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John A. Spanogle Jr
Bond University

William Wallace Kirkpatrick
George Washington University

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Abstract
There have been several articles which have compared the current Australian approach, using charges, and the North American approach, using security interests; but they have all been prepared by non-North American authors, and some do not have a full perspective of the effects of UCC Article 9. In addition, the Commonwealth Attorney General's office seems to base its current evaluation of the North American approach on a single quotation from a book published in 1964. Both UCC Article 9 and the United States insolvency laws have been redrafted since that time of twenty-eight years ago, so perhaps it is useful for an American explanation of current American law. Thus, this paper will outline the significant aspects of the North American 'security interest' approach to secured financing.

Keywords
United States, Australia, security interests, charges, secured financing

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Articles

SECURITY INTERESTS US STYLE: A DEVICE FOR FINANCING SMALL BUSINESSMEN AND PROTECTING YOURSELF IN LIQUIDATION

by
John A Spanogle, Jr
Visiting Professor of Law
Bond University
William Wallace Kirkpatrick
Professor of Law
George Washington University

Ordinarily I would not bore an audience of Australian lawyers with a description of United States law. But, in the case of secured financing, such a description may be warranted because there is some consideration in this country of adopting the 'security interest' approach to secured financing as it is represented by Uniform Commercial Code (UCC) Article 9 in the United States and the Personal Property Security Acts in Canada. First, there is a review of current Australian law on 'charges' by the Law Reform Commission.[1] Second, New Zealand is seriously considering the United States - Canadian approach to secured financing, and New Zealand adoption of that approach would require its consideration by Australia under the Australia - New Zealand Memorandum of Understanding on Harmonization of Business Law.[2]

1 See Everett D, 'Personal Property Security Reform Proposals' 63 ALJ 721 (1989).

2 Reprinted in Farrar JH 'Harmonization of Business Law Between Australia and New Zealand', (1989) 19 Victoria U Wellington L Rev 435, at 442. The Memorandum of Understanding arose out of the Closer Economic Relations Trade Agreement, March 28, 1983, Aust - NZ, (1983) 22 Int'l Legal Mat 948.

3 See, eg Peden JR, *Stock-in-Trade Financing* (Butterworths, 1974); Gough WJ, 'The Floating Charge: Traditional Themes and New Directions', in *Equity and Commercial Relationships* at 239 (Finn PD, ed); Everett D, note 1 above.
The principal study of English secured financing provisions is Diamond A, *A Review of Security Interests in Property* (1989), which recommends adoption of the North American model, at 9:2:2. Other English studies include Davies RI, 'The Reform of English Personal Property Security Law,' 32 Mal LR 88 (1990); Bridge MG, 'Form, Substance and Innovation in Personal Property Security Law,' January [1992] JBL, at 1; Lawson M 'The Reform of the Law Relating to Security Interests in Property,' [1989] JBL 287.

There have been several articles which have compared the current Australian approach, using charges, and the North American approach, using security interests;[3] but they have all been prepared by non-North American authors, and some do not have a full perspective of the effects of UCC Article 9. In addition, the Commonwealth Attorney General's office seems to base its current evaluation of the North American approach on a single quotation from a book published in 1964.[4] Both UCC Article 9 and the United States insolvency laws have been redrafted since that time of twenty-eight years ago, so perhaps it is useful for an American explanation of current American law.

Thus, this paper will outline the significant aspects of the North American 'security interest' approach to secured financing. It will first review the history of pre-UCC chattel security to determine what problems existed - - and did *not* exist - - under the American law before creation of the security interest concept. Identification of these problems will permit determination of the goals sought by the North American statutory reform. Examination of the statute itself will be divided between an analysis of the relationship between the debtor and the secured creditor and an analysis of the relationship between the secured creditor and third parties (secured and unsecured creditors, bankruptcy officials and buyers). Since UCC Article 9 is a codification, all of these aspects must be examined in order to comprehend fully the status of the secured creditor in liquidation. The paper thus concentrates on North American law, and the author does not claim any expertise in current Australian law of secured financing. I will leave it to the audience to make the necessary comparisons.

