name and address are required under UCC § 9-402.

47. In Massachusetts, the State Secretary has approved a multiple form financing statement which contains designated spaces for names, addresses, and descriptions of the collateral, with carbon copies for indexing and other purposes. When this form is used as the financing statement, in the space that provides for description of the collateral a cross reference is made to the attached copy of the indenture, or the pages containing the description of the collateral. Here it is clear that the signed copy of the separate financing statement, and not the unsigned copy of the agreement, is the operative filing instrument. On the other hand when a signed copy of the agreement is to be used as the financing statement, the practice has grown up of submitting the essential information, minus the signatures, on the semiofficial form. Here the agreement is of course the operative document, but use of the form aids the filing officers in the mechanics of filing.

Use of a semiofficial form in run-of-the-mill transactions has obvious merits, but sponsors of the Code in each new state may have to convince filing officers that filing problems involve more than mechanical convenience. The cost of maintaining an "oversized" filing drawer is infinitesimal as compared with the cost of defeating the reasonable expectations of the parties because of too slavish a regard for mechanical efficiency in filing. The senior author has raised the question elsewhere as to whether the Code may not have extended notice filing to areas where a less abbreviated filing would produce no inconvenience to the parties and would protect against unintended results produced by an unwise use of liberties given by the Code. Coogan, *supra* note 3, at 879-80. The English Companies Act might well be studied as a model. Registration of "the particulars" of a floating charge in a public office gives more information than that required under UCC § 9-402 but would seem not to impose any great burden on the parties. Companies Act, 1948, 11 & 12 Geo. 6, c. 38, §§ 95(2)(f), 95(8). See also §§ 96-102 of the Companies Act. Further, the English act does what the Code fails to do; it provides a mechanism whereby interested parties may learn estate covered is described in a separate exhibit, as is not unusual, that exhibit should be attached and incorporated into the description of the collateral, for some of the personal property is almost sure to be now or later affixed to parts of that realty. Including in the filed document the description of all realty covered will almost automatically insure compliance with the requirement of section 9-402 that the "real estate concerned" be described in connection with a security interest in fixtures.

In connection with security interests in real estate, note that the Code leaves undisturbed present state filing laws, which may require the filing of the entire indenture in various registries of deeds in order to perfect the real estate mortgage. When this has been done, the parties may seek to avoid further work by filing with the Secretary of State (or other designated officer) a financing statement referring to "all personal property described in the indentures on file with the registrars of X, Y, and Z counties." This type of filing is not desirable; it may not fulfill even the minimum objectives of a notice filing system—to enable a searcher to learn from the files of the office designated by the Code whether he must make further inquiries as to a given type of collateral.

When a financing statement is filed on what might be called the Code side of the registry of deeds,[48] however, a reference to a mortgage recorded on land records of the same office would seem eminently proper.

There will be cases in which the debtor wishes to make it clear that a particular financing statement is intended to protect no debt other than that which may from time to time be outstanding under the agreement as filed; in other cases the parties may desire to leave open the possibility of covering future debt other than that to be issued under the present agreement. If the point is significant, a sentence or two in the financing statement will eliminate any ambiguity as to whether or not the filing of the entire agreement limits the debt that may be covered to that described or referred to in the financing statement. Since the Code does not require that the financing statement give any description of the debt, it would seem that a description of the debt in the financing statement *without more* is surplusage. But clearly the parties can, and sometimes should, indicate otherwise. If the financing statement in any

from the debtor's records just what assets are at the time pledged under particular security agreements. Sections 103 and 104 require the company to keep copies of all instruments creating charges and to maintain a register indexing all specific and floating charges. Under § 105 both the register and the copies must be kept available for inspection by any person. The Code nowhere requires the debtor to furnish any information to other interested parties. UCC § 9-208 provides only a mechanism by which the debtor may demand that the secured party verify certain information which the debtor ought to have in his own possession.

48. Under UCC § 9-401(1)(b) a financing statement claiming an interest in goods which at the time the security interest attaches are or are to become fixtures must be filed "in the office where a mortgage on the real estate concerned would be filed and recorded." See note 53 *infra* for a discussion of the problem of perfecting a security interest in after-acquired fixtures installed on after-acquired realty.

way limits the debt covered, creation of debt other than within those limits obviously requires a new filing.

Is it necessary to describe the collateral by "types" or "items," the words used in 9-402 to indicate the contents of minimum financing statements? When this section is read together with 9-110,[49] it would seem clear that a type or item description is not required so long as the description "reasonably identifies the collateral." For example, a filing which simply covers "all of the debtor's property wherever located" would seem adequate even though it does not "indicate types" or "describe items." In short, the test set forth in 9-402 is less strict than that of 9-110; 9-402 can be met by an indication of types of collateral covered, *e.g.*, "cars and trucks," which need not "reasonably identify" exactly which cars or trucks are covered. But whenever the collateral is otherwise "reasonably identified," no indication of types or description of items is necessary.[50]

Of course, when individual items are large and likely to be long lived, the cautious draftsman will probably describe in terms of items. And if it were possible to describe all of the collateral under a long term indenture by items, counsel for the borrower might properly insist that this be done as a means of freeing his client from the burden of later proving to other interested parties that other items of property were not covered by the indenture.[51]

To return to our hypothetical indenture, the draftsman may assume that once he has filed an adequate financing statement no further execution of supplementals will be necessary to cover after-acquired property and that the only additional filing necessary will be the "continuation statement" the Code requires every five years.[52] This will be true so long as any after-acquired fixtures are placed only on land "generally" described in the original filing.[53]

We have assumed above that the parties are interested primarily in per-

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49. UCC § 9-110 provides that "any description of personal property or real estate is sufficient whether or not it is specific if it reasonably identifies what is described."

50. The careful draftsman must be aware that the judicial conception of "reasonable identification" may be somewhat strict. Not all cases in which security is lost because of sketchy description arose under old statutes requiring specific descriptions. See United States v. United Aircraft Corp., 80 F. Supp. 52 (D. Conn. 1948), in which the language in a mortgage describing the collateral as "all parts, engines, equipment and accessories" was held insufficiently definite to give notice of a lien on an aircraft engine in a filing under the filing provisions of the Civil Aeronautics Act, ch. 523, 62 Stat. 494 (1948). The holding can be explained by the language of the statute, but the court purported to be applying general law.

51. It may be noted that while the debtor may demand as of right that the secured party file a termination statement when no debt is outstanding, UCC § 9-404, no mechanism exists by which the debtor can trim down the financing statement to the collateral actually covered by existing security agreements except with cooperation of the secured party.

52. UCC § 9-403(2).

53. This assumes that a proper filing has been made in the appropriate land records office. See notes 47-48 *supra* and accompanying text.

Questions may arise as to the type of filing required to perfect a Code security interest fecting the security interest in collateral actually covered, while at the same time leaving the debtor free to deal with his other assets as he sees fit. Should greater control of the debtor be desired, intentional overdescription of the collateral in the financing statement offers interesting possibilities as a means of enforcing the so-called negative pledge clause—one by which the borrower agrees not to create a lien upon certain classes of assets even though not covered by the indenture. For example, utility mortgages commonly exclude inventory and accounts receivable, but nevertheless prohibit the creation of any other security interest therein. If the parties are satisfied that the use of these assets for any other kind of borrowing, secured or unsecured, is unnecessary, the financing statement could be made broader than the coverage of the indenture. In this manner, any prospective competing secured lender would be discouraged, since the first-to-file priority rule[54] would make his security

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in after-acquired fixtures installed on after-acquired real estate. The practical importance of these questions is derived from two factors:

(1) Although UCC § 9-313(1) allows the parties to perfect interest in fixtures in accordance with local real estate law, a creditor holding a perfected Code security interest in fixtures has certain remedies which may not be available under local real estate law, *e.g.*, the right to remove the fixtures under UCC § 9-313(5). This right becomes particularly important when the fee interest in the real estate is held by or mortgaged to one other than the debtor or secured party.

(2) Typical practice calls for annual filing in the appropriate land records of a supplemental mortgage picking up all real estate interests acquired by the debtor during the course of the year. In cases such as that of a utility company, where fixtures of substantial value may be installed on real estate interests such as easements, automatic and immediate perfection of Code interests in the fixtures offers obvious advantages to the secured party.

It is submitted that this goal may be attained, at least in states with a grantor-grantee index, by indicating on the papers filed as a financing statement in the land records office that an interest is claimed in fixtures which may later be attached "to any real estate of which the debtor is now or hereafter the record owner of any interest therein." If the index is maintained on a grantor-grantee basis, this would seem to "reasonably identify" the real estate, UCC § 9-110, and it would also satisfy the Massachusetts requirement that a description of real estate in a financing statement contain "the name of the record owner thereof," MASS. ANN. LAWS ch. 106, § 9-402(1) (Spec. Supp. 1958). The proposed description would also seem to satisfy the purpose of notice filing, for as long as an adequate cross-indexing system is maintained, anyone interested in real property in which the debtor has a recorded interest, will be able to discover that a Code interest in fixtures may exist simply by running a grantor-grantee check on the real estate side.

If after-acquired realty is located in a district where no Code financing statement is on file, a separate financing statement must of course be filed in that district to protect a Code interest in fixtures which may be attached to that land. Practices as to fixtures must of course be adapted to the real estate filing or recording system of the applicable state.

54. UCC § 9-312(5)(a). It should be noted however, that this section relates only to contests between two or more secured parties, each of whom claims a Code-created security interest in the same collateral and both of whom have perfected through filing. If particular items or classes of collateral are not covered by any security agreement there

interest subordinate to the lien of the indenture should it ever be amended to include this collateral. But thus strengthening the negative-pledge may discourage insecured credit otherwise available.

Remedies on Default

A corporate indenture ordinarily gives a trustee a variety of remedies which he may invoke upon "default," a term which includes, but is by no means limited to, a default in the payment of principal or interest. Default clauses in a Code indenture will not be much different from others, but each indenture should be checked against the provisions of section 9-207 and part V of article 9 generally to ensure that some particular Code rule is not made applicable by the absence of a permitted agreement to the contrary. For example, under section 9-207 a secured party in possession has the duty to take necessary steps to preserve rights against prior parties who are liable on instruments constituting part of the collateral, but the parties may agree that these steps must be taken by the debtor. Likewise, counsel should determine whether in any case it is wise to specify the "standards" by which compliance with certain provisions of the Code are met. The Code imposes an overall requirement that "every aspect of the disposition of the collateral including the method, manner, time, place and terms must be commercially reasonable."[55] The parties might want to agree, for instance, that five-days' notice of a sale was commercially reasonable or that a sale of the collateral through a particular channel was proper. Such an agreement would be upheld providing the standards were not "manifestly unreasonable."[56]

While, as a general rule, the Code's remedies may be changed by agreement, the parties are not free to modify certain fundamental rights of the debtor and duties of the creditor.[57] The debtor may waive his equity of redemption only if he does so by a writing after default; otherwise he may redeem by paying what is due at any time before the secured party has disposed of the collateral or bound himself to do so.[58] The secured party may retain the collateral in satisfaction of the debt without a sale only in accordance with the provisions of section 9-505. A debtor cannot waive his right to an accounting for surplus proceeds,[59] or his rights to demand that the secured party buy the collateral only at a public sale.[60] The debtor cannot waive his

is nothing to prevent an unsecured creditor from attaching, and probably nothing to prevent another secured party from perfecting by taking possession of the collateral. See generally Coogan, *supra* note 3, at 857-61, 866-68, 872-73.

55. UCC § 9-504(3).

56. UCC § 9-501(3).

57. UCC § 9-501(3) lists these rights.

58. UCC § 9-506.

59. UCC §§ 9-502, 9-504(2).

60. UCC § 9-504(3). An exception exists for collateral "of a type customarily sold in a recognized market or . . . the subject of widely distributed standard price quotations . . . ."

right to the kind of notice required by the flexible standards of section 9-504 (3); but as indicated above, the parties might well agree in advance as to what constitutes reasonable notice.[61]

SECURING LONG TERM DEBT WITH CURRENT ASSETS

Turning to the problems posed by the possibility of including current assets under the indenture lien, it will be helpful to assume a few more facts about our hypothetical debtor. For some years Metal Products has had an informal arrangement with its principal bank, under which it finances its inventory and accounts on a secured basis from time to time. The bank requires Metal Products to follow what the debtor's treasurer feels are cumbersome procedures to ensure that each advance is secured by a separate batch of inventory or accounts, and that the loan is repaid out of the proceeds thereof, even though an equal amount is borrowed almost contemporaneously against new collateral. Prior to adoption of the Code these procedures were justified by the bank as "legal requirements."[62]

After enactment of the Code, the treasurer suggested to the bank's lending officer that the parties do away with the "paper work" which went with pre-Code inventory financing. But the lending officer insisted upon continuing the established practices under the Code. He claimed that until Metal Products' credit position comes close to the point at which unsecured loans are justified, some degree of bank control is a practical necessity, and that the paper work and other requirements were, quite simply, the price of obtaining credit.[63] Fur-

61. A final problem with respect to remedies on default has been solved by the adoption of the sponsors' 1958 amendments. Mass. Acts 1959, ch. 580, amending §§ 9-207, 9-501. In the form first adopted by Massachusetts, the remedies section provoked the question whether the enumeration of remedies might be construed to be exclusive. This was particularly disturbing to the draftsmen of corporate indentures, who had commonly provided that on default the trustee could enter the debtor's premises and "collect and receive all rents, tolls, issues, income and proceeds therefrom," or seek the appointment of a receiver so to collect. The greatest importance of this procedure was as a means of preserving the real value of the collateral pending a sale or other final disposition, or in some cases in avoiding more drastic remedies through operation of the business by the secured party. No provision was made for this remedy in the Code, although it had been generally enforceable under pre-Code law. See, *e.g.*, Realty Inv. & Sec. Co. v. N. L. Rust Co., 109 F.2d 456 (D.C. Cir. 1939); Fitchburg Coop. Bank v. Normandin, 236 Mass. 332, 128 N.E. 415 (1920).

The possible loss of this remedy was not looked upon with favor, and in 1958, the national sponsors prepared amendments to UCC §§ 9-207 and 9-501 to make it clear that the right to operate the collateral was not intended to be excluded by the Code, and that, except for certain fundamental rights and duties, the parties were free to vary their remedies by agreement. These Massachusetts amendments are included in the versions of the Code passed in New Hampshire and Connecticut and in the amended Pennsylvania Code, Pa. Laws 1959, act 426. They are not presently included in the Kentucky version.

62. The bank's position would have been based primarily on the "dominion and control" rule of Benedict v. Ratner, 268 U.S. 353 (1925). See notes 18 *supra*, 126 *infra*.

63. Compare NATIONAL COMMERCIAL FINANCIAL CONFERENCE, INC., PROCEEDINGS OF

thermore, although willing to continue the informal arrangement, he refused, as a matter of banking policy, to obligate the bank to continue making loans over a long period of time.

Somewhat dissatisfied, the treasurer of Metal Products now suggests to its investment banker that its existing indenture be amended to include all of its inventory and accounts receivable, and that an additional 1,000,000 dollars of bonds be issued thereunder with the entire 4,000,000 dollars to be secured *pari passu* as to all of the collateral. The treasurer presents evidence that during the past five years Modern Metal's current assets have never amounted to less than 1,500,000 dollars, and proposes that the indenture as amended require that an officer of the borrower certify to the trustee within forty-five days after the end of each calendar quarter that at no time during that quarter had the book value of the inventory and accounts been less than 1,500,000 dollars. Under the indenture as now written the company covenants not to create or permit to exist any other security interest in any collateral of the type covered by the indenture, except certain liens involuntarily created; after execution of the proposed supplemental this covenant would apply to inventory and accounts. A breach of this covenant or a failure to maintain the

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FOURTEENTH ANNUAL CONVENTION OF THE COMMERCIAL FINANCE INDUSTRY 19 (1958), where Eli S. Silberfield, general counsel for the Conference, advised its members as follows:

> As additional States enact the Code, I expect that we will hear further discussion on [the] very interesting question:
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> . . . 1. Does the Code really repeal the dominion doctrine of *Benedict v. Ratner*? I think that the answer . . . is "yes"; but to those of you who are operating executives, and not lawyers, I say this: don't expect the Uniform Commercial Code to analyze or manage your collateral for you. It is up to you to examine the assignment schedules offered to you by your customer, and the documentation underlying the schedules, to determine for yourself whether the collateral meets your standards and is properly assigned to you; and after your accept a schedule and make your advance on it, it is up to you to exercise dominion and assure yourself, by all necessary auditing, verification, and other policing measures, that the proceeds of the collateral are duly turned over to you. This you must do for yourself; the Code won't do it for you. . . . Don't rely on a blanket or floating lien, even though the Code invites you to take everything in sight as security. It is far better and safer, I think, to make your advances against specific, limited, well-defined security—such as accounts receivable, or merchandise inventory, or mortgage, or a reasonable combination of them—based upon a conservative valuation of the security. A blanket lien doesn't help you unless you find out what's under the blanket. The Code can't do that for you. Eternal vigilance is the price of a successful financing operation, and no statute will ever replace it.

See also BANKERS MANUAL ON THE UNIFORM COMMERCIAL CODE 157 (Mass. Bankers ed. 1958) (art. 9 material written by the senior author and two of his associates); FUNK, PENNSYLVANIA BANKS AND THE UNIFORM COMMERCIAL CODE 32 (1954). If the free-handed mortgage rule of the applicable state required more dominion than the lender's common sense indicates is necessary, adoption of the Code will of course affect a change in control practices. It will clearly avoid practices based only on worries caused by the extensions of *Benedict* represented by Lee v. State Bank & Trust Co., 54 F.2d 518 (2d Cir. 1931).

1,500,000 dollars in current assets would enable the indenture trustee to call the bonds.

Before recommending that its customers purchase the additional bonds, the investment house through which the original bonds were sold to widely scattered customers must satisfy itself that a new issue will not dilute the security standing behind all the bonds. Accordingly, counsel for the underwriter and counsel for the borrower are asked whether under the Code they can draft a supplemental indenture which will give the bondholders the same degree of protection as to inventory and accounts which they now enjoy with respect to the collateral already covered, but without materially increasing the control over the debtor and the collateral traditionally exercised by the indenture trustee.[64]

The Quality of Security Interests in Traditional Collateral

In order intelligently to answer the question of whether or not current assets can serve as a basis for sound long-term borrowing, counsel must first evaluate, in the light of the changes worked by the Code, the qualities of the security interests in the various assets which now secure the bonds. With these in mind, counsel can determine whether security interests of comparable quality can be created in the inventory and accounts receivable which Metal Products would now like to place under the indenture.

Equipment

The major category of personal property covered by Metal Products' indenture is equipment—fixed assets, ranging from the almost immovable hydraulic press to highly movable hand tools. The security interest in this type of personal property has traditionally served as a benchmark against which security interests in other types of personal property are measured. And under the Code, the quality of security interests attainable in equipment has, if anything, increased.[65] Assuming that the debtor has full title to and possession of the property at the time the security interest is created, a security interest perfected through the earliest filing[66] is invulnerable to attack by any other

64. The indenture trustee is the nominal representative of the often widely scattered bondholders. Under the typical indenture, his duties are almost entirely ministerial until default. He is not employed, nor compensated sufficiently, to exercise the judgment and day to day supervision of the borrower characteristic of professional lenders in the short-term field.

65. A possible exception exists as to fixtures. Under pre-Code law the indenture trustee with a real estate mortgage could conceivably fall heir to some fixtures supplied by one who attempted but failed to perfect a purchase-money security interest therein. Under UCC § 9-313, a security interest created in a fixture before it becomes such, like an interest created in almost any other form of personal property, may be prior to the interest obtained under the after-acquired property clause of the indenture.

66. Since equipment is bought to be used, a possessory security interest in equipment is usually impractical. If the state has a title certificate law as to automobiles and other automotive equipment, that state's version of UCC § 9-302(3)(b) may require that per-

secured party. In addition, if the indenture's financing statement is the first filed, new equipment will be brought under the lien of the indenture by the action of the after-acquired property clause subject only to the superior rights of one who holds a purchase money security interest in it. This qualification reflects a policy decision to permit the debtor to acquire new property subject to such an interest even though his action may constitute a default under an existing security agreement.[67] But the turnover of fixed assets is generally low, at least as compared with that of current assets, and the purchase money security interests outstanding at any given time are unlikely to represent a sizeable proportion of the debtor's total equipment. Nor need the draftsman worry about the bondholders' rights being defeated by sales of the equipment. Although the "buyer in the ordinary course of business" enjoys superior rights over security interests perfected prior to his purchase,[68] to become such a buyer one must purchase goods from a seller "in the business of selling goods of that kind."[69] Since few debtors are engaged in the business of selling their fixed assets, buyers of equipment will generally take subject to all previously filed security interests.[70]

The Code's abolition of the "dominion rule"[71] will be helpful in settling any doubts counsel may have had as to whether this rule applies to equipment. Although the cases in which the rule arose almost invariably involved current assets—consumable supplies, goods held for sale, or accounts—draftsmen have been concerned that the reasoning of these cases might be applied to invalidate liens on fixed assets.[72] To avoid the possibility, fairly strict accountability has sometimes been demanded, even for items of trifling value. This type of for-

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fection be achieved only through notation of the security interest on the certificate of title. See UCC § 9-302, comment 8.

67. UCC § 9-311; see UCC § 9-312, comment 3. In general, this preferred treatment of purchase-money interests is a continuation of pre-Code law. See Blair, *The Allocation of After-Acquired Mortgaged Property Among Rival Claimants*, 40 HARV. L. REV. 222 (1926).

68. UCC § 9-307(1). See also cross reference in 9-312(1).

69. UCC § 1-201(9).

70. Under an earlier version of 9-307, the rule enabling a buyer in ordinary course of business to take free of a security interest applied to all inventory, and only to inventory. Due to a mechanical error this former version is still reflected by some language in § 9-307, comment 2, and § 9-109, comment 3. This language is obviously inconsistent with the present text of § 9-307 under which there could be a "buyer in ordinary course of business" of some equipment and there could not be such a buyer of some inventory. See note 11 *supra*. Note that under UCC § 9-307(1) no protection is given a buyer of "farm products," the inventory of a farmer.

71. UCC § 9-205; see notes 18-21 *supra* and accompanying text.

72. Brown v. Leo, 12 F.2d 350 (2d Cir. 1926), is partly responsible for this confusion. In that case an otherwise valid mortgage on land was held ineffective because the debtor was allowed too much dominion over current assets covered by the same mortgage. Although Shepard's shows few subsequent citations, lender's counsel will be slow to disregard a bankruptcy decision by the Second Circuit, particularly one written by Judge Learned Hand. The case may represent an incorrect application of *Benedict*. See note 126 *infra*.

mality can now be dispensed with and the secured party (and more particularly his lawyer) relieved of the task of trying to defend overstringent provisions inserted only to overcome legal doubts.

If the indenture covers equipment which is turned over with fair frequency, the Code's after-acquired property provisions will eliminate the need for execution and filing of supplemental mortgages. Futhermore, if the parties desire to permit buyers of such equipment to take free of the indenture lien, conventional indenture release provisions may easily be modified to establish any procedure which is felt to be safe and convenient. For example, the indenture might permit the sale of used cars or office equipment free of a lien so long as a certain number of such items or a fixed dollar amount of that class of items are maintained by the debtor. For equipment of substantial value, it will ordinarily be appropriate to continue to prohibit sale without a specific release. Most present-day indentures permit the trustee to release collateral of substantial value only if part of the debt is paid or additional collateral has been substituted.

Pledged Stock and Notes

Metal Products has been able to give the bondholders fairly complete protection as to the stock and notes pledged under the indenture. Once the trustee assumes possession of the borrower's securities, no lien or other interest in the pledged securities prior to the trustee's can be created without his consent.[73] Of course, the trustee's position under the Metal Products indenture was not quite as impregnable as it might have been, since the securities are those of a company controlled by the borrower. Ordinarily, however, the borrower can do little to diminish the value of the pledged collateral. Since a security interest in instruments can be fully perfected only through possession,[74] an after-acquired property clause will be only partially effective until possession is taken; prior to that time a security interest in after-acquired securities is "unperfected" and may be defeated by either a creditor who does not have actual notice of it or by a party to whom the debtor sells the securities even if in so doing the debtor acts wrongfully.[75] This possible disadvantage is balanced by the fact that a possessory security interest in securities

73. Until the Supreme Court decides otherwise, however, a possibility exists that claims of the United States given priority by REV. STAT. § 3466 (1875), 31 U.S.C. § 191 (1952), even though unsecured, could come ahead of any kind of security interest in any kind of collateral. See United States v. Gilbert Associates, Inc., 345 U.S. 361, 365 (1953).

74. UCC § 9-304(1). The long-term secured creditor will not ordinarily be interested in the partial protection given to a secured party who files with respect to instruments which "constitute part of chattel paper," see UCC §§ 9-304(1), 9-308, or the twenty-one-day perfection of an interest in instruments under UCC §§ 9-304(1), (4), (5). The latter sections might be helpful in the event the trustee had to part with possession of the pledged securities temporarily and for a limited purpose—*e.g.*, for exchange or collection. Note that an interest perfected under those sections is vulnerable to a purchaser of the securities. UCC § 9-309.

75. See UCC §§ 9-312(1), 9-309.

is ordinarily superior even to a purchase-money security interest if it is non-possessory.[76] As a practical matter, therefore, bondholders can be given an almost invulnerable security interest in securities owned and pledged by the debtor.

Assignment of Contract Rights and General Intangibles

Another class of collateral, more commonly employed with each passing year, consists of various long-term intangible interests, divided by the Code into "contract rights" and "general intangibles." "Contract rights"—limited by definition to rights to the payment of money under an executory contract[77] —are already a familiar type of commercial security. Examples of "general intangibles" are numerous: Modern Metals' right to be supplied with natural gas at an advantageous rate, or similar rights under long-term contracts other than the payment of money; licenses; patents and copyrights; or trademarks, tradenames and general good will.[78] The Code, for the first time, affirmatively recognizes such "general intangibles" as a legitimate form of collateral and provides a mechanism for perfection of a security interest therein.

With respect to both of these types of intangibles, perfection can be obtained only through filing. Thus, under the Code's priority rules, the secured party first to file has a security interest inferior only to purchase money security interests,[79] and purchase money security interests in general intan-

76. The indenture trustee who gets possession of the securities will ordinarily be a "bona fide purchaser of a security" or a "holder in due course of a negotiable instrument" or otherwise entitled to full protection under the special priority rules of UCC §§ 9-308, 9-309, even against one who holds a purchase-money security interest or one who has some other interest which can be cut off under rules protecting negotiability.

77. UCC § 9-106.

78. See UCC § 9-106 comment. Registration with a federal authority is required to perfect assignments of patents, copyrights and trademarks. 17 U.S.C. §§ 28, 30 (1958) (Copyrights); 35 U.S.C. § 261 (1952) (Patents); 60 Stat. 431 (1946), 15 U.S.C. § 1060 (1958) (Trademarks). See UCC § 9-104 and note 8 *supra* on the applicability of article 9 to patents, copyrights and trademarks.

79. UCC §§ 9-312 (4), (5)(a).

Because of this priority rule, bondholders' counsel would normally insist upon having the record cleared of any earlier filing as to the kinds of collateral relied on as security for the indenture. It is not sufficient to establish the nonexistence of a security interest perfected under that filing. Under the first-to-file rule a security interest created later but perfected through the earlier filing will take precedence over an earlier security interest perfected through a later filing. If no obligation is outstanding the debtor can demand that a prior creditor clear the record by filing a "termination statement." UCC § 9-404. If some obligation is outstanding counsel for the bondholders will demand that the earlier financing statement be narrowed down to the exact collateral now claimed or that the prior filer enter into an agreement subordinating his interest to that of the bondholders. See UCC § 9-316. Failing that, the obligation must be prepaid and thereafter a termination statement demanded as of right and filed. See generally Coogan, *Article 9 of the Uniform Commercial Code: Priorities Among Secured Creditors and the "Floating Lien,"* 72 HARV. L. REV. 838, 857-61 (1959).

gibles and contract rights are likely to be rare.[80] By definition, no "buyer in ordinary course" of intangibles can exist, since that term relates only to buyers of goods.[81]

By negating the dominion rule, the Code removes the possibility that a court will later hold the bondholders' security interest invalid simply because the debtor was allowed to exercise too much control over rights assigned for security.[82] But the Code does not and, of course, cannot say that a creditor who exercises no control over the debtor's use of this kind of collateral enjoys a security interest of the same quality as one who does. No security interest continues in rights disposed of with the authorization of the secured party.[83] More important, the value of an intangible as security frequently depends on receipt of proceeds from its use or on continued debtor performance of various obligations. "Depreciation" of intangibles can be swift and unpredictable; the secured party who permits his debtor to use proceeds without accountability, to fritter away his contract advantages or to depreciate the value of his tradenames may find that his security is of little value in the event of trouble, even though the freedom accorded the debtor will no longer affect the validity of the security interest in whatever rights are left.

The Quality of Security Interests in Current Assets

An evaluation of the utility of current assets as security in long-term finance will largely depend on how many of the factors which originally led to their exclusion from Metal Products' former indentures are still operative and on whether any other considerations exist which militate for or against their use. They have certain obvious advantages, either as an independent base for borrowing or as additional collateral behind existing bonds. If disaster occurs, the addition of current assets to the creditors' security package may add much more than the value of the current assets themselves. It may enable the indenture trustee to sell the debtor's property as a going business, and, perhaps more important, to continue operations while preparing for a sale. To the debtor, obtaining additional long-term funds on the security of current assets may appear to obviate the need for short-term transactions, which are more likely to be characterized by annoying policing requirements, even after adoption of the Code.[84] But against these advantages must be weighed the fact that in the United States several generations of corporate draftsmen have excluded inventory and accounts from indentures, at least before default.[85]

80. This is not to say that such interests would be nonexistent. See *id.* at 860 n.84.

81. UCC § 1-201(9).

82. See UCC § 9-205; notes 18-20 *supra* and accompanying text.

83. UCC § 9-306(2). Authorization to dispose of collateral may be inferred from the reservation of a right to proceeds together with other circumstances, or may be expressly given. UCC § 9-306, comment 3. Prior to 1956 the text of 9-307(2) made a filing claiming an interest in proceeds conclusive evidence of authorization.

84. See note 63 *supra*.

85. A grant of a security interest in current assets sometimes resulted in a good lien on assets acquired after a receiver appointed under the indenture took possession of the

This practice has continued side by side with the extension (especially during the last twenty-five years) of billions of dollars of short-term credit secured by this very collateral, through trust receipts, consignments, "field" or public warehousing, "factors liens" and assignments of accounts receivable.[86] This long history of exclusion may indicate that there is something about current assets which makes them inappropriate security for long-term debt. On the other hand, the very special type of lien called the "floating charge" on current assets is very common in English and Canadian corporate indentures, even though English law generally does not otherwise encourage the use of current assets as a form of security.