When the United States was founded it received, as part of its own Common Law, the Statute of Elizabeth,[5] which voided transactions in fraud of creditors. Eighteenth century interpretation of that statute regarded any separation of the 'ownership' and possession of goods as presumptively fraudulent, and the subsequent history of secured financing became a dynamic duel between creditors (and their attorneys) and the courts and legislatures to find mechanisms which would permit the separation of title and possession. Each attempt sought to manipulate concepts of title, and each was met with a legislative response. The validity of possessory security interests, such as the pledge, had never been in doubt, but such devices had little utility in financing business equipment, stock in trade and accounts.[6]

4 Interview with Hynes P, 2 April, 1992. The book quoted was Bunn, Snead and Speidel, *Uniform Commercial Code* (1964).

5 13 Eliz c 5, ssII and VI (1570).

6 The creditor could not maintain possession of equipment while the debtor used it, or of stock in trade while the debtor offered it for sale, and could not obtain possession of accounts at all. The exception was a remarkable device called the field warehouse, which was used extensively throughout the US to finance canning factories. This device suffered from all the defects of the other pre-UCC security devices, but in even greater degree. It was horrendously expensive, and could fail to protect the creditor's security rights if any of its many, technical details were not followed with great precision. It has largely been found to be unnecessary after enactment of the UCC.

The first attempt to use chattels for security in America came through the use of chattel mortgages.[7] The debtor would execute a mortgage document on goods, which might or might not be registered, and then claim to have 'title' via the executed mortgage. The state legislatures in the United States promptly enacted legislation which regulated the device, some establishing legal title in the mortgagee (title jurisdictions), others not (lien jurisdictions). In all states public registration of chattel mortgages was required as a prerequisite to their enforceability against third parties, although the office for such registration varied from state to state. Sometimes the office for recording real estate mortgages was used, but often a different local office was selected. In addition, the legislation required elaborate identification of the chattel, comparable to a real estate description, and neither after-acquired property nor future advances were coverable by chattel mortgages. Such mortgages were useful in equipment financial, but less useful for stock in trade financing.

Use of the title retention clauses was the second device attempted to provide secured financing. In Australia this is commonly referred to as a 'Romalpa' clause, and in the United States it primarily concerned the 'conditional sale' transaction. Since it involved a purchase-money transaction, it could be used for seller financing of either equipment or stock, but non-seller financiers found it either impossible or very awkward to use. Case law concepts were created which allowed automatic release of the retained title to any buyer in the ordinary course of business (*market ouvert*) and attachment of the creditor's interest to the proceeds of that sale, including accounts.

The state legislatures responded in two ways. Some enacted legislation which concentrated on defining the conditional sale transaction narrowly, so as to limit its use to sellers. Others enacted legislation which concentrated on establishing public registration as a requirement for any title-retention (Romalpa) clause to be enforceable against third parties. Many did both. There was, however, no agreement as to where the notice of the transaction should be registered, and often it was in a different location from the office for registering chattel mortgages. Thus, a useful secured financing device had been created, but it was available only to sellers, who were not very interested in becoming financiers, and not available to other lenders. Half a century was spent in (usually unavailing) attempts by banks to attain the status of 'conditional sellers' without becoming actual sellers with warranty responsibility. However, the state courts were very zealous in narrowing the availability of the device by focussing on the transaction, not on the contract clauses.

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7 The following half dozen paragraphs of this paper are derived from personal observation, but are also supported by the complete analysis of the historical development of US chattel security devices in Grant Gilmore, *Security Interests in Personal Property* (1965). See also Official Comment to UCC s 9 - 101.

Having failed to co-opt the conditional sale device, around the turn of the century banks turned to a different avenue. The trust receipt had long been recognized in international transactions as a device for securing a creditor's interest in goods in a warehouse during short-term possession of the goods by the buyer. This 'old-style' trust receipt was gradually expanded to include protection of a financier's interest in goods when the debtor was given possession for an indefinite (long) time period, provided that 'title' was technically in the financier as 'trustee'. The latter requirement could be met by using a negotiable warehouse receipt in the transaction.

Finally, with the advent of the Uniform Trust Receipt Act, a 'new style' trust receipt device was made available to American financiers, that gave them a secured financing device which automatically detached itself from any collateral sold to a buyer in the ordinary course of business, could automatically grasp after-acquired property and could secure future advances to the debtor. In short, it allowed secured financing of stock in trade. It could even be used by lenders who were not sellers, so long as 'title' to the goods was held by the creditors when the debtor held possession of the goods. The filing of a public notice of trust receipt financing was required, usually at a centralized filing office. It was not limited to international transactions, but was also used domestically - - for example, to 'floor plan' the stock of automobile dealers.