Legal Obstacles

The historic reasons for not using current assets in the same way that fixed assets are used to secure long-term debt are principally the fears of lenders' counsel that courts may refuse to give full effect to such an arrangement.[87] By far the most important of the long-standing doctrines which either are, or are feared to be, applicable is the "free handed mortgage" or "unfettered dominion" rule which invalidates agreements in which a debtor purports to give a lien on assets which he continues to use and dispose of without accountability to his secured creditor.[88] The acutely disturbing aspect of this

mortgaged property. See, *e.g.*, New York Sec. & Trust Co. v. Saratoga Gas & Elec. Light Co., 159 N.Y. 137, 53 N.E. 758 (1899). *But cf.* Zartman v. First Nat'l Bank, 189 N.Y. 267, 82 N.E. 127 (1907).

86. In an address to the Commercial Finance Conference, October 19, 1959, William J. Drake stated that the

> National Bureau of Economic Research . . . showed that the total annual volume of commercial receivable financing in the United States, engaged in by commercial finance companies, in the year 1941 was about $536,000 . . . . [T]he total volume of all receivable financing for all commercial financing companies in 1959, we estimate, . . . has increased [to] 7.8 billion dollars [and] the volume of old line factoring in 1959 [has increased to 4.4 billion dollars] . . . .

While figures for commercial banks are not readily available, the amount is substantial.

See also BECKART, BUSINESS LOANS OF AMERICAN COMMERCIAL BANKS (1959), especially pt. I, ch. 5, pt. III, ch. 12; NATIONAL INDUSTRIAL CONFERENCE BD., ECONOMIC ALMANAC § VI (1958) (interesting comparison as to the growth of debts of all types by various classifications).

87. When the question of legality is doubtful, stock in trade should be excepted from the mortgage by clauses as precise as language permits. Even in jurisdictions where mortgages of stock in trade have not been declared void it is sometimes prudent to omit such property from the principal indenture and to include it in a supplemental indenture as further security for the debt, so that the invalidity of the supplement may not affect the principal indenture.

Address by George H. Gardiner, *Corporate Bonds, Mortgages, Collateral Trusts and Debenture Indentures*, May 5, 1927, reprinted as *Some Legal Phases of Corporate Financing, Reorganizations and Regulations*, in 8 LECTURES ON LEGAL TOPICS BEFORE THE ASSOCIATION OF THE BAR, CITY OF NEW YORK 19 (1930).

88. This is usually associated with Benedict v. Ratner, 268 U.S. 353 (1925), although the freehanded mortgage doctrine originated in much older cases. Strangely enough, the

rule is that the lien is lost not only on property actually disposed of, but also on all other assets of that category purported to be covered by the mortgage. And worst of all, under some of the cases, both before and after *Benedict v. Ratner*, inclusion of assets over which the debtor exercises dominion invalidates the security interest even as to the other categories of property on which the lien would otherwise clearly be valid.[89]

Next in importance was the lack of any security device which would pick up new inventory without going through mechanics too cumbersome to be usable. Many cases and statutes denied validity to agreements purporting to create a security interest in future inventory unless a new chattel mortgage was executed and recorded after the debtor acquired the new property.[90] Current assets likely to be included in a corporate indenture are virtually certain to be replaced by others of like kind almost as soon as the ink on the indenture is dry; turnover is too frequent to permit practical coverage of these assets by repeated execution and recording of new chattel mortgages. The newer security devices (the trust receipt for new inventory and the "revolving credit" for accounts)[91] which have eased the *Benedict* and after-

"dominion" problem attacked by UCC § 9-205 is assumed by many to be a new one. But no modern commentator has added much to the discussion in PIERCE, FRAUDULENT MORTGAGES OF MERCHANDISE (1884). Early cases invoking the doctrine include Edgell v. Hart, 9 N.Y. 213 (1853); Griswold v. Sheldon, 4 N.Y. 581 (1851). But the views of these cases were not universally accepted. See, *e.g.*, Hughes v. Cory, 20 Iowa 399 (1886); Briggs v. Parkman, 43 Mass. (2 Met.) 258 (1841); Gay v. Bidwell, 7 Mich. 519 (1859). The doctrine is one of state, not federal law. The opinion of Mr. Justice Davis in Robinson v. Elliot, 89 U.S. (22 Wall.) 514 (1874), is one of the more articulate statements of the reasons behind the doctrine. But when the U.S. Supreme Court was presented with a case involving Iowa law, Mr. Justice Brewer wrote an equally able opinion for the opposite view. Etheridge v. Sperry, 139 U.S. 266 (1891). See also the defense of the Massachusetts rule in Brett v. Carter, 4 Fed. Cas. 67 (No. 1844) (D. Mass. 1875).

See also the exhaustive review of the freehanded mortgage and the post-*Benedict* cases up to 1946 in New York Law Revision Comm'n, *Communication to the Legislature Relating to Assignment of Accounts Receivable*, N.Y. LEG. DOC. No. 65K (1946).

An interesting study could be made as to the relationship between the dominion cases and the status of the preference section of the national bankruptcy act at the time a particular case was decided. During the greater part of the nineteenth century, there was no national bankruptcy act; if the present version of § 60 had been in effect in 1925 (or if the exact case arose today) Ratner's assignment might well have been upset as a voidable preference. A study of the record before the Supreme Court raises the question as to whether Brandeis may not have revived an old doctrine to upset one of a series of questionable family transfers made on the eve of bankruptcy. Possibly because questions of fact were not open to the Supreme Court, Brandeis' opinion gives none of the flavor of family fraud indicated by the record.

89. Brown v. Leo, 12 F.2d 350 (2d Cir. 1926); Russell v. Wynne, 37 N.Y. 591 (1868). See also notes 72 *supra*, 126 *infra*.

90. The cases are reviewed in Cohen & Gerber, *The After-Acquired Property Clause*, 87 U. PA. L. REV. 635 (1939).

91. UTRA does not authorize the automatic creation of a security interest in property not owned at the time, but by allowing one "notice" filing to cover all transactions within

acquired property problems for short-term financers have, as a practical matter, been unavailable under the traditional corporate indenture. The continual process of repayment followed by the making of new loans typical of trust receipt financing or a revolving credit requires frequent exercise of judgment by a professional lender; this judgment and the concomitant "policing" of the debtor and his collateral are foreign to traditional indenture operations.[92]

The third doctrine which has led to the exclusion of current assets is expressed in cases which, by construction of the security instrument as a whole, have subordinated the interest in current assets of long-term creditors to the claims of current creditors. Cases in the United States often refused to recognize the long term creditors' "lien" on "earnings," "income," "rents," or "profits" until after satisfaction of current claims;[93] English cases established

a year, makes the mechanics of covering future property much more workable. See UTRA § 13. UTRA can be availed of only for new advances made against specifically designated new inventory. See UTRA § 2(1) (a); *In re* Yost, 107 F. Supp. 432 (D. Md. 1952); *In re* Chappell, 77 F. Supp. 573 (D. Ore. 1948). Thus it is unusable for any scheme where all of the money is advanced at one time. Under a revolving credit arrangement, as old inventory is sold or accounts collected, the proceeds are turned over to the creditor, the debtor being kept in funds by making of new advances against new collateral. For a description of a revolving credit, see *In re* New Haven Clock & Watch Co., 253 F.2d 577 (2d Cir. 1958).

92. The trustee under the ordinary corporate indenture has, of course, no funds to loan after the initial advance has been made and ordinarily has no authority to decide whether to release proceeds of collateral to the debtor or apply it to payment of the secured debt.

93. Perhaps the most significant of these are the nineteenth-century railroad and utility cases, *e.g.*, Gilman v. Illinois & Miss. Tel. Co., 91 U.S. 603 (1876); Smith v. Eastern R.R., 124 Mass. 154 (1878), in which current creditors were allowed to come ahead of bondholders despite broad indenture clauses claiming a security interest in almost every kind of a debtor's assets including its "income." The policy behind these cases was well articulated by Mr. Justice Waite in a dictum in the case of Fosdick v. Schall, 99 U.S. 235, 252-53 (1878):

> The business of all railroad companies is done to a greater or less extent on credit. This credit is longer or shorter, as the necessities of the case require; and when companies become pecuniarily embarrassed, it frequently happens that debts for labor, supplies, equipment, and improvements are permitted to accumulate, in order that bonded interest may be paid and a disastrous foreclosure postponed, if not altogether avoided. In this way the daily and monthly earnings, which ordinarily should go to pay the daily and monthly expenses, are kept from those to whom in equity they belong, and used to pay the mortgage debt. The income out of which the mortgagee is to be paid is the net income obtained by deducting from the gross earnings what is required for necessary operating and managing expenses, proper equipment, and useful improvements. . . . If for the convenience of the moment something is taken from what may not improperly be called the current debt fund, and put into that which belongs to the mortgage creditors, it certainly is not inequitable for the court, when asked by the mortgagees to take possession of the future income and hold it for their benefit, to require as a condition of such an order that what is due from the earnings to the current debt shall be paid by the court from the future current receipts before anything derived from that source goes

a rule that a "floating lien" (which usually covers current assets) is subordinate to the claims of an unsecured creditor who completes legal process before the lien becomes "crystallized,"[94] while the Companies Act takes these cases a step further by specifying certain claims which are always superior to the floating lien.[95]

Some portions of article 9 may seem to say that lenders' counsel can forget both legal and practical worries about *Benedict*[96] and after-acquired property problems.[97] But all the provisions of article 9 must be read together. The long-term creditor may get little comfort from a security interest which, though "perfected," may be disregarded by a "buyer in the ordinary course of business" or become subordinated to the rights of another secured creditor. And the "buyer in the ordinary course of business" and the purchase-money lender are ubiquitous in inventory transactions. Further, the Code does not contain all of the law which must be considered in determining whether to use short term assets and earnings to secure long term debt.[98] These facts suggest that it may be well to examine briefly the practical difficulties involved in the use of current assets.

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to the mortgagees. In this way the court will only do what, if a receiver should not be appointed, the company ought itself to do. . . .

Although Mr. Justice Waite was speaking of an equity court's power in a receivership proceeding, the basic principle that current assets should remain available to satisfy current creditors applied a fortiori when such creditors sought satisfaction before a secured party had taken any steps to protect his interest. See Smith v. Eastern R.R., *supra* at 156.

Since the indentures in these cases covered "income," the courts were able to reach their results by construing the indenture to cover only what was left after expenses had been paid. A Code security interest covering "inventory" and "accounts receivable" could not be so easily upset by this method, but *query* as to whether the judicial policy evidenced by the cases may remain viable in spite of the Code. For an excellent treatment of this class of cases, see Israels & Kramer, *The Significance of the Income Clause in a Corporate Mortgage*, 30 COLUM. L. REV. 488 (1930).

94. See Evans v. Rival Granite Quarries, Ltd., [1910] 2 K.B. 979; text at notes 184-89 *infra*.

95. Companies Act, 1948, 11 & 12 Geo. 6, c. 28, § 319, lists the claims (for certain taxes and wages), while § 94 makes § 319 priorities applicable to any enforcement of floating liens.

96. See UCC § 9-205. *Query* as to the effect of UCC § 9-205 on cases such as *Smith* and *Gilman*, discussed in note 93 *supra*. *Smith* involved Massachusetts law and *Gilman* probably involved Iowa law. These cases were decided shortly after Judge Lowell's classic statement in Brett v. Carter, 4 Fed. Cas. 67 (No. 1844) (D. Mass. 1875), of the reasons that led Massachusetts and Iowa to reject the free-handed mortgage doctrine. *Smith, Gilman*, and other cases, however, construed the indenture as a whole, holding that the grant to the mortgagee of current assets was cut down by a later clause which gave the mortgagor the right to operate prior to default as though no mortgage had been granted, at least on current assets. Permission to operate was said to involve permission to incur operating expenses including tort claims (*Smith*) and telegraph fees (*Gilman*).

97. See UCC §§ 9-201, 9-204.

98. Compare note 93 *supra* and accompanying text.

Practical Difficulties

Even if applicable law permitted the creation of an airtight long term security interest which took priority over all other claims, practical considerations might militate against the use of such a device to cover current assets. For example, inventory is acquired only to be sold in its original form or converted into something else which will be sold. Commercial necessity would dictate that the "buyer in ordinary course of business" take free of all security interests in inventory created by the debtor even if the Code did not. The draftsman can and normally will provide that the security interest then flows over to the "identifiable proceeds"[99] of the inventory so sold. Thus, since most inventory will first be converted into accounts receivable, the secured party can retain a good security interest at that stage.[100] But if the proceeds of the accounts receivable were all applied to payment of long-term debt, with no mechanism for making new loans, the secured party might well find that his merchant or manufacturer debtor was out of business. If the debtor is to remain alive, the indenture must allow him to make use of the proceeds received from last week's accounts to pay for last week's purchases and this week's payroll.[101] The necessary liquidity of the debtor is achieved in short-term transactions by various types of revolving credit and collateral substitution mechanics which involve a degree of supervision and control incompatible with present practice in long-term financing. Thus, while proceeds must ordinarily be permitted to become unidentifiable[102] and to be disposed of in the course of business, the traditional indenture provides no mechanism which assures the indenture trustee that new collateral will equal the value of the old.

The bondholders must therefore continuously look to the good faith and economic ability of the debtor to replace the original inventory and accounts

99. See UCC § 9-306. If insolvency ensues, the secured party may be entitled to a limited priority under § 9-306 even as to non-identifiable proceeds but the indenture trustee cannot safely assume any recovery from this rather indefinite source.

100. It should not be too difficult to identify accounts which are "proceeds"; it is much more difficult to identify cash and bank accounts. *But see* note 102 *infra*.

101. In this respect, long- and short-term credit may not be as far apart as they seem to be. Although the short-term secured party almost invariably has the right to demand the cash proceeds of his collateral and to refuse to make any further loans, in practice this right is often illusory. The collateral will repay the loan only if sold in the ordinary course of the debtor's business, and the debtor will not be alive to sell the collateral in that manner if the secured party exercises his "rights" to pick up his money and make no more advances. The short-term creditor may in effect supply long-term capital, and when he does, he may be "frozen in" to nearly the same extent as the long-term creditor. But he has greater control over the situation. See generally Kripke, *Current Assets as a Source of Long-Term Capital*, 36 MINN. L. REV. 506 (1952).

102. This point is premised on the assumption that once accounts are turned into cash and the cash commingled in the debtor's bank account, the proceeds would become "unidentifiable." Arguably, a secured party holding a lien on all the debtor's fixed assets and all of his inventory and accounts could claim that any cash the debtor had was "identifiable proceeds" of the collateral.

receivable. And herein lies another practical difficulty. Since continual replacement of inventory is a necessity, the purchase-money priority given by the Code is so likely to become important that the quality of the trustee's security interest in current assets cannot be ranked as comparable to that obtained in the debtor's noncurrent assets. True, the priority of the purchase-money man does not flow over to accounts produced by the sale of the collateral.[103] Furthermore, before giving the debtor possession, the inventory purchase-money man must, at the risk of losing his special priority, give notice of his claim to anyone known to have a security interest in, and anyone who has filed with respect to, that class of collateral.[104]

Since the proposed Metal Products indenture makes the giving of a competing security interest in inventory an event of default, this provision could provide at least theoretical protection for the bondholders. But in times of trouble the debtor's suppliers are likely to refuse to sell to him except on a title-retained basis; the debtor then has the unpleasant choice of surely being put out of business if he cannot obtain necessary supplies or of creating a default which *might* (but probably will not) cause the trustee under the indenture to accelerate the long-term debt. The indenture draftsman must assume that he will acquire goods subject to a prior purchase-money interest.