Thus, before enactment of the UCC, the United States had a device which, like the Australian 'charges' device, permitted financing of stock in trade. It caught after-acquired property and proceeds; it did not hinder sales by the retailer-debtor; and it provided public notice of the financing arrangement.[8] There were also Factors Acts, both 'old-style' and 'new-style', which provided similar protection respectively to those who bought, or took security in, accounts. Financiers of equipment could obtain protection either through the conditional sale device (Romalpa clauses) if they were sellers, or through the chattel mortgage device if they were not.

What then were the problems to which Article 9 of the UCC was directed? One problem was created by the number of different devices available, each using a different methodology to manipulate title concepts. For a potential secured creditor to be assured that no other secured creditor was in place ahead of it, several different filing systems had to be checked. Even checking all the different filing systems would not furnish complete protection, because some devices, such as Romalpa clauses, did not require filing of any public notice in many states. Further, some devices, such as 'old-style' factoring, provided no public notice of their existence, even though they performed exactly the same business function as secured

8 Cf; Gough, see note 3 above at 240-1. Gough is correct that chattel mortgages could not be used to cover after-acquired property, but seems to ignore the ability of the trust receipt device to cover after acquired property in the US long before the introduction of the UCC.

financing of accounts. Since those factors bought the debtors' accounts, rather than took them as security, a title-based analysis excluded them from consideration as a security device.

The use of multiple statutes also created priorities problems. Thus, a trust receipt financier which believed that it had covered all stock in trade could be surprised when a subsequent sale under a Romalpa clause led to a claim of higher priority by the subsequent credit-seller. The difficulties caused by conflicting priority schemes for different security devices also opened up avenues for United States bankruptcy officials (liquidators) to attack secured claims. Under United States insolvency laws, the liquidators could succeed to the claims of other creditors, including secured creditors, in liquidation proceedings. Thus, conflicting priority schemes could threaten the position in liquidation of creditors who thought themselves secured.

A third problem was that most of the popular security devices depended upon some manipulation of title concepts. That meant that the transaction and its underlying documentation had to conform to legal requirements for which there was no business need. Business men often did not appreciate the necessity of the legal framework, and often 'rationalized' their transaction in a way that precluded effective security. If the title manipulations were not done correctly, the attempt to create a security interest could be voided. Finally, use of title manipulation concepts sometimes led to the bizarre result that a secured creditor would be given all the collateral, even though the debtor had paid off most of the loan, merely because 'title' had passed and could not revert.

The effect of all these problems was that, although the secured financing devices available were often a conceptual tour de force of legal development, potential secured creditors did not trust them. The amount and cost of secured credit for small and medium sized businesses was not greatly affected by taking security, even though any creditors who could take such security did so. In short, the borrower usually could get an unsecured loan almost as large and at almost the same rate. Thus pre-UCC secured financing, with its multiple, unconsolidated laws, did not give much assistance to borrowers, and therefore did not give much assistance to commerce.

I do not know whether this survey of pre-UCC secured financing law describes the current situation in Australia in any way. I can say, however, that it conforms to many complaints I have heard about secured financing devices in Australia, from businessmen, lenders and attorneys. With that background, I would like to describe the analysis behind the creation of the 'security interest' of UCC Article 9, and how it works in practice.

The UCC drafters concluded that they wanted to provide cost-effective secured financing which would both expand the amount of credit available to

business, and lower its cost. To accomplish their cost-effectiveness goal, they decided that the pre-UCC law needed three basic reforms. First, all the different approaches to providing security needed to be brought together under one umbrella. Second, that umbrella needed to be statutory in format, because the case law development in 50 states was too random and diverse to provide the requisite certainty. Third, although manipulation of title concepts had been the foundation which allowed the then current financing devices to be built, such manipulation had become a limiting factor in the further development of secured financing. The concept of title, rather than providing a 'seamless web', created only a 'tangled web', and should be jettisoned, not merely tinkered with.[9]

The result was to drop all the pre-UCC distinctions between chattel mortgages, conditional sales (Romalpa clauses), trust receipts, 'new' and 'old' style factoring, equipment leasing, etc. Instead, Article 9 adopted a unitary concept, the security interest, and substituted it for all of the above. To ensure that title manipulation concepts would not be re-introduced, UCC s 9-202 explicitly states that 'title to the collateral' is irrelevant to any analysis of the rights, obligations and remedies of the parties.