In our hypothetical case, then, counsel would have to point out to the investment house that *so far as the Code alone is concerned* a long-term security interest in current assets would be good as to the portion represented by accounts, but that a first priority lien could be maintained on inventory only to the extent the debtor lived up to his contract obligations not to create or permit purchase money security interests in that collateral. The investment banker would then have to make a practical judgment as to the likelihood of the existence of a satisfactory quantity of accounts if trouble came. He would also have to judge whether the receipt of notice that inventory is about to be purchased subject to a security interest would enable him to protect his rights.[105]

In contrast to the ordinary bondholder and the indenture trustee who represents him, the professional lender who is willing and able to insist upon a high degree of control if necessary has a wide range of choice among various

103. The priority of §§ 9-312(3)-(4) relates to "the same collateral"; this apparently was meant *not* to include proceeds of that collateral. Under bankruptcy or other insolvency law the purchase-money man may be enjoined from repossessing the collateral furnished by him, but his security interest must be appropriately recognized. See UCC § 9-507, comment 1: As to priority when the goods are made part of other goods, see UCC §§ 9-314 to -315.

104. UCC § 9-312(3). No notice is required to maintain priority for a purchase-money interest in equipment. UCC § 9-312(4). This is not likely to cause the indenture trustee much trouble since at any given time the percentage of equipment subject to a purchase-money interest is likely to be small.

105. It is easy enough to draft an indenture, such as our hypothetical, which makes such an even an occasion of default, giving the trustee the right to accelerate the loan. In many cases, however, this "right" cannot practically be exercised.

security devices. In one case he may refuse to lend unless the inventory is deposited in a public warehouse; in another he will lend against inventory kept in a field warehouse; in another he will lend against the specific lien obtained through a trust receipt but not against the amorphous lien created under a factor's lien act.[106] Further, the professional lender is prepared to exercise his control by deciding when to release proceeds of his collateral, or even to make new loans, to enable the debtor to pay other obligations clearly junior to his own but which as a practical matter must be paid to safeguard the secured lender's interest. The indenture trustee has no comparable leeway.

The short-term lender's judgment as to the degree of control required as to different borrowers—or from time to time as to the same borrower—is dictated by the "credit risk" involved—a shorthand expression for the lending officer's judgment of the personal integrity and business ability of those in control of the borrower, the nature and value of the collateral and the borrower's other assets, the amount and kind of other obligations of the borrower, and its past and prospective earnings. The loan officer of a bank or finance company might be persuaded to enter into an agreement which gave the debtor complete freedom to deal with the collateral subject only to such minimal controls as a duty to report quarterly that he has honored his covenant to maintain a prescribed amount of collateral free from competing security interests, but he is likely to do so only with a debtor of fairly good credit standing—perhaps one who almost justifies an unsecured line of credit. And since the term of his credit is short, he ordinarily will be in a position to shut off future advances as soon as he receives notice that inventory has been purchased subject to a purchase money security interest in favor of another, whereas the indenture trustee could only accelerate the maturity of an existing debt. Moreover, only when the borrower is subject to the continued surveillance customarily given the affairs of even reasonably high credit borrowers (whether secured or not) by short-term lenders would violations of a security agreement by the debtor be discouraged, or brought to light shortly after they occur. If the surveillance is to be perfunctory and the credit long-term, any lender relying on inventory and accounts as basic security must face the fact that his security interest in those assets is not as good as that to which he has been accustomed when loaning against assets conventionally covered by a long-term indenture, or that which the active and careful short-term secured lender can acquire with comparative ease in a state where the Code is in effect or in one with a reasonably adequate law governing chattel security.

106. In many states a security interest in inventory may be created under either UTRA or a factor's lien act. In many cases the latter is the more convenient mechanically, but UTRA is far more popular with financers. In Massachusetts, for example, there were 3208 filings under the UTRA, and less than 100 under the factor's lien act, between October 1, 1957, and September 30, 1958, the last year before the Code became effective. Financers who were consulted seemed to express an almost instinctive preference for the far more specific lien afforded by UTRA, and its advantages as a purchase-money interest.

Since long-term credit of any kind is likely to be extended only to borrowers with fairly good credit standing, the investment banker may nonetheless be willing to increase the amount of credit extended if current assets are included under a long term indenture. But before arriving at a final answer various non-Code legal problems must be explored more fully.

Impact of Non-Code Law on the Quality of Code Security Interests

While the Code replaces much of the debtor-creditor law of the adopting state, it does not replace it all.[107] Clearly, article 9 does not replace the Uniform Fraudulent Conveyance Act. It does negative that part of fraudulent conveyance law (if such it is) which is represented by *Benedict v. Ratner*,[108] and that part dealing generally with ostensible ownership,[109] but whether there are other fragments of fraudulent conveyance law still viable will depend upon the particular state. If a security interest is vulnerable to a single unsecured creditor, no matter how small his claim, the debtor's trustee in bankruptcy can set aside the transaction for the benefit of all the debtor's creditors.[110] And even if no individual creditor can set aside the security interest, the trustee may be able to do so if the transfer was made, or is deemed to have been made, within four months of bankruptcy and was for an antecedent debt.[111] Furthermore, the degree to which a security interest is vulnerable to attack by other creditors may affect its vulnerability under the "federal priority" given by section 3466 of the Revised Statutes or as against a state or federal tax lien.[112] It is first necessary to determine, however, the extent to which article 9 governs the relations between the secured party, the debtor, those who buy from him and his other secured and unsecured creditors.

The Code's priority rules apply to many possible conflicts between persons claiming a security interest in the same collateral.[113] But non-Code law may

107. See UCC §§ 1-103, 9-201, 9-203.

108. See text at note 18 *supra*; notes 88 *supra*, 126 *infra*.

109. See text at notes 122-25 *infra*.

110. Moore v. Bay, 284 U.S. 4 (1931). If Constance v. Harvey, 215 F.2d 571 (2d Cir. 1954), represents the law, the trustee can also step into the shoes of a hypothetical creditor who might have existed on the date of bankruptcy.

111. Bankruptcy Act § 60, 52 Stat. 869 (1938), as amended, 11 U.S.C. § 96 (1958). [Hereinafter cited as Bankruptcy Act. Sections of the act will be cited as they appear in BANKRUPTCY ACT (Collier pamphlet ed. 1959). The corresponding United States Code section numbers may be ascertained by adding 36 to § 60, 40 to §§ 64, 67 and 70, and 400 to § 199. Sections 60, 64, 67, 70 and 199 are the only ones cited in this Article.]

112. See text at notes 159-67 *infra*. For an excellent discussion of these problems, see A.B.A. COMM. ON FEDERAL LIENS, FINAL REPORT (1959), presented to A.B.A. House of Delegates on February 23, 1959.

113. UCC § 9-312 sets out rather elaborate priority rules to determine which of several security interests created under the Code are junior and which are senior. Section 9-311 recognizes the possibility that an attaching creditor may acquire rights in the collateral, but to the extent the security interest is at the time perfected, the attaching creditor is of course junior thereto. Section 9-310 makes certain statutory possessory liens superior to interests created under the Code. And §§ 9-307 and 9-301 set out the

also play a part in determining the rights as between the secured party and others. Section 1-103, which relates to the Code as a whole, provides that, "unless displaced by particular provisions of the Code, the principles of law and equity, including . . . the law relative to capacity to contract, . . . fraud . . . bankruptcy or other validating or invalidating cause shall supplement its provisions."

To make more clear the general intent of the Code's draftsmen to validate article 9 security interests, section 9-201 was revised in 1956 to read as follows:

> Except as otherwise provided by this Act [or by other rule of law or regulation,] a security agreement is effective according to its terms between the parties, against purchasers of the collateral and against creditors. Nothing in this Article validates any charge or practice illegal under any [rule of law] *statute* or regulation *thereunder* governing usury, small loans, retail installment sales, or the like, or extends the application of any such *statute* [rule of law] or regulation to any transaction not otherwise subject thereto.[114]

The phrase "or by other rule of law or regulation" was taken out for fear that it invited courts to look back to bodies of law inconsistent with the philosophy of the Code. But even as amended, 9-201 does not say that article 9 is entirely self-contained, for "except as otherwise provided by this Act," appears to include 1-103's reference to certain non-Code law. Section 9-201, as its title indicates, creates a presumption of validity, and represents a reversal of some of the older chattel security laws which began from the opposite approach.[115] But it probably goes little further than to state this general principle.[116]

The principal question then becomes one of determining how much of the statutory and common law relating to "fraud," "fraudulent conveyances" or "other invalidating cause" is "displaced" by article 9 and the extent to which results under the Bankruptcy Act are affected. Counsel for the lender will

rights of certain buyers. See also §§ 9-308 (priority of purchaser of chattel paper or nonnegotiable instrument) and 9-309 (protection of purchasers of instruments and documents).

114. The words deleted are bracketed, the additions italicized. For original text, see UCC § 9-201 (1952).

115. *Compare* UCC § 9-201 *with, e.g.*, Missouri Chattel Mortgage Act, Mo. ANN. STAT. § 443.460 (1952), *and* English Bills of Sale Act, 1878, 41 & 42 Vict. c. 31, as amended, Amendment Act, 1882, 45 & 46 Vict. c. 43. For legislative background on the English acts, particularly that of 1882, see WALDOCK, MORTGAGES 78 (2d ed. 1950).

116. For one thing, UCC § 9-201 speaks in terms of the validity of a security *agreement*; the attaching creditor may admit that the agreement is valid but still challenge the validity of a particular security *interest* created thereunder—*e.g.* a security interest in a truck may be valid to the extent of any advance made prior to the time a man injured by the truck gets a lien thereon, but may not be valid as a security interest for an advance made thereafter, even though made under the original agreement. See Coogan, *supra* note 79, at 872-73. But nevertheless the positive statement in § 9-201 should be given considerable weight.

think first of testing his interest against the power of a bankruptcy trustee to disregard it, but since many of the trustee's powers are derived from the real or hypothetical creditors he represents, it will be helpful to discuss first the power of any individual creditor to upset any part of the security transaction.

Attack on a Transaction as Fraudulent

"Fraud" in secured transactions is a slippery concept. Elements of misconduct or intent to deceive need not be present.[117] As Judge Learned Hand put it, "whatever trenches upon the creditors' remedies by means which the law forbids is a fraud upon them."[118] Some, but not all,[119] of the "means which the law forbids" are embodied in the Uniform Fraudulent Conveyance Act.[120] Under that act an individual creditor may avoid a transaction either because it was made with an actual intent to hinder, defraud, or delay other creditors, or because it is one of a class of transactions condemned without regard to intent because the legislature considers that such transactions are too likely to treat other creditors unfairly. Various other statutes establish rules in particular areas—for example, a state's corporation law may make a transfer by a corporation for an antecedent debt "fraudulent" (and therefore voidable) if made to a chief stockholder under circumstances in which no fraud would be involved if the transaction had been with a stranger.[121]

"Fraud" and "fraudulent" are terms used by the courts (and sometimes the legislatures) to cover not only "means which the law forbids" but also failure to comply with details prescribed by statute or case law. Many cases say that a purported security agreement is void because it is "fraudulent" when it would have been just as easy to have said that the security interest was ineffective because the statutory prerequisites for the creation of an effective

117. The word fraud as used here should be distinguished from trickery between the parties—for example, the creditor who induces the debtor to sign a "receipt" which is really a security agreement—or even trickery by the parties which would affect other creditors. See United States v. Conyngham, 25 Fed. Cas. 599, 600 (No. 14850) (C.C.D. Pa. 1801), where the court observed, "When I use the word fraud it is understood that no actual misconduct or immorality is ascribed . . . [to the secured parties] who are gentlemen of fair character, and have acted in this business, in all probability, solely from principles of friendship and humanity."

118. Irving Trust Co. v. Finance Serv. Co., 63 F.2d 694, 695-96 (2d Cir. 1933).

119. Even where the UNIFORM FRAUDULENT CONVEYANCE ACT [hereinafter cited as UFCA] is in effect, the state's case law may define other "means which the law forbids," *e.g.*, allowing the debtor to exercise "unfettered dominion" over the collateral. See notes 88-89 *supra* and accompanying text; note 126 *infra* and accompanying text.

120. For a complete discussion of this act, see generally GLENN, FRAUDULENT CONVEYANCES AND PREFERENCES ch. V(A) (1940); MacLaughlin, *Application of the Uniform Fraudulent Conveyance Act*, 46 HARV. L. REV. 404 (1933). While the Uniform Act has been enacted in less than half of the states, its provisions must be kept in mind in every security transaction because an abbreviated form of the act is contained in Bankruptcy Act § 67d.

121. See generally MACLACHLAN, BANKRUPTCY § 242 (1956), and cases cited therein.

security interest had not been met. These cases state that the real or supposed evils of "ostensible ownership" and "fraudulent retention of possession" can be avoided only by following whatever mechanism state law prescribes, and hold, for example, that continued possession of the collateral by the debtor is a fraud upon other creditors if the parties fail to give the requisite public notice of the transaction or give it too late, thus allowing other persons to be misled by the debtor's ostensible ownership of the collateral;[122] or that fraud occurs if the parties fail to comply with some technical legal requirement once thought effective in preventing fraud, such as attaching an affidavit of good faith or executing an acknowledgment in a prescribed form.[123]

If a transaction involves an actual intent to defraud, or if it is condemned without regard to intent by the Uniform Fraudulent Conveyance Act, section 67d of the Bankruptcy Act, or some other statute, non-Code law and not the Code will control.[124] But such transactions seldom bother the corporate drafts-

122. In Karst v. Gane, 136 N.Y. 316, 324, 32 N.E. 1073, 1075 (1893), the court said, "The filing stands as a substitute for immediate delivery . . . and avoids the conclusive presumption of fraud which would otherwise attach to the instrument under the Act of 1833 . . . ." See generally HANNA & MACLACHLAN, CASES ON CREDITORS RIGHTS 144-47, 158-62 (5th ed. 1957).

123. In Rhode Island Hosp. Nat'l Bank v. Larson, 137 Conn. 541, 79 A.2d 182 (1951), the "fraud" consisted of failure to insert the date of the month upon which payments were due and failure to state that the one who acknowledged the instrument did so as president of the corporation on whose behalf he signed the instrument. In Amberson Inv. Corp. v. Fitzgerald, 266 F.2d 767 (10th Cir. 1959), the Colorado chattel mortgage statute was construed to require implicitly that the mortgage give the maturity date, and a chattel mortgage was invalidated for failure to give that date.

124. It is unlikely that the UFCA, and its counterpart, Bankruptcy Act § 67d, could ever upset a Code security interest created under a typical indenture. UFCA § 9(2) provides that a "purchaser" who "without actual fraudulent intent" gives less than a fair consideration for the assets transferred to him "may retain the property . . . as security for repayment." "Purchaser" probably includes a lienor. The corresponding language in Bankruptcy Act § 67d(6) is different, including a lienor as well as a bona fide purchaser. Full protection is provided only to a lienor who has given a "present fair equivalent value." A creditor who obtains a security interest in all of the debtor's assets to secure an antecedent debt "disproportionately small in amount is compared with the property . . . transferred" might anticipate an attack under § 67d(1)(e) notwithstanding § 67d(6). Once the party attacking a transfer under UFCA or § 67d establishes that it is vulnerable because made under appropriate circumstances for less than fair consideration, the burden of proof of "lack of fraudulent intent" is on the party seeking to reestablish his lien. 4 COLLIER, BANKRUPTCY § 67.43, at 452 & n.6 (14th ed. 1942) (collecting cases). In *In re* Peoria Braumeister Co., 138 F.2d 520 (7th Cir. 1943), a transfer of a note and chattel mortgage for $3000 to secure a $2500 advance was held fraudulent under § 67d, but the secured party was allowed a lien for the advance less payments plus interest. In that case, the trial court had made no finding of fraudulent intent. Nevertheless, a reading of the cases where trial court findings of fraudulent intent have been upheld seems to indicate that the type of parties who fail to reinstate their liens under § 67d(6) are scarcely to be classed as legitimate businessmen engaged in arm's length secured financing. See Chorost v. Grand Rapids Factory Show Rooms, 172 F.2d 327 (3d Cir. 1949) (transfer to corporation organized by bankrupt's controlling stockholder and controlled by members of his family; fraud inferred from circumstantial evidence); *cf.* McWilliams v. Edmonson,

man; he is more troubled by questions of constructive fraud, including particularly those associated with unfettered dominion and ostensible ownership.