But the history of the development of secured financing shows that creditors always try to bypass any statutory security device to create a device through case law that is not statutorily regulated. Article 9 seeks to prevent repetition of that dynamic by stating that all devices intended as security are subject to Article 9 rules. You can call it a 'trust receipt' or a 'charge', but it still falls under the definition of 'security interest', and is therefore governed by Article 9. It then does not matter whether a new device is created, or what its name is, or what its conceptual foundation is. It will still be subject to Article 9 rules, which have effectively pre-empted the field. For common law lawyers, the most important connotation of this pre-emption is that equitable interests are subject to exactly the same requirements as legal interests. *If* a legal interest is enforceable only if in writing, or only if filed with the proper public office, then an equitable interest is also only enforceable if in writing or so filed. No longer can the statutory rules be evaded by an allegation that the debtor had promised to sign a writing, but had fraudulently refused to do so after the funds were disbursed. Now it is the creditor's responsibility to obtain proper documentation, at its peril.

The UCC substitute for the various manipulations of title concepts was the 'security interest'.[10] Attorneys from Commonwealth countries invariably ask whether a security interest gives "legal title" to the creditor, or only 'equitable title'. The appropriate answer is that it gives neither. Under UCC s 9 - 202, a security interest by definition is not title. Thus, title (legal or

9 See Davies, note 3 above, at 91. As Davies correctly points out, the UCC drafters adopted the same position for UCC Article 2 on Sales. Thus, the Article 9 approach was not unique.

10 UCC s 1-201 (37).

equitable) can be placed in any party to the transaction, as may best suit the needs of the parties, for tax or other purposes. The secured creditor has only a security interest, but by the statutory provisions that security interest is sufficient to allow it to repossess and resell the collateral, passing title to the bona fide purchaser. That security interest, if 'perfected', is also sufficient to allow the secured creditor to reclaim the collateral from the hands of a levying unsecured creditor, a liquidator and a buyer who does not purchase in the ordinary course of business, such as a buyer in bulk.

Once the concept of title manipulation could be jettisoned, the primary foundation concepts for the Article 9 drafters became first, the reduction of the costs of creating and enforcing the security interest, and second, the creation of actual value to the creditor from the collateral in case of default. Together these foundation concepts would create a cost-effective security device which would lower the creditor's risk and costs, allowing the debtor to obtain a lower interest rate than it would for an unsecured loan.

The drafters sought to meet five basic tests: (i) to create an enforceable security interest at little cost; (ii) to allow enforcement of the security interest at little cost; (iii) to allow enforcement of the security interest to produce the maximum real commercial value for the secured creditor; (iv) to enable a lender to determine, *before* making the loan, whether any other lender has or will have better claims to the collateral; and (v) to protect the secured creditor from the claims of third parties, including purchasers of the security, secured and unsecured creditors, and liquidators and tax authorities,

To meet the first test, the UCC drafters stripped all unnecessary formalities from formation of the security interest: all the formalities that had been required by the rituals for manipulating title concepts. The basic formalities enacted were: (i) that the parties execute a written, signed 'security agreement' giving a security interest in described collateral to the secured creditor;[11] and (ii) that a public notice be given of the security interest, usually by filing a 'financing statement' with the appropriate agency.[12]

The agreement, written or otherwise, does not need to take any particular form. More importantly, the transaction did not have to take any particular form, such as routing the goods on a document of title through the creditor to the debtor. In particular, the description of the goods could be very general. 'All inventory, accounts and equipment now owned or hereafter acquired and their proceeds' would create a 'floating lien' and cover both present and after-

11 Ibid s 9 - 203(1). There is an exception for possessory security interests. For them, an agreement is still needed, but it need not be written. The necessary 'description' of the collateral is defined in s 9 - 110.

12 Ibid s 302. This requirement is called 'perfection' and is further described in text at note 19.

acquired stock in trade, accounts and equipment without any further elaboration.[13] A statement that the collateral was subject to future advances was sufficient to do so.[14] Other types of collateral, such as documents, chattel paper, instruments and general intangibles, could also be added with a similar simple description. On the other hand, a description could also be very specific. 'One 1991 Caterpillar Model CX Tractor, Serial No. 56473', for example, gives a security interest in that tractor and only in that tractor. In other words, the parties' rights and obligations and the extent of the collateral is determined by the agreement between the parties. The cost of creating the security agreement can be minimal through use of a standarized form, although in large transactions the agreement may be separately negotiated, which can raise the cost proportionately.

Once there is a security agreement and value has been given, the creditor's security interest is enforceable *against the debtor* for any collateral in which the debtor has rights. This includes any after-acquired collateral (inventory, accounts) as soon as the debtor acquires rights, including less than full ownership in the after-acquired property. Once the security interest is enforceable, if the debtor defaults on the loan obligation, the creditor's interest can be enforced immediately and directly. There is no requirement of obtaining court permission before enforcing rights against business collateral, or of operating through any receiver or other official to exercise those rights. The aggrieved secured creditor, after default, does not get title, but does get a right to take possession of the collateral (repossession), regardless of who has title. Alternatively, it can render the collateral unusable, or notify account debtors or other obligors to make any future payments directly to the secured creditor.[15] Thus, the costs of enforcement are reduced as far as possible, meeting the drafters' second test. There are, of course, instances where the debtor makes enforcement difficult, such as by hiding the collateral, but there are no costs added by legal formalities.

Enforcement of the security interest and realization of value from the collateral are not the same, conceptually or practically. The creditor is not likely to want to keep and use repossessed stock or equipment. further, the creditor does not have 'title' to the collateral after repossession. The creditor does, however, have the power to sell the collateral to a buyer who will receive all the rights and interests of both the debtor and the creditor. This route from repossessed collateral to payment to the creditor comprises two steps: the sale of the collateral and the disbursement of the proceeds of the sale.

The primary issue in selling the collateral is who controls the sale? Experience in the United States indicates that the lowest price will be realized if the seller is a public official (sheriff or other court official) who

13 Ibid s 110, 204 (1).
14 Ibid s 204 (3).
15 Ibid s 503, s 502.

follows a statutory sale format. A higher price will be realized if the seller is an official receiver, who may have more flexibility in the format of the sale, but (in our system) has no personal interest or risk in the amount of the proceeds of the sale. But, the UCC drafters believed that the creditor was more likely to make arrangements which would realize the highest sale price, unless a 'sweetheart deal' was made with the buyer. Thus, Article 9 gives the creditor total control over the sale after repossession. It may sell at auction or otherwise ('private sale'), at whatever price the market will bring, but there are some restrictions which attempt to prevent 'sweetheart deals'.[16] The only cost requirement on the secured creditor is that it must notify the debtor of its sale plans, and delay the sale to allow the debtor time to attempt to redeem the collateral.[17]

After the sale, the proceeds of the sale are distributed by the creditor, not by a court or other governmental official. The creditor first may allocate these proceeds to its own costs of repossessing and selling the collateral, then to its own debt until that debt is paid in full.[18] The creditor can keep the proceeds of the sale only up to the amount of 'value' it has given to the debtor. If that is $0, then the secured creditor takes nothing. With the discarding of title manipulation, it is not entitled to collateral or proceeds merely because 'title' to the collateral has passed under some security device. After the secured party is paid in full, any proceeds are applied to any junior secured creditors, and any remaining surplus goes to the debtor. The creditor need not apply any of the proceeds to any court or receiver costs, to the debtor's tax delinquencies, or to amounts owing to employees. Since the creditor controls the sale and pays only itself first, and regulatory costs are limited to notifying the debtor and junior secured creditors, the UCC drafters believed that they had met the third test.

All of the preceding discussion dealt only with the secured creditor's relationship with the debtor, not with third parties. Further, it should be noted that, in defining this debtor-creditor relationship, only the security agreement need be consulted. There was no necessary reference to any public notice requirements. However, once the focus shifts to the relationship between the secured creditor and third parties, the public notice aspects become paramount. They arise in two different ways. One is cautionary: before a creditor makes a loan, can it find out whether there are any prior secured creditors? The other concerns the secured creditor's powers: can it protect its interests against buyers, other creditors, secured and unsecured?

The UCC drafters decided that one aspect of minimizing the cost of creating a security interest was to increase the certainty with which a potential secured creditor could determine the relative status of its claim.

16 Ibid s 504.
17 Ibid s 504 (3).
18 Ibid s 504 (1).

The most efficient method to accomplish that goal was to require the registration of a public notice of secured financing. In UCC terms, the foundation concept was that almost all creditors were required to file a financing statement in the appropriate governmental office in order to obtain rights against third parties.[19] The filing of the financing statement in the proper office, which cost about $5, 'perfected' the secured creditor' security interest, giving protection against third parties from the time of perfection. The underlying principle is the prevention of ostensible ownership problems, not the application of title, or even security interest concepts. Thus, it does not matter what the security device is called, chattel mortgage, trust receipt or factor's lien, a financing statement must still be filed. A financing statement must also be filed to 'perfect' a security interest under a Romalpa clause. A financing statement must sometimes even be filed when a security arrangement is not intended, such as the sale of accounts or some types of equipment leasing.[20] The reason for the latter is the traditional ostensible ownership problem: to provide any potential lender with a warning that those accounts or that equipment does not belong to the debtor free and clear of all claims.