Curiously enough, the Uniform Fraudulent Conveyance Act made no attempt to cover the rather large area of fraudulent conveyance law variously designated by the terms "ostensible ownership" and "fraudulent retention of possession."[125] It was construed not to affect the law of "unfettered dominion."[126] The Code, on the contrary, would appear to replace completely the state's case law as to unfettered dominion and ostensible ownership so far as secured transactions are concerned.

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162 F.2d 454 (5th Cir. 1947) (transfer to sister-in-law of bankrupt in suspicious circumstances; trial court finding of no fraud reversed). But the draftsman of a corporate indenture—or, indeed, any other security agreement—will do well to avoid transactions which involve even the remotest possibility that the lender will be put in a position where he will have to prove lack of "actual fraudulent intent" or that his security interest was given for "a present fair equivalent value." UCC §§ 1-201(37), 9-311 make it clear that the "security interest" must be measured by the outstanding obligations and that the debtor's equity is available to creditors; nevertheless, a court may be impressed with the practical difference in the unsecured creditor's position depending on whether he can realize on unencumbered assets or must realize on the equity in the same assets behind a prior security interest.

125. See MacLachlan, Bankruptcy 255 n.7 (1956).

126. See Lee v. State Bank & Trust Co., 54 F.2d 518 (2d Cir. 1931) (*Benedict v. Ratner* not overruled by UFCA).

There is some difference in the cases as to where *Benedict* fits into the law of fraud. It is clear that it is not based on ostensible ownership. 268 U.S. at 363. *But cf. In re* New York, N.H. & H.R.R., 25 F. Supp. 874 (D. Conn. 1938) (*Benedict* distinguished in part as "secret lien" case). The *Lee* court may seem to be saying that *Benedict* is not based on fraud at all but upon some "other invalidating cause" left intact by the passage of UFCA. This is in line with the court's prior statement in Brown v. Leo, 12 F.2d 350, 351 (2d Cir. 1926), that the doctrine "can rest only upon some supposed conceptual repugnancy between the mortgage and the reserved power, quite regardless of any evils which may result from their coupling." Asked in Irving Trust Co. v. Finance Serv. Co., 63 F.2d 694 (2d Cir. 1933), to reverse its holding in *Lee*, the court adhered to its previous ruling that the enactment of the UFCA did not upset the dominion doctrine but talked in terms of the kinds of fraud which were and those which were not changed by UFCA. The court expressed its continued puzzlement as to the basis of the *Benedict* doctrine. *Id.* at 695.

While Brandeis in *Benedict* uses language which indicates that not enough was done to create a transfer, the element of fraud was clearly in his mind. Thus he says of the doctrine, "It does not raise a presumption of fraud. It imputes fraud conclusively because of the reservation of dominion inconsistent with the effective disposition of title and creation of a lien." 268 U.S. at 363.

If the *Benedict* doctrine means only that the parties have not done enough to constitute a transfer, it would seem that Brown v. Leo, *supra* (discussed in note 72 *supra*), is clearly wrong; if no element of fraud is involved, the failure to perform a necessary step would be akin to the failure to file as a chattel mortgage a single instrument covering both chattels and realty which would result in loss of lien only as to the chattels, provided the real estate mortgage was properly filed. *Brown v. Leo* may also be wrong if the fraud is viewed as constructive rather than actual. *In re* Hanover Milling Co., 31 F.2d 442 (D. Minn. 1929); Stockmen's Nat'l Bank v. Lukis Candy Co., 47 Wyo. 127, 33 P.2d 254 (1934).

The requirement for public notice is extended by the Code to practically every kind of security transaction (including assignments of contract rights and other intangibles) where the debtor is a business entity.[127] While extending the requirement of public notice to new fields, the Code goes in the opposite direction by generally simplifying methods of giving public notice, severely cutting down,[128] if not eliminating entirely, the "unfettered dominion" doctrine and eliminating entirely any requirement for taking certain steps which are no longer considered useful in preventing fraud—for example, the use of a prescribed form of agreement,[129] the attachment of acknowledgments, affidavits, statements of good faith and the like.

Nevertheless, there may be fragments of the law of "fraud" or "fraudulent conveyance" not involving dominion or ostensible ownership, not set forth in statute, not contained in the Code and not displaced expressly or by implication by the Code. Where the Uniform Fraudulent Conveyance Act is in effect such remmants would seem to be rare, if indeed they exist at all. Where the act is not in force, the state's common law of fraudulent conveyances is probably in force except where specifically displaced by the Code. The draftsman should therefore not come too quickly to the conclusion that the Code solves all of his problems coming under the comprehensive heading of fraud. This is particularly true when dealing with inventory, because of the long history of judicial distaste for security interests in that kind of collateral.[130] And, even if a careful search of applicable state law assures the draftsman that he has created a security interest safe from the inroads of unsecured creditors, he must now apply the more severe test of whether the security interest is vulnerable to attack by the debtor's trustee in bankruptcy.

127. Under UCC § 9-302, public notice is excused as to a purchase-money security interest in goods purchased for personal, family or household use and certain lower priced farm equipment; under UCC § 9-304 certain business transactions may be perfected temporarily (not more than 21 days) and for somewhat limited purposes without filing. Neither exception is likely to be important in long term finance.

128. As pointed out elsewhere, there is still a practical difference between the protection secured where the creditor does or does not give the debtor complete control over the collateral. See notes 99-102 *supra* and accompanying text. And it is not impossible that such complete dominion *coupled with other circumstances* might be evidence of actual intent to hinder, delay and defraud creditors under UFCA. Even the courts which most vigorously rejected the freehanded mortgage doctrine admitted that full dominion in the debtor could be evidence of fraud in fact. See, *e.g.*, Hughes v. Cory, 20 Iowa 399, 403 (1866); Briggs v. Parkman, 43 Mass. (2 Met.) 258, 263 (1841).

129. In a few cases, some other body of law not repealed by the Code may require use of certain forms—*e.g.*, a regulatory statute applying to automobile sales or consumer goods. See, *e.g.*, MASS. ANN. LAWS ch. 255, § 12 (Supp. 1958).

130. It would seem, however, that the policy behind judicial hostility toward inventory liens—*i.e.*, maintaining a pool of assets for unsecured creditors—has been largely reversed by the multitude of legislative enactments permitting the general use of inventory and accounts as security for loans through use of the trust receipt, factors' liens and assignments of accounts receivable. Further, as a practical matter UCC § 9-306 makes "unidentifiable proceeds" available to unsecured creditors and § 9-311 makes the debtor's equity likewise available.

Status of Code-Created Security Interests Under the Bankruptcy Act

The draftsman of our hypothetical indenture cannot overlook the possibility that Metal Products might become a bankrupt sometime during the fifteen years the indenture is to be outstanding.[131] He must, therefore, determine at the outset how the security interest will be treated in bankruptcy. To do this, he will assume the worst at every uncertain point. In particular, he will assume that the trustee in bankruptcy or his counsel will be experienced, resourceful and probably better versed that the bondholder's counsel in the Bankruptcy Act, the cases decided under it, and particularly in local bankruptcy practice. Further, he must assume that the claims of those who have more recently supplied the debtor with goods and services may have a stronger emotional appeal to the court than the claims which arose years ago in favor of the bondholders. For purposes of this discussion, let us assume that the bankruptcy of Metal Products occurs four years after the indenture is signed and the notice is filed.

Since a transaction valid under one section of the Bankruptcy Act may be vulnerable under another,[132] the trustee will test each suspicious looking transfer under sections 60, 67 and 70 (particularly 70c and 70e). Under sections 67d, 70c and 70e, a voluntary conveyance may be upset only if there is some tinge of fraud, although, as pointed out in the preceding section, that tinge may consist merely of a failure to give public notice in the prescribed manner and time, or in non-Code states, to perform some other technical act required.

131. In a transaction involving the family washing machine or like goods, the creditor may deliberately choose to take his chances on losing the collateral to a buyer from or an attaching creditor of the debtor, as long as he can use the threat of repossession under the security agreement as a means of collecting his debt. In some short-term business transactions bankruptcy seems so improbable that the creditor may be satisfied if his remedies are adequate to prevent other individual creditors from defeating his security interest. But if security is needed at all in a long-term credit, the possibility of bankruptcy cannot be disregarded. On the status of Code security interests in bankruptcy, see generally Comment, *The Commercial Code and the Bankruptcy Act: Potential Conflicts*, 53 Nw. U.L. Rev. 411 (1958).

132. For example, in Constance v. Harvey, 215 F.2d 571 (2d Cir.), *cert. denied*, 348 U.S. 913 (1954), the chattel mortgage was filed late, but still filed more than four months before bankruptcy, and hence could not be avoided as a preference under Bankruptcy Act § 60. Under New York law, a chattel mortgage not filed within a reasonable time may be filed later, becoming valid as against those who became creditors prior to its execution and after its filing, but not as against those who become creditors between the date of execution and the date of filing (a "gap creditor"). Under § 70e the trustee can step into the shoes of any such actual creditor to avoid the transaction. In *Constance* there apparently was no such actual creditor, hence 70e was not usable. But the court held that under § 70c, if on the date of bankruptcy there *could have been* a creditor who could have attached the collateral, the trustee could step into his hypothetical shoes and invalidate the lien. Although the peculiarities of local law which gave rise to *Constance* and to Moore v. Bay, 284 U.S. 4 (1931), have been eliminated by the Code, the doctrines of these two cases cannot be overlooked. Note that the trustee's status as a lien creditor under 70c may enable him to attack some transaction which under UCC § 9-301 is subject to attack by a lien creditor but not by an unsecured creditor.

While the Bankruptcy Act to some extent regulates creditors' rights directly (as under section 67d), the trustee's rights under sections 67 and 70 are derived primarily through those given a real or hypothetical third party creditor by applicable state law.[133] Therefore, generally speaking, the Code affects the trustee's rights in the same way as it affects individual creditors' rights. The secured party's position will be improved by the Code's repeal of the dominion rule even in states where it is not clear that the rule ever applied. Although some security transactions which, under pre-Code law were perfected without filing, will, after adoption of the Code, be vulnerable under sections 70c or 70e (as well as under 60) if not filed, the secured party's position will in general be improved by the elimination of over-technical requirements as to the time and manner of filing or recording.[134]

Section 60—Preferences

Under section 60 the trustee may upset a transaction which conforms completely to state law and has not even a tinge of fraud if (i) it was made to secure an antecedent debt in favor of a creditor who knew the debtor was insolvent at the time of the transfer, (ii) the transfer enabled that creditor to obtain a greater share of the debtor's assets than he would have gotten in bankruptcy and (iii) the transfer was "made or suffered" or is "deemed" to have been made or suffered within four months of bankruptcy, a time which the Bankruptcy Act arbitrarily says is too close to the time of trouble for the transfer, even though completely honest, to be given effect against other creditors.

Our draftsman will anticipate no serious preference problems as to any part of Metal Products' noncurrent assets. Much of the original equipment covered by the indenture will still be on hand. No great portion is likely to have been added within the four months period, and any new equipment is likely to be

133. Particularly where multistate transactions are concerned, it is sometimes almost physically impossible to make all the filings in such a way that no creditor can acquire rights which may be used by the debtor's trustee in bankruptcy to upset the mortgage as to goods in the applicable state. Sometimes filing in advance of the passage of consideration is made impossible by state requirements, while any delay in filing after the execution of the mortgage raises the possibility of a "gap creditor." The trustee in bankruptcy succeeds to such a creditor's rights and can defeat the secured transaction. See, *e.g.*, Mercantile Trust Co. v. Kahn, 203 F.2d 449 (8th Cir. 1953) (recording delayed over weekend; actual gap creditor). See also Constance v. Harvey, *supra* note 132 (hypothetical gap creditor).

134. So far as personal property and fixtures are concerned, it is clear that an indenture may be filed before it is executed. The bondholders are protected immediately against other secured parties who perfect through later filing, but not necessarily against creditors who attach or perfect liens through methods other than filing before the security interest has actually been created by execution of the indenture and the making of the advance or a commitment therefor. See Coogan, *Article 9 of the Uniform Commercial Code: Priorities Among Secured Creditors and the "Floating Lien,"* 72 HARV. L. REV. 838, 857-61, 866-68; *cf. id.* at 872-73.

a replacement for old equipment contemporaneously released from the indenture.[135] Nor need the draftsman be particularly concerned about his interest in the long-term natural gas contract. Under the rule of *Rockmore v. Lehman*[136] the "transfer" will be held to have been "made" not when individual segments of Metal Products' rights matured within the four months period but rather at the time the rights under the existing contract were originally assigned,[137] which in our case was contemporaneous with the time the advance was made.

Current Assets. As to current assets, the draftsman will be less confident. As previously pointed out, much (and possibly all) of the inventory on hand at the time of bankruptcy will have been acquired within the previous four months. Furthermore, the debtor may have acquired much of it subject to purchase-money security interests, which are senior to the indenture lien, notwithstanding the debtor's promise not to create or suffer to exist any such interest.[138] The draftsman must assume that at the time of bankruptcy various suppliers will be able to repossess their inventory[139] or take other steps which will make part of the inventory unavailable to the bondholders. But even if at the time of trouble a substantial portion of the debtor's inventory was acquired on open credit and is available to the bondholders by the terms of the Code, the indenture draftsman must nevertheless anticipate a struggle for the inventory with the debtor's trustee in bankruptcy, at least until a bankruptcy court of standing passes on the status in bankruptcy proceedings of shipments of inventory placed under the mortgage during the preceding four months.

But while a preference contest with the trustee in bankruptcy should be anticipated, the bondholders should win if their counsel can convince the court of any one of three propositions: (i) this is just not the kind of situation at which section 60 is aimed; or (ii) the entity theory approved in *Rockmore v. Lehman* should apply to inventory in this case; or (iii) in section 9-108

135. Substitution of collateral does not constitute a preference. The cases are numerous. See, *e.g.*, *In re* Pusey, Maynes, Breish Co., 122 F.2d 606 (3d Cir. 1941). If the value of the new collateral exceeds that of the old, there may be a preference to that extent.

136. 129 F.2d 892 (2d Cir. 1942), *cert. denied*, 317 U.S. 700 (1943), *reversing* 128 F.2d 564 (2d Cir. 1942).

137. City of New York v. Bedford Bar & Grill, 2 N.Y.2d 429, 141 N.E.2d 575, 161 N.Y.S.2d 67 (1957), may appear to be contra; but in that case, no contract right existed at the time the assignment was made. Thus the requirement of an independent intervening act to perfect an interest in after-acquired property may have been relevant. Moreover, the case involved the assignment of a claim against the state, bringing into play the right of the sovereign to insist that a claim against it be enforced only through strict compliance with statutory procedures. For another case involving the assignment of intangibles in New York, see Matter of Gruner, 295 N.Y. 510, 68 N.E.2d 514 (1946), *modified on remand*, 4 Misc. 2d 471, 74 N.Y.S.2d 38 (Surr. Ct. 1947).

138. UCC §§ 9-312(3), 9-311.

139. See note 103 *supra*. As to when repossession is permitted, *compare In re* Lake's Laundry, Inc., 79 F.2d 326 (2d Cir. 1935), *with In re* White Plains Ice Serv., Inc., 109 F.2d 913, 915 (2d Cir. 1940) (concurring opinion of Clark, J.).

of the Code state law says that the transfer here is not for an antecedent debt, and this is a situation in which state law controls, even in proceedings under the Bankruptcy Act. Each of these arguments will be examined in turn; then the position likely to be taken by the bankruptcy trustee will be taken up.