The result is that the potential lender can check the records in the appropriate governmental office, often by computer and at little cost, and quickly determine what assets are, and are not, subject to the claims of prior creditors. It need not fear the hidden, undisclosed interest arising out of a title retention clause, a factor's agreement or an equipment lease. With that procedure available, and the cost of filing a financing statement at about $5, the UCC drafters believed they had met the fourth of their tests.

There are, however, exceptions to the requirement for filing a financing statement, which detract from the drafter's efforts. Most such exceptions are due to political compromises deemed necessary by the drafters in the 1950s if Article 9 was to be enacted at all. They are not based on any fundamental doctrine and, if the political necessity does not exist in other countries, they need not be emulated. One such exception is for possessory security interests: the pledge.[21] Pawnbrokers had traditionally not filed, and escaped the filing requirement by asserting that potential lenders would certainly check whether the collateral was in the debtor's possession before lending. A second exception was made for 'purchase money security interests in consumer goods', at the request of the industry.[22] The industry argued successfully that non-purchase money lenders to consumers did not rely on the economic value of the collateral, and therefore would not bother to search the public records, so that filing was not necessary to protect them. A third exception concerns cars and other types of collateral for which certificates of title are issued, if security interests *must* be noted on the

19 Ibid s 302.

20 Ibid ss 1 - 201 (37) and ss 9 - 102 (1) (b).

21 Ibid s 9 - 302 (1) (a).

22 Ibid s 302 (1) (d).

certificate of title.[23] The predominant reason for this exception was to avoid dual perfection requirements, one under the UCC and another under an independent statute. Since some of the states in the United States already had certificate of title statutes with 'mandatory notation' requirements, the UCC drafters decided not to expend political capital to attempt to change them. There are other, minor exceptions to the filing requirements, but the main thrust of Article 9 is to require filing, and none of the UCC exceptions need be followed where not politically necessary.

After its security interest is perfected the secured creditor is protected against any attempts to claim the collateral by most third parties. UCC s 9 - 201 states the foundation principle: 'Except as otherwise provided by this Act, a security agreement is effective according to its terms between the parties, against purchasers of the collateral and creditors.' Thus, to defeat the secured creditor's rights, one must find an explicit statutory provision which does so: interpretation of anomolous common law doctrine is not sufficient. The analysis of third party claims is usually divided between claims of purchasers, other secured creditors, unsecured creditors and liquidators.

The analysis of the rights of purchasers shows the benefits of abandoning title concepts for that of the security interest. It is no longer necessary to concoct implicit consent by the creditor to some types of sales of stock in trade. Nor is it necessary to watch helplessly as goods are sold in bulk because the creditor's interest has not yet crystallized into title. Instead, the rights of buyers vis a vis the secured creditor can be treated as a matter of 'priorities' between the two, and priorities can be established by statutory provisions. Retail and wholesale buyers 'in the ordinary course of *the debtor's business*' have priority over the secured creditor, even if they are aware of its perfected security interest.[24] This is the standard *market ouvert* protection, and the secured creditor is expected to look only to the proceeds of such sales.

However, buyers in bulk are not given any statutory priority, and therefore they must surrender the collateral to the secured creditor upon demand. There is a small exception to this rule where the secured creditor knows of a purchase by a buyer in bulk and then makes a voluntary future advance, or where a voluntary future advance is made more than 45 days after the purchase in bulk.[25] There are also exceptions for purchasers of negotiable instruments, documents and securities to protect holders in due course.[26] Purchasers of chattel paper who have no knowledge of the specific security interest are given priority if they obtain possession and give new value in the ordinary course of *the purchaser's business*.[27] This provision

23 Ibid s 302 (3), (4).

24 Ibid s 307 (1). Consumer to consumer sales are also excepted, unless the secured creditor has filed a financing statement. Ibid s 307 (2).

25 Ibid s 307 (3).

26 Ibid s 309.

27 Ibid s 308.

was believed necessary to protect the secondary market in such paper.