A very persuasive argument can be made by the bondholders' counsel that apart from the help obtained from the entity theory and from section 9-108 a transfer of new collateral within limits set by 9-108 is not one of the evils which section 60 is intended to remedy. The typical transaction at which section 60 is aimed is one in which a creditor provides money or goods on an unsecured basis and then after trouble seems imminent, jumps in to secure himself with assets which up until that moment had been available to all creditors. Prior to 1938 such a creditor sometimes accomplished his objective by taking a security interest prior to the beginning of the four months period which he failed to record or file until sometime within the four months period, then claiming (often successfully) that the perfection related back to the time of the transfer.[140] The evil here, of course, was that other creditors were deprived of property they had a right to count on in the absence of the notice required by state law. This is not the situation with respect to our hypothetical bondholders. They agreed to lend their money only upon a secured basis from the beginning and they and the debtor gave notice to this effect four years earlier at the time the advance was made. The Code's after-acquired property clause picked up the debtor's equity in each batch of new collateral at the moment it was acquired, leaving no moment of time during which this collateral could have been subjected to an attachment prior to the security interest of the bondholders. Where the parties have taken every action which could be taken to create a legal lien at the earliest possible time it could be created, section 60a(6) by negative implication says that no preference is created.[141] Not only will the bondholders not obtain additional security during the four months period, but they are almost sure to have lost severely to suppliers who will have refused to continue to ship goods except subject to a purchase money interest which is prior to that created by the indenture. Conversely, the unsecured creditors will probably have been helped by receipt of the cash ultimately received from the sale of inventory once subject to the indenture. Furthermore, a secured party willing and able to exercise the necessary control could have eliminated any preference question by requiring the debtor to substitute new inventory contemporaneously with the release of

140. The classic "relation back" cases include Humphrey v. Tatman, 198 U.S. 91 (1905), *reversing* 184 Mass. 361 (1903); Thompson v. Fairbanks, 196 U.S. 516 (1905).

141. Perhaps the elimination of the need for an independent intervening act in itself eliminates the preference problem. See 2 GLENN, FRAUDULENT CONVEYANCES & PREFERENCES § 576 (rev. ed. 1940), suggesting that where state law validates the lien of the mortgagee under an after-acquired property clause without the necessity for an independent intervening act, "[§ 60] . . . makes no change." But the Code concept that a security interest cannot be perfected until the debtor acquires rights in the collateral must be considered. See text accompanying note 154 *infra*.

the proceeds of old inventory and accounts receivable.[142] To strike down the lien here as a section 60 preference would be to impose a penalty on the indenture trustee for his failure to police his collateral, although in section 9-205 of the Code, state law expressly says that lack of policing does not invalidate the lien.[143]

Further, section 60 recognizes that not every transaction where the giving of security and the giving of value are not strictly contemporaneous has the seeds of a voidable preference. Section 60c allows a creditor who has been preferred to set off any new credit he has extended in good faith without security. And the last sentence of 60a(8) explicitly recognizes that there may be a valid transfer in which the making of the advance and the giving of security are not contemporaneous, providing that "A transfer to secure a future loan . . . shall have the same effect as a transfer for . . . a new and contemporaneous consideration." When the indenture trustee permits proceeds from past security to be released to the debtor, he is accomplishing the same result as the preferred creditor who extends new credit.

A Preference Problem Under a Factors' Lien Act. The second line of defense of the bondholders' counsel is that inventory should be treated as an entity which was transferred four years ago. Over fifty years ago Williston remarked:

> To the mind of the layman, a stock in trade has a continuous existence as an entity regardless of the articles which compose it. This idea . . . rests on a sound basis, and a desirable result [on the use of inventory as a basis of secured credit] cannot be reached without it.[144]

In connection with this concept, it may first be helpful to examine an analysis made by a former colleague of Williston, Judge Magruder, of the preference problem in a case involving the New Hampshire Factors' Lien Act which, like the Code, permits after-acquired property to be picked up without any further act and dispenses with the requirement of accountability.[145] The actual holding of the case is not in point. What is important is that in reaching the conclusion that an assignment of future accounts receivable could not be perfected under that act, the court assumed that a continuing general lien on merchandise would be good. The reasoning is interesting:

142. No preference arises where one form of collateral is contemporaneously substituted for another. See note 135 *supra.* See BIRNBAUM, SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE §§ 104, 105 (1954), where a form is suggested. But even a form as simple as the one Birnbaum suggests requires more supervision of the debtor's day to day business than our hypothetical indenture contemplates.

143. The freehanded mortgage doctrine is one of state law. See Benedict v. Ratner, 268 U.S. 353, 359 (1925); note 88 *supra.*

144. Williston, *Transfers of After-Acquired Property,* 19 HARV. L. REV. 557, 581 (1906).

145. Manchester Nat'l Bank v. Roche, 186 F.2d 827 (1st Cir. 1951), construing N.H. Laws 1943, ch. 161, as amended, N.H. Laws 1949, ch. 156. The legislature again amended the Act in 1951, N.H. Laws 1951, ch. 218, to permit an assignment of accounts to arise in the future. In its present form the act is N.H. REV. STAT. ANN. §§ 446:1-10 (1955).

> In other words, the *res* which is the subject of the lien . . . is the . . . stock in trade, conceived of as a unit presently and continuously in existence—a "floating mass", the component parts of which may be constantly changing without affecting the identity of the *res*. . . . So conceived it is not inconsistent with the existence of the lien or floating charge on the inventory, as it may be made up at any particular time, that the borrower is free to withdraw an item from stock for sale in the regular course of business, without any obligation to account to the lienholder for the proceeds.[146]

Judge Magruder went on to say that the legislature might have applied the same concept to permit the creation of a valid lien on after-acquired accounts, but had not done so. Although apparently willing to accept a blanket lien on a shifting mass of accounts, he argued that to view the transaction as involving an automatic accrual of a lien on each account as it came into existence would create a preference problem.[147] The language of the New Hampshire Act which he felt avoided this problem states that the "lien shall be valid from the time of filing the notice . . . whether such merchandise be in existence at that time . . . or shall come into existence subsequently . . . ."[148] This is reinforced by what is now section 4 of the Act which provides that "such notice . . . shall be effectual from the time of the recording thereof as against all creditors of the borrower . . . ."[149]

This statutory language seems awkward but practically it may make sense as to the only kinds of collateral that may be covered by a factors' lien act. That act, of course, conceives of the "collateral" as *the inventory*, and not the individual shipments which make it up at any given moment. Magruder's rationalization of the intent of the New Hampshire statute is certainly permissible. It is arguable, though not entirely clear, that this reasoning can be applied directly to a security interest in inventory under the Code without help from section 9-108.

Section 9-204(1) states that "a security interest cannot attach until . . . the debtor has rights in the collateral." Under section 9-303 "a security interest is perfected when it has attached and when all of the applicable steps required for perfection have taken place." Obviously the security interest cannot be perfected until the debtor has rights in the collateral and it would seem that no "transfer" could take place before that time. This raises the question as to what is meant by "the collateral" as that term is used in 9-204(1). Section 9-204 (2)(c) seems to adopt the view of *Rockmore v. Lehman*—all of the contract rights, whenever maturing, can be transferred when the contract is made—*i.e.*, all contract rights are taken as an entity. If the same view applies as to "the inventory" the analogy to the New Hampshire act is complete. But the Code gives a special rule only when the inventory consists of fish, oil, gas,

146. 186 F.2d at 831.

147. *Id.* at 829-30 n.3.

148. N.H. Rev. Stat. Ann. § 446:2 (1955) (formerly § 446:1).

149. N.H. Rev. Stat. Ann. § 446:4 (1955) (formerly § 446:3).

minerals and timber. For some purposes, "the collateral" means only a specific bit of collateral, but under our assumed facts, section 9-204 is not inconsistent with the idea that "the collateral" is "the inventory."[150]

But regardless of how the court views "inventory" under 9-204, any ambiguity in practical results should be removed by section 9-108.

UCC Section 9-108. Section 9-108 provides:

> When a secured party makes an advance . . . to be secured . . . by after-acquired property his security interest in the after-acquired collateral shall be deemed to be taken for new value and not as security for an antecedent debt if the debtor acquires his rights in such collateral either in the ordinary course of his business or under a contract of purchase made pursuant to the security agreement . . . .

The Bankruptcy Act generally takes state law as it is and applies its own rules from that starting point. But the state law must be one of general application outside bankruptcy if it is to be recognized in bankruptcy.

Section 9-108 says that certain security interests are deemed to be given for new value and not for an antecedent debt. Only a small percentage of secured transactions ever involve any insolvency problems, and even when insolvency follows the situation is frequently worked out through the state's own mechanisms such as those governing assignment for the benefit of creditors. Here again the state's case and statutory law may, and often does, differentiate between security interests given for antecedent debt and those given for new value.[151] Thus 9-108 may well have general application outside of bankruptcy. The Bankruptcy Act does not define antecedent debt; the result of the state's definition in 9-108 does not create any of the evils section 60 is aimed at preventing. Counsel for the trustee may properly argue that 9-108 should be accepted at its face value in the limited area it purports to govern.[152]

150. UCC § 9-204(2)(d) says that a debtor cannot acquire rights in an account until the account "comes into existence." This need not bother the counsel for the bondholders, however, because their interest in accounts is likely to be derived from a prior interest in the inventory which produced the accounts, and that security interest dates back to the earlier time it attached to the inventory. UCC § 9-306(3). It is possible to cover the collateral in another form at a still earlier stage. See note 152 *infra.*

Although it has been suggested here that the security interest in inventory be treated as a unitary one, on other facts it might be necessary and desirable to view a transaction as creating a number of separable security interests. See Coogan, *supra* note 134, at 872-73.

151. See, *e.g.*, N.Y. Stock Corp. Law § 15. The Code itself, in §§ 9-304(4), (5), distinguishes between new value and antecedent debt.

152. Viewing the situation covered by UCC § 9-108 as a substitution of collateral suggests an alternative means of avoiding the preference problem. If the debtor has purchase contracts under which his inventory is to be acquired, an assignment of the contracts in a security agreement would be considered to have been made and perfected when the agreement was executed and filed and value given. See text accompanying notes 137-38 *supra.* Subsequent acquisition of the inventory would involve no preference but would be considered a substitution of goods for the right to demand delivery under the purchase contracts (a "general intangible"). Pre-Code law in Massachusetts carried the assignment of intangibles a step further by permitting the debtor to make a present assign-

By confining its operation to goods received in the ordinary course of business, or received pursuant to a term in the security agreement, 9-108 makes it most unlikely that a secured party could allow himself to be stripped of collateral and yet receive the benefit of a substantial block of assets obtained by the debtor within the four-month period.

The Trustee's Position. The argument which would likely be made by the trustee in bankruptcy is a tenable one, provided that section 60 is read literally and its purpose disregarded. No security interest can be "perfected" under 9-303 until it has "attached" under 9-204, and that section looks, as it logically should, to the time at which each bit of collateral is acquired by the debtor. In our case, filing took place four years ago, but under section 60, the time of actual transfer controls except in instances not applicable here.[153] Since the debtor first acquired rights in parts of this inventory within the four-month period, a series of "transfers" can be said to have taken place at the time those rights were acquired. If the transfer of inventory within the four-month period did not contemporaneously replace collateral freed from the indenture, its addition to the bondholders' security, if allowed, would give the bondholders a greater portion of their antecedent debt than they would otherwise have received. Under 60a this is a preference, and, assuming knowledge of the debtor's insolvency on the part of the secured party, a preference voidable under 60b. As to 9-108, the trustee would take the position that a state statute cannot by language which "deems" the transfer not to have been made for an antecedent debt override the Bankruptcy Act. State law may properly excuse the parties from the duty to perform the traditional independent intervening act after the debtor acquires the collateral; this the Code does, but it can do no more.

This argument overlooks the fact that what actually happens under both the New Hampshire act and the floating lien of our hypothetical indenture is that new current assets are received in substitution for old current assets which are released to the debtor. In the normal course of business operations under a long-term indenture there would be a rough equivalence between the value of the old collateral released and that of the new inventory coming in. Because of seasonal fluctuations in the amount of inventory and accounts, mathematical equivalence is impossible to attain in practice without tying up cash proceeds

ment of rights arising out of a course of dealing short of contract or a "present engagement." Claycraft Co. v. John Bowen Co., 287 Mass. 255, 191 N.E. 403 (1934). The Code's category of "general intangibles" apparently recognizes this kind of property. See MASS. ANN. LAWS ch. 106, § 9-106 annotation (Spec. Supp. 1958) (written by the senior author). If the debtor's relationship with his various suppliers is such that he can be said to have a right (a "general intangible") to acquire future inventory, an assignment of these rights would avoid the preference problem just as an assignment of contract rights would. See MASS. ANN. LAWS ch. 106, § 9-108 annotation (Spec. Supp. 1958).

153. When some step necessary to perfect occurs after the transfer, the later time controls. Bankruptcy Act § 60a(2). Under § 60a(7), however, if perfection is completed within twenty-one days of transfer or such shorter time as state law permits, the actual time of the transfer controls.

received from collection of pledged accounts for substantial periods of time, an expedient that may be harmful to both the debtor and his unsecured creditors. Section 9-108 says, in effect, that so long as the transactions are within the banks prescribed by it, one may consider that the water in the river today replaced the water there a month ago, even though various factors dictate that at one instant more collateral is released than is substituted, or vice versa. Since nothing in the Bankruptcy Act specifically prescribes otherwise, 9-108 should on these facts be honored. To hold otherwise would be to impose an unjustified penalty on legitimate secured transactions.

But while the merits of the argument lie with the bondholders, the indenture draftsman must be conscious of decisions in other cases where the courts by following strictly the language of the Bankruptcy Act produced results not contemplated by the sponsors and draftsmen of the language in question. For example, the *Klauder* case [154] gave section 60 a literal reading, striking down accounts receivable transactions and causing some surprise and confusion in the financial community.[155] Nor will the indenture draftsman be comforted by the almost universal agreement of bankruptcy authorities [156] that the language of section 70c which produced *Constance v. Harvey* [157] was not directed at that result.[158]

Tax Claims

In addition to evaluating the effectiveness of the indenture in bankruptcy proceedings, the draftsman must be acutely conscious of the potential threat to the bondholders' rights posed by the preferred status given tax claims. One example is the Secretary of the Treasury's veto power over any plan of

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154. Corn Exch. Nat'l Bank & Trust Co. v. Klauder, 318 U.S. 434 (1943).

155. See discussion by MacLachlan, one of the principal draftsmen of § 60, in MacLachlan, Bankruptcy § 260, especially at 300 (1956).

156. See, *e.g.*, *id.* at 186 n.4; Marsh, *Constance v. Harvey—The "Strong-Arm Clause" Re-Evaluated*, 43 Calif. L. Rev. 65, 67-68 (1955); Weintraub, Levin & Beldock, *The Strong-Arm Clause Strikes the Belated Chattel Mortgage*, 25 Fordham L. Rev. 261, 261-65 (1956).

157. 215 F.2d 571 (2d Cir.), *cert. denied*, 348 U.S. 913 (1954).

158. It will be noted that in the discussion of bankruptcy problems no reliance has been placed on UCC § 9-306(4), which gives the secured party a perfected security interest in:

> (d) . . . all cash and bank accounts of the debtor, if other cash proceeds have been commingled or deposited in a bank account, but the perfected security interest . . . is . . . limited to an amount not greater than the amount of any cash proceeds received by the debtor within ten days before the institution of the insolvency proceedings and commingled or deposited in a bank account prior to the insolvency proceedings less the amount of cash proceeds received by the debtor and paid over to the secured party during the ten day period.