Conflicts between two or more secured creditors are decided by which one filed or perfected its security interest first.[28] Thus, if a potential secured creditor can determine that no other person already holds a perfected security interest, then its interest will have priority over all others by immediately filing a financing statement. To make that determination it must check the appropriate registry and the debtor's possession of the collateral (see discussion of test (iv), although there are some exceptions for business collateral which resemble the type of temporary release of possession of the collateral allowed by 'old-style' trust receipt transactions.[29] Thus, once the secured creditor has become the first to file or perfect on 'all accounts, equipment and inventory, now owned or hereafter acquired', it has priority over subsequent lenders, as to both current and after-acquired collateral.

However, there is an exception for subsequent purchase-money security interests, which can obtain a 'superpriority' over the prior secured creditor if the subsequent creditor perfects its security interest. Such subsequent purchase money secured creditors must notify the prior perfected secured creditor 'of the conflicting security interest' if the collateral is inventory, but not if it is equipment.[30] These provisions were intended to allow the debtor to have some freedom to seek alternative financing, but secured creditors regularly insert a clause in the security agreement that any such grant of a subsequent purchase money interest to another creditor is a default under the first security agreement. Thus, in practice the debtor can use this device without the secured creditor's consent only if it is prepared to pay the secured debt in full at once.

The secured creditor which perfects its interest is protected against any claims by subsequent unsecured creditors. Even if the unsecured creditor obtains a judgment and acquires a lien against the property subject to the security interest by attachment, levy or execution, the secured creditor will prevail.[31] Only if the unsecured creditor acquires such a lien before the secured creditor perfects its security interest will the unsecured creditor prevail. For the purpose of determining the time of perfection, a security interest in after-acquired property dates from the time of the original perfection.[32] Thus, unsecured creditors are not able to create and use the time between the original filing and the delivery of the after-acquired property as a 'gap' in perfection to defeat the secured creditor's interest in the after-acquired property. However, where a voluntary future advance is made more than 45 days after an unsecured creditor has acquired such a lien, the

28 Ibid s 312 (5).

29 Ibid s 304 (4) and (5). There is significant debate about the commercial utility of continuing these exceptions.

30 Ibid s 312 (3) and (4).

31 Ibid s 301 (1) (b) and (3).

32 Ibid s 204 (1) and Official Comment 1.

unsecured creditor has priority over claims based on that future advance.[33]

In United States insolvency proceedings, the liquidator (called a 'trustee in bankruptcy') both represents and occupies the same position as ('stands in the shoes of') an unsecured creditor who obtains a lien on all the debtor's property on the date of the commencement of the liquidation proceedings. Thus, if the secured creditor has perfected its interest before that date, it has priority over the liquidator in its claim to the collateral just as it would over unsecured creditors. Its protection extends to after-acquired stock in trade, accounts and equipment, just as it would against unsecured creditors. Two additional questions do arise in liquidation proceedings. Can collateral which is in the possession of the debtor at the commencement of the liquidation proceedings be seized by the secured creditor through self-help repossession? And, are security interests in after-acquired collateral held to be fraudulent or preferential transfers under United States insolvency law?

The answers to these two questions in the United States do not depend upon the UCC, but upon the Federal *Bankruptcy Act* of 1978. Thus, any other country adopting the UCC need not have the same results as those in the United States and could draft its own insolvency law to produce any result it desired.

Under s 362 of the *Bankruptcy Act*, the filing of a petition for liquidation proceedings creates an 'automatic stay' which prevents a secured creditor from repossessing the collateral without court permission. It also prevents any resale of already repossessed collateral without court permission. In liquidation proceedings, this stay can be lifted at the secured party's request if the debtor has no equity in it. In any event, it will lapse after 30 days unless the court explicitly extends it. In reorganization proceedings, the court will usually extend the stay if the collateral is 'necessary to an effective reorganization' *and* the secured creditor is offered 'adequate protection'. Such adequate protection includes continuation by the 'trustee in bankruptcy' of periodic payments at the contract level, or substituting new stock to cover any stock sold,[34] but a firm criteria for analysis of the concept awaits further case law development.[35]

Under the Federal *Bankruptcy Act*, the liquidator can avoid a fraudulent transfer of a security interest made within one year of the filing of the petition, while the debtor was insolvent or had 'unreasonably small capital'.[36] However, the time of the transfer for a secured creditor is the time of perfection of the security interest, even for after-acquired property.[37] Further, the secured creditor's rights to the collateral are protected to the extent that it gave value at the time of the perfection of the security interest.

33 Ibid s 301 (4).

34 *Bankruptcy Act* s 361 (1).

35 White J & Summers R, *Uniform Commercial Code*, at 1112, 1116 - 17, 3rd ed, (1988).

36 *Bankruptcy Act* s 548 (a).

37 Ibid s 548 (d) (1).

Thus, the secured creditor who took a 'floating lien' on all stock and accounts, and gave value at the time of the creation and perfection of that security interest, protected in its claims to after-acquired property. Each state also has its own fraudulent conveyancing laws, many with a longer or no time period, which the liquidator can use under s 544(b). However, a security interest in after-acquired property is not a fraudulent conveyance under these state laws either.

The liquidator can also avoid a preferential transfer of a security interest made within 90 days (in some instances, within one year) of the filing of the petition.[38] The debtor will be presumed to be insolvent during the last 90 days before the filing of the petition.[39] However, the transfer occurs at the time of perfection, and the original security interest is therefore normally not preferential if it was created and perfected more than 90 days before the petition.

However, for a 'floating lien' on after-acquired property, there is a separate treatment by two different subsections. First, s 547 (e) (3) postpones the 'transfer' of after-acquired property until 'the debtor acquires rights in the collateral'. That provision would require the secured creditor to show that it was made for contemporaneous value, such as the release of security on some other collateral. On the other hand, the second subsection, s 547 (c) (5), creates special rules which explicitly protect the UCC's 'floating lien' on stock or accounts from attack as a preferential transfer. There is, however, an exception to that protection, but only if the secured creditor is under secured *and* there is a last-minute swelling of assets covered by the security interest. In that case, the increase in assets during the last 90 days will be treated as a preferential transfer, but the secured creditor will still receive the value of the assets actually under the debtor's control 90 days before the filing of the petition.

The result is that the small or medium-sized businessman can give the creditor a security interest in all of his accounts, stock in trade and equipment which costs little, has real value and is protected against insolvency officials. The secured creditor is entitled to priority over the liquidator, both as to the goods and as to their proceeds of sale. Tax officials and employees do not have greater priority. The security interest covers after-acquired property, unless the creditor is under secured, *and* there has been a last minute swelling of assets. It also covers future advances up to the commencement of the insolvency proceedings.

There are three policy problems: (i) should title be dropped as the primary determinant of the creditor's status? (ii) should persons who are not parties to technical security arrangements be required to file a financing statement? and (iii) should a debtor be allowed to tie up all his assets (stock in trade and

38 Ibid s 547 (b).

39 Ibid s 547 (f).

accounts) on a 'revolving basis' for the benefit of a single creditor? The first two of these issues have been referred to in the prior discussions.

The use of title doctrines was necessary to gain court approval of any chattel security device. Further, many of the title manipulation schemes were brilliant in conception and execution. However, they all came at a price. One price was that the title manipulation scheme was a limit on the utility of the device presented: a transaction had to be handled in a certain manner or it would not qualify. A second price was the forced separation, through legal technicalities, of devices and transactions which served the same *commercial* function: secured financing. The real cost of this separation was the conflicting rules and priorities of the several devices, which made all of them commercially untrustworthy. Thus, in the aggregate they fail to serve their commercial purpose, the creation of financing which is lower in interest rate and with greater credit availability than unsecured lending. Until a unitary concept, such as the security interest, is provided, the division of secured financing into different legal concepts of title manipulation will continue to obstruct its commercial purpose.

Undisclosed, or secret, interests in property in the debtor's possession is antithetical to any secured lending system. To that extent, the Statute of Elizabeth is still good policy. Creditors simply will not lend on a lower rate and greater credit availability basis unless they are certain that they know the entire asset position of the debtor. Third party interests in property in the debtor's possession are not limited to those which were 'intended as security arrangements'. Thus, in modern day finance, the chattel mortgage on equipment, the sale of the equipment with a Romalpa clause and the long-term lease of that equipment (with or without an option to buy at the end of the lease) all serve the same commercial function, and all pose the same dangers to the potential secured creditor. Under the UCC, all three must disclose their interests to the public by filing a financing statement, even though the equipment lessor can argue that no security arrangement was intended.

Likewise, the same commercial function is served by an 'old-style' factor who buys accounts from the debtor and other creditors who lend on the security of those accounts. Further, the latter are unlikely to take seriously the security value of the accounts