It is assumed here that the indenture trustee will not rely too heavily upon cash in any substantial amount being present at the time of the insolvency. As to whether this is a security interest or a priority, see Comment, *The Commercial Code and the Bankruptcy Act: Potential Conflicts*, 53 Nw. U.L. Rev. 411, 420-24 (1958).

reorganization under chapter X of the Bankruptcy Act.[159] Thus, if the debtor lands in a chapter X proceeding, the Secretary can insist that priority be given his tax claim.

This provision would apply to any indenture. More directly relevant to long-term security interests in current assets is a weapon which may have been added to the tax collector's arsenal in 1958. In *United States v. R. F. Ball Constr. Co.*,[160] the Supreme Court (in a per curiam decision with four dissents) may have applied the doctrine of "choateness" in order to give a tax claim priority over an assignment for security valid under the law of the applicable state. The "choateness" doctrine, originally developed in a series of cases involving federal priorities under section 3466 of the Revised Statutes[161] and later extended to federal liens under the Internal Revenue Code,[162] rests on the principle that not everything labelled a "lien" by state law need be considered as such when the third party claimant is the United States.[163] Building on this foundation, the Supreme Court had ruled prior to *Ball* that state statutory liens by fiat, such as liens for state taxes and mechanics' liens which required some further act to determine either the amount of the indebtedness secured or the particular property subject to the lien, were insufficiently specific, or "choate," to defeat the priority statutorily given to government claims.[164] On the other hand, no cases had applied the doctrine to contractual liens. The *Ball* lien was an assignment of long-term contract rights to secure debts which might become due to a surety. At the time the government filed its tax liens, the amount of the indebtedness was uncertain. Furthermore, the assignment was not recorded. Given these distinguishing features and the brief per curiam opinion, which cited only the statutory lien cases, *Ball's* ultimate effect is at this moment hard to determine. Possibly, any lien not absolutely specific as to both the total amount of debt secured and the specific property covered will be deemed too inchoate to defeat a federal claim.[165] It scarcely need be mentioned that, because of the rapid turnover of

159. Bankruptcy Act § 199.

160. 355 U.S. 587 (1958).

161. Rev. Stat. § 3466 (1875), 31 U.S.C. § 191 (1952).

162. Int. Rev. Code of 1954, §§ 6321-23.

163. See United States v. Wadill, Holland & Flinn, Inc., 323 U.S. 353 (1945).

164. See, *e.g.*, United States v. White Bear Brewing Co., 350 U.S. 1010 (1956), *reversing* 227 F.2d 359 (7th Cir. 1955) (mechanics lien); United States v. Gilbert Associates, 345 U.S. 361 (1953) (town taxes). For an excellent summary of the development of the choateness doctrine, see Note, 43 Minn. L. Rev. 755, 755-765 (1959). See generally A.B.A. Comm. on Federal Liens, Final Report (1959).

H.R. 7914 and H.R. 7915, 86th Cong., 1st Sess. (1959), would change the law considerably.

165. At least one district court has already adopted this interpretation. See Wolverine Ins. Co. v. Phillips, 165 F. Supp. 335 (N.D. Iowa 1958); *cf. In re* New Haven Clock & Watch Co., 253 F.2d 577-84 (2d Cir. 1958). In this latter case, decided three weeks after *Ball*, the court held an assignment of accounts receivable good against a Federal tax lien to the extent of principal amount of debt secured, but invalid as to attorney's fees, the amount of which were not definitely ascertained when the tax lien attached. By trans-

current assets, the lien of an indenture on inventory and accounts is much less specific as to the items covered than that obtained on equipment.

The fears engendered by the possibility that a federal tax lien may be held to come ahead of an "inchoate" security interest are magnified by the doctrine of the *Quaker City Uniform* case,[166] which held that a nonstatutory lien subordinated by state law to a statutory lien is also subordinated to those claims to which the statutory lien was subordinated by sections 67c and 64a (in *Quaker City*, administration costs and wage claims). Since 67c and 64a also apply to federal tax liens, a combined *Ball-Quaker City* doctrine could subordinate the "inchoate" lien to claims for administration expenses and wages as well as to a federal tax lien. The law in this area is too unsettled to permit definitive comment, but the indenture draftsman must at least be aware that the danger of the tax collector making a successful attack on a security transaction may be somewhat increased when that transaction involves a "floating lien" on current assets.

The English Floating Charge and the Code's Floating Lien

Thus far we have noted many of the shortcomings of a long-term security interest in current assets—the nature of the collateral, some of the priority rules of the Code itself, and the at least theoretical possibility of attack on such transactions under non-Code state law, under the Bankruptcy Act, and by the Internal Revenue Service. But before concluding that such a security interest is of little practical use, the draftsman may find it helpful to examine briefly the body of law governing the English "floating charge," a long-term corporate financing device covering current assets which has been used successfully for nearly a century.

Although the text of the Code nowhere uses the terms "floating charge," "floating lien," or "continuing general lien," the Comments to sections 9-204 and 9-205 speak of the Code's acceptance of the "principle of the continuing general lien" associated with section 45 of the New York Personal Property Law and of its validation of the "floating charge or lien on a shifting stock of goods," which suggests a reference to the English doctrine.[167] Since the "continuing general lien" has been traditionally associated with a certain type of short-term transaction involving maximum control of the debtor, a study of the law related to it would seem to be of limited value to the long-term financer.[168] The English "floating charge" on the other hand, presents many

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ferring the "all or none" theory which permeates some other areas of security law to this field, a future court could subordinate the entire contractual lien in similar situations.

166. Matter of Quaker City Uniform Co., 238 F.2d 155 (3d Cir. 1956). H.R. 4158, 86th Cong., 1st Sess. (1959), would change the law as announced in this case.

167. UCC § 9-205, comment 1; UCC § 9-204, comment 3.

168. While the New York Factors' Lien Act, like the floating charge of English case law and what we are calling the floating lien of the Code, cut into the then-prevailing doctrines which made difficult the use of inventory as security, the indenture draftsman

points of comparison with the types of long-term interests in current assets which can be created under the Code. Primarily because of differences between the insolvency laws of the United States and England there probably cannot be an exact equivalent of the English floating charge under the Code. Nevertheless, an understanding of the similarities and dissimilarities between the "floating lien" of the Code and the floating charge, floating security, or floating lien developed under English case law should help to give the draftsman a deeper insight into the use of current assets as collateral and a better appreciation of the legal devices the Code puts at his disposal.

The term "floating lien," may be properly used to describe a secured transaction which allows the debtor to use or dispose of collateral without requiring him to pay the debt with the proceeds or to replace the collateral with substitutions of at least equal value, except as the debtor's interest (which may, however, be only an equity behind a purchase-money security interest) in new collateral is automatically covered. The Code's floating lien is a composite product of two basic groups of provisions of the Code which (a) cut down the dominion rule [169] and (b) permit almost automatic inclusion of the debtor's equity in after-acquired goods.[170] The full effect of these basic rules is made possible by two other provisions: (c) the Code's simplified notice filing [171] and (d) the first-to-file priority rule.[172]

The "floating lien" of the Code is a legislative repudiation of a substantial body of American case law (and, to a much smaller extent, statutory law) which, reaching its height in the last quarter of the nineteenth century, both refused to give effect to after-acquired property clauses and invalidated securi-

will get little comfort from the practices developed under it. At least as far as the New York act (N.Y. PERS. PROP. LAW § 45) is concerned, its scope is limited as to the kind of collateral that can be covered and the kind of secured party who may make use of it. Since it was associated with the practices of "factors," there was little chance for the full play of the freedom on the part of the debtor which is the most essential element of the floating lien. As late as 1943 the New York legislature found it wise to negate the application of a small segment of the dominion rule, namely, that applying to the debtor's dominion over returned goods, and this in spite of the fact that Mr. Justice Brandeis in *Benedict* had invited the taking of the contrary view. See 268 U.S. at 361 n.11. While the Factors' Lien Act permits the automatic acquisition of a lien on new inventory, as to accounts purported to be covered it is unclear as to whether the performance of an independent intervening act is not still necessary after the account comes into existence. See the discussion in N.Y. Law Revision Comm'n, *Communication to the Legislature relating to Assignments of Accounts Receivable*, N.Y. LEG. Doc. No. 65k, at 149-63 (1946). See also Manchester Nat'l Bank v. Roche, 186 F.2d 287 (1st Cir. 1951) (involving New Hampshire Factors' Lien Act). As to goods, *cf. In re* Comet Textile Co., 15 F. Supp. 963 (S.D.N.Y. 1936). Some of the later factor's lien acts affirmatively overrule all or part of the dominion rule. One of these acts was upheld as against an attaching creditor in Colbath v. Mechanicks Nat'l Bank, 96 N.H. 110, 70 A.2d 608 (1950).

169. UCC § 9-205.

170. UCC § 9-204(3).

171. UCC § 9-402.

172. UCC § 9-312(5)(a).

ty arrangements in which the debtor retained too much dominion or control over the collateral and its proceeds, a combination which made an effective security interest in current assets almost impossible to obtain.[173] They parallel a body of English statutory law directed toward the same ends. These cases seem to have been based on two premises which were seldom articulated: (a) The unsecured creditor is entitled to a cushion in the form of current assets of his debtor; and (b) the debtor should be discouraged from hypothecating his current assets. Perhaps the earliest inroads on this philosophy were made by the English courts almost a century ago by the acceptance of a nonstatutory "floating security" or "floating charge."[174] Thus, while the Code floating lien represents a legislative rejection of American case law, the English floating charge cases represent judicial inroads on the philosophy of the English Bills of Sale Act,[175] and the English Bankruptcy Act,[176] and is only to a much lesser extent a rejection or revision of early English case law.[177]

Even at the present time, the English Bills of Sale Act[178] (where applicable) effectively discourages the use of inventory as security by limiting the coverage of a bill of sale for security (roughly the equivalent of the American chattel mortgage) to goods "owned" at the time the bill of sale is executed

173. See notes 88-90 *supra* and accompanying text. For an example of the statutory law see CAL. CIV. CODE ANN. § 2955, which prohibits a chattel mortgage on a merchant's stock of goods. In most states at the present time a modified possessory security interest may be created in inventory through a "field warehouse," and a nonpossessory interest through a consignment, trust receipt or so-called factors' lien.

174. For a discussion of the floating charge, see generally GOWER, MODERN COMPANY LAW 389-393 (2d ed. 1957); WALDOCK, MORTGAGES ch. 7 (2d ed. 1950). See also SIMONSON, DEBENTURES AND DEBENTURE STOCK 15-33 (4th ed. 1913); PALMER, COMPANY LAW 399-405 (20th ed. Schmitthof & Curry 1959); PALMER, COMPANY PRECEDENTS pt. III, ch. 7 (16th ed. Topham 1952).

In Illingworth v. Houldsworth, [1904] A.C. 355, 358, Lord Macnaghten described the floating charge rather colorfully as follows:

> I should have thought there was not much difficulty in defining what a floating charge is in contrast to what is called a specific charge. A specific charge, I think, is one that without more fastens on ascertained and definite property or property capable of being ascertained and defined; a floating charge, on the other hand, is ambulatory and shifting in its nature, hovering over and so to speak floating with the property which it is intended to affect until some event occurs or some act is done which causes it to settle and fasten on the subject of the charge within its reach and grasp.

175. 41 & 42 Vict. c. 31 (1878), as amended, 45 & 46 Vict. c. 43 (1882), 53 & 54 Vict. c. 53 (1890), 54 & 55 Vict. c. 35 (1891).

176. Bankruptcy Act, 1914, 4 & 5 Geo. 5, c. 59, § 38; WALDOCK, *op. cit. supra* note 174, at 123-25.

177. For an illuminating comparison of the judicial approach to what might seem to be the same kind of problem, *compare* Thomas v. Kelly, 13 App. Cas. 506 (1888) (decided under the Bill of Sale Act), *with* Tailby v. Official Receiver, 13 App. Cas. 523 (1888) (contemporaneously decided under the non-statutory floating lien law).

178. Particularly the 1878 act as amended by the 1882 act, both cited note 175 *supra*.

and by requiring a degree of particularity in description of the collateral which makes it practically impossible to cover future inventory.[179] In addition, the generally low standing accorded a bill of sale in bankruptcy detracts from its value as a security device.[180] Use of the other major form of current assets—"book debts" or what we call accounts receivable—is discouraged by the requirement that the account debtor must be notified of the assignment if the secured party is to be protected against a subsequent assignee.[181]

The courts' circumvention of these rules was made possible by the Bills of Sale Act's inapplicability to a "debenture" issued by an "incorporated company."[182] Furthermore, the Bankruptcy Act generally does not apply to a company organized under the Companies Act, which provides its own insolvency procedure.[183] Slipping through these openings, English solicitors and courts developed the doctrine that a company could secure its debentures by a charge on all presently owned and after-acquired assets of a given class or even on its "undertaking"—*i.e.*, all of its assets, present and future.

As worked out in the cases, the doctrine permits the secured party to allow the debtor corporation to use the assets in almost any way it sees fit. The lien "floats" over the assets until the secured party causes it to "crystallize," usually through the appointment of a receiver.[184] Prior to crystallization, the debtor is free to sell its property and even a purchaser who is not a "buyer in the ordinary course of business" will take free of the lien. Indeed, the secured party's only weapon against such a sale would be to prove the transaction

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179. Section 4 of the Amendment Act of 1882 requires that there be annexed to the bill of sale a written "inventory of personal chattels covered" which must be "specifically described." And even though the property be "specifically described," under § 5 the bill of sale is void "as to chattels of which the grantor is not the true owner at the time of execution of the bill of sale." These sections may have their greatest impact on inventory. Section 6 makes them inapplicable to what the Code calls equipment; here future "substitutions" may be covered. See WALDOCK, *op. cit. supra* note 174, ch. 5.

180. The English Bankruptcy Act makes even a registered bill of sale of limited value as to any kind of collateral since the security interest is not good in bankruptcy unless the creditor has taken possession prior to bankruptcy. Bankruptcy Act, 1914, 4 & 5 Geo. 5, ch. 59, § 38; *In re* Ginger, [1897] 2 Q.B. 461; *cf.* Hollinghead v. Egan, [1913] A.C. 564 (Ire.) (applying same rule to bill of sale given under Irish Bill of Sale Act). Under § 13 of the Amendment Act of 1882, "five clear days" must elapse between "seizure" of chattels and the creditor's taking of possession by removing them from the premises where they were seized. See discussion in WALDOCK, *op. cit. supra* note 174, at 85, 100, 123-25.

181. Dearle v. Hall, 3 Russ. 1, 38 Eng. Rep. 475 (Ch. 1823); WALDOCK, *op. cit. supra* note 174, at 133, 401 and other cases cited therein.

182. Bills of Sale Act (1878) Amendment Act, 1882, 45 & 46 Vict. c. 43, § 17.

183. Bankruptcy Act, 1914, 4 & 5 Geo. 6, c. 59, § 126; Companies Act, 1948, 11 & 12 Geo. 6, c. 38, pt. V. The Companies Act does, however, incorporate certain bankruptcy rules. See, *e.g.*, Companies Act §§ 317, 318, 320.

184. See *In re* Yorkshire Woolcombers Ass'n, [1903] 2 Ch. 284, 295; *In re* Panama, N.Z. & Australian Royal Mail Co., L.R. 5 Ch. 318 (1870); WALDOCK, *op. cit. supra* note 174, at 163-164.

ultra vires.[185] Furthermore, not only can the debtor acquire new assets subject to a purchase money security interest, but he can create "fixed charges" (similar to the American chattel mortgage) on his presently owned fixed assets which will take priority over the lien of the floating charge, even when the party in whose favor the fixed charge is created has constructive notice of the floating charge.[186] Thus registration of the floating lien, compulsory since 1900,[187] provides no protection comparable to that given against other secured creditors by the Code's "first to file" priority.

But, compared with a Code floating lien, the most striking characteristic of the English floating charge is its vulnerability to unsecured creditors. *Evans v. Rival Granite Quarries, Ltd.*[188] made it clear that an unsecured creditor who pursues his remedy to completion before the floating lien crystallizes comes ahead of the holder of the floating charge as to any collateral out of which he obtains satisfaction. Although the floating charge thus appears in many ways to be a second-rate security, its wide use would indicate that creditors find it a useful device despite its risks.[189]

Further comparisons between the English floating charge and the Code's floating lien must be made in the light of the differences between a "winding up" under the English Companies Act and proceedings under the American Bankruptcy Act, and the differences in the effect given an "equitable lien" or "equitable charge" in the insolvency proceedings of the two countries. Under the American doctrine of *Moore v. Bay*,[190] if, on the date of bankruptcy, one unsecured creditor exists who could defeat the lien, it may be avoided by the bankruptcy trustee and the secured party forced to share pro rata with the

185. This is not much of a restriction; in *In re* Borax Co., [1901] 1 Ch. 326, a sale of all the company's assets to a new company for the purposes of continuing the business was held intra vires. See WALDOCK, *op. cit. supra* note 174, at 161. An amendment of the Company's Articles of Association, if registered under § 143 of the Companies Act, might restrict the Company's power to sell except in a prescribed manner. See Wilson v. Kelland, [1910] 2 Ch. 306; HOLDEN, SECURITIES FOR BANKERS' ADVANCES 319 (2d ed. 1957).

186. *In re* Connolly Bros., [1912] 2 Ch. 25; see *In re* Hamilton's Windsor Ironworks, Ltd., 12 Ch. D. 707 (1879). Space does not permit a full discussion as to the effect of knowledge on the part of the later secured party who takes a more specific charge. GOWER, *op. cit. supra* note 174, at 391, assumes that if the public notice includes a reference to a restriction on the power of the company to create a specific charge which would become prior to the floating charge, such notice would be effective. In conversation with the senior author, Professor Gower reports that he has no specific authority for that statement but believes it is correct. Compare WALDOCK, *op. cit. supra* note 174, at 162; WEGENAST, CANADIAN COMPANIES 659, 661 (1931).

187. Companies Act, 1900, 63 & 64 Vict. c. 48, now incorporated in Companies Act, 1948, 11 & 12 Geo. 6, c. 38, § 95(2) (f). See also §§ 96-102. Section 103 requires the company itself to keep a copy of every registered charge at its own office, where it is open to public inspection under § 105.

188. [1910] 2 K.B. 979.

189. Gower, *Some Contrasts Between British and American Corporation Law*, 69 HARV. L. REV 1369, 1396-97 (1956).

190. 284 U.S. 4 (1931).

unsecured creditors.[191] And if *Constance v. Harvey*[192] is the law,[193] the same result follows if on the date of bankruptcy there *could have been* one such creditor.[194] As we have seen, the English floating charge is subject to being defeated not only by almost anyone who buys the collateral or anyone who is granted a more specific or fixed lien but also by an unsecured creditor to whom collateral or proceeds are transferred through judicial proceedings. Moreover, certain current claims, though unsecured, are paid in priority to payment of the indebtedness secured by a floating charge.[195] But as to all other unsecured creditors, the floating charge generally retains its validity.[196] Furthermore, under the Companies Act, it makes no difference that the lien on after-acquired property is characterized as "equitable";[197] this is quite different from the treatment of "equitable liens" under section 60a(6) of the Bankruptcy Act, which recognizes such liens only where a legal lien is not possible.

The draftsmen of the Code made it clear that a security interest perfected under the Code is not a mere "equitable lien" which could be disregarded by an attaching creditor or other person who obtained a legal lien or other property interest.[198] To create such a lien would appear ridiculous to any student of American chattel security law, and the use (in the Comments only) of the term "floating lien" by no means indicates an intention to reproduce all the effects of the English floating charge. Under the Code, the debtor, like his English cousin, may be given freedom to deal with the collateral without supervision by or accountability to the secured party. In most cases, the property subject to either type of floating lien will be current assets—inventory,

191. The size of the claim of the single creditor who could come ahead of the secured party is of no significance; even if such a claim is for only a few dollars the trustee can upset the secured transaction in its entirety. See MACLACHLAN, BANKRUPTCY 330-33 (1956).

192. 215 F.2d 571 (2d Cir. 1954), *cert. denied*, 348 U.S. 913 (1955).

193. Not all courts have accepted the reasoning of *Constance*. See, *e.g.*, *In re* Billings, 170 F. Supp. 253 (W.D. Mo. 1959). H.R. 4158, 86th Cong., 1st Sess. (1959), would change the law as announced in *Constance*.

194. Fortunately for the Code creditor, the *Constance* doctrine would seem to be applicable only where the state law allows an unsecured creditor who becomes such between the date of the execution of the mortgage and the date of its filing to attach the property even after filing has been made, and therefore should not arise under the Code. See generally Marsh, *Constance v. Harvey—The "Strong-Arm Clause" Re-Evaluated*, 43 CALIF. L. REV. 65 (1955); Weintraub, Levin & Beldock, *The Strong-Arm Clause Strikes the Belated Chattel Mortgage*, 25 FORDHAM L. REV. 261 (1956).

195. Companies Act, 1948, 11 & 12 Geo. 6, c. 38, § 319 (tax claims for previous twelve months, wages, including defined fringe benefits). Under Companies Act § 94, these priorities are applicable to any proceeding for the enforcement of a floating charge even in the absence of a winding up. A fixed charge is not subject to these infirmities. *In re* Lewis Merthyr Consol. Collieries, Ltd., [1929] 1 Ch. 498.

196. See also Companies Act § 322 (floating charge given within one year of bankruptcy while insolvent invalid to the extent not given for present consideration).

197. WALDOCK, *op. cit. supra* note 174, at 55-56.

198. See UCC § 9-204 & comments.

accounts or short term contract rights—short-lived collateral subject to rapid turnover. Both the Code and the English "floating liens" are characterized by the ability to obtain a security interest in after-acquired property, and an easy method of giving public notice. Yet, despite these similarities, the Code's floating lien is intended to be a full-fledged "legal" security interest, taking priority over all parties except those expressly given preference by the Code or some provision of non-Code law.

If the secured party is to be permitted to acquire a blanket lien on the debtor's assets while allowing him to deal freely with them vis-à-vis other parties, some form of protection for unsecured creditors is necessary. Rather than attempting to compile a list of unsecured creditors with priority or permitting an attaching creditor to acquire a lien on assets of the debtor covered by the floating lien, as does English law, the Code allows diligent unsecured creditors to reach "unidentifiable proceeds."[199] If the debtor is not required to account for all proceeds, the lien on them is likely to be lost as soon as they become cash. Thereafter, an unsecured creditor who obtains satisfaction from the cash will come ahead of the secured party as to what originally were proceeds of the latter's collateral. But since no lien exists at this stage on the cash which the attaching creditor can be said to overcome, the security interest in the rest of the collateral remains valid in bankruptcy.

Under both English law and the Code the parties can, and frequently should, create only a "fixed charge." As pointed out previously, no need ordinarily exists to give the debtor power to deal freely with equipment; conventional indenture practices as to pieces of equipment with a high unit value are not inconvenient and ensure a continuously valid lien. The Code permits even a lien on current assets to be "fixed." If the debtor is required to account fully, the lien can be followed through to the cash which ultimately comes in from sale of goods and collection of accounts. But, particularly where there are many bondholders, present indenture practices would require considerable modification to provide for sufficiently flexible control by the trustee to create that kind of a lien on current assets which, over the long period of an indenture, is likely to be outstanding.

Fortunately, the Code allows the parties great flexibility in shifting, from time to time, by agreement or by conduct, the degree of control exercised by the trustee, and with it the quality of the security interest in current assets. An agreement could, for example, allow the debtor complete freedom so long as the amount of his current assets exceed the amount of his current liabilities by a certain figure, and thereafter require him to account strictly and either to apply proceeds to paying down the debt or to substitute new collateral.

This type of arrangement presents one possible solution to the problems of a debtor, such as Metal Products, who is annoyed by short-term policing

199. The rules regarding proceeds are set out in UCC § 9-306. An unsecured creditor can reach the debtor's other assets by using whatever mechanism the applicable jurisdiction provides for attachment subject to a security interest. UCC § 9-311 & comment.

procedures. The parties cannot legitimately object to a certain amount of what may be considered "red tape" when the application of controls is deferred until circumstances indicate an actual need for them. The secured party may also find this arrangement to his liking. Under the Metal Products indenture in its proposed form, the bondholders could enforce their rights only by calling a default and initiating procedures similar to those necessary to "crystallize" the English floating lien—for example, the appointment of a receiver. Both debtor and secured parties usually suffer greatly from this kind of enforcement proceeding. By providing for an increase in the trustee's powers and duties in appropriate circumstances, the draftsman can avoid requiring the unnecessary labor that goes with policing an eminently solvent debtor, yet ensure that effective control measures short of calling a default will be initiated when the situation warrants. Since the Code gives full legal protection to a lien on current assets except for the purchase money priority and the possibility that unsecured creditors can reach unidentifiable proceeds, policing methods which prevent the creation of competing interests and prevent proceeds from becoming unidentified will have the same practical effect as the appointment of a receiver, and yet not require judicial intervention. The opportunity that the Code offers the creditor to bring his security into full play in many instances by initiating procedures for strict accountability without killing the debtor in the process appears to be a distinct advantage of the American system,[200] and raises interesting possibilities for the draftsman. It is nevertheless to be hoped that the possible advantages of the floating lien will not lead to its use in long-term finance when it is not needed. The debtor should think twice before he agrees to an action which may shut him off from possibilities of making use of current assets for seasonal and other short term borrowings. There are and will continue to be many situations in which a combination of long-term and short-term finance is proper, particularly when the need for money fluctuates with seasonal or other factors, and the long-term creditor who ties up all the debtor's security may do a disservice to himself and his debtor. In this case the difference between the Code's floating

200. In practice no difficulty is found in building in a considerable amount of flexibility into the English floating charge. It is customary to permit within limits charges to secure borrowing from bankers in the ordinary course of business and to provide for meetings of the debenture holders to agree to modifications of the terms of the debentures. Nor is it a case that in practice the debenture holders are over-eager to enforce their full rights by appointing a receiver and manager. This is something that is adopted only as a last resort and very often a modification is agreed to, either in accordance with the terms of the debentures or under a scheme of arrangement under section 206 of our Act.

Letter From Prof. L. C. B. Gower, London School of Economics, to Peter F. Coogan, September 7, 1959.

Granting that the secured party under a floating charge can frequently work out difficult situations without resorting to insolvency proceedings, it would nevertheless seem that no method exists whereby he can obtain complete protection against future creditors without exercising the right to "crystallize" the lien.

lien and its English counterpart cuts the other way. The English debtor can ordinarily obtain money or credit by creating a superior "specific charge" on then owned as well as after-acquired property notwithstanding the earlier filed floating lien. The Code allows the debtor to create a superior lien only if it is a purchase money security interest, a device useful for the acquisition of new noncash assets, but one which fails to solve the problem of a debtor pressed for ready cash. Theoretically, the Code debtor could appeal to the bondholders for modification of the indenture to permit secured borrowings from others. But when the holders of long-term debt are scattered, modifications of an indenture are difficult to obtain. Flexibility must be built into the indenture in advance, in order to get its full advantages. This requires a careful projection of the debtor's potential credit requirements, and drafting so that they can be met in an expeditious fashion. Whether or not current assets fit in to the long-term security picture will be a matter for the business judgment of both parties.

The draftsman of a Code indenture will find the English "floating charge" an interesting example of a workable long-term security interest in current assets. Some of the problems involved in this type of financing are solved by the Code in a somewhat different manner, but others are left to be worked out by the parties. In theory, the Code system, which combines great flexibility with a high degree of legal protection for whatever agreement is ultimately reached, should prove even more workable than its English counterpart. But only intelligent and imaginative use of the "floating lien" will ensure that its potential value is achieved in practice.

Impact of Non-Code Law—A Summary

The conclusions to be drawn from the discussion in this section would seem almost too obvious to need an explicit statement. A security interest in inventory and accounts under a long-term indenture when the debtor is given as much freedom to deal with the collateral as is assumed in the Modern Metal indenture is of a lower quality than either a security interest in fixed assets traditionally covered by the indenture or that acquired through traditional practices in short-term secured financing, whether under the Code or the pre-Code law of any state with the usual assortment of chattel security devices. This does not mean, however, that a Code floating lien on current assets is necessarily an unacceptable form of security. It offers, if anything, a higher degree of protection than that afforded by its cousin, the English floating charge, which over almost a century has been proven to be a very useful device for long term finance despite its obvious disadvantages.

CONCLUSION

In the typical indenture—one which covers only noncurrent assets and under which the trustee assumes only the usual obligations and has the usual limited powers—the effect of the Code is not likely to be startling. The elimination of the *Benedict* dominion rule will be reassuring. The easier mechanics for obtaining a security interest in after-acquired equipment may be helpful but not momentously so, because equipment normally changes in makeup only over a relatively long period of time and the pre-Code practice of occasionally executing supplementals to pick up new equipment has not generally been too burdensome. The clarification of the law as to long-term intangibles is helpful. Filing provisions are somewhat simplified with respect to all kinds of collateral. This is particularly the case in states where pre-Code law raised questions of whether an indenture could be filed before the advance was made or where a lapse of even a short period of time between execution and filing invited the "gap" creditor to come in. Finally, the creditor's remedies after default are generally clearer than under pre-Code law, particularly since the 1958 official amendments.

But the greatest contribution of the Code will be in those situations where the "typical" indenture is not a satisfactory solution. The Code eliminates most of the legal difficulties that have discouraged the use of current assets in long-term finance. True, the secured party must be willing to accept a lower quality security interest because of the risks inherent in current assets —their tendency to disappear without necessarily being replaced by other assets of equal value. But when business requirements make the use of current assets as long-term collateral desirable or necessary, the draftsman is now free to work out an arrangement which will serve the practical needs of the parties.

At the present time it would seem likely that the taking of a security interest in current assets to become effective at the time the indenture is executed will be the exception rather than the rule. However, the Code's mechanism for covering current assets may be useful should trouble appear on the horizon. This would seem particularly true in situations in which the secured debt is held by a single institutional investor, or by a group of investors who are willing to allow one of their number to make the necessary judgments for all. In many instances, the security analyst will be unwilling to recommend the purchase of the bonds at all unless the security in the form of noncurrent assets seems adequate to him at the time the bonds are issued. But later, when unforeseen circumstances may appear to have increased the credit risk significantly, and when the debtor may appeal for an extension of time or a decrease in the installment payments or some other form of relief, the secured party may find it helpful to take a security interest in current assets by means of an amendment to the indenture and from that time on to exercise whatever degree of control and judgment he feels necessary to make the current assets something close to first-class collateral. In the alternative, the indenture may have a built-in safety valve in the form of a grant of a security interest which automatically becomes effective upon the happening of a prescribed event which evidences a deterioration of the debtor's credit. Resourceful counsel for various long-term lenders will doubtless work out other arrangements.

Even before the days of chapter X, exercise by a creditor of his "right" to foreclose on or sell a large industrial property had often become an economic impossibility, and chapter X merely recognized this change. Realistically, what the secured party obtains in a typical indenture is a strong platform from which he can bargain with the debtor and his other secured and unsecured creditors. Ability to control unsecured assets at a time of trouble may well be worth the problems which are inherent in taking a security interest in that kind of collateral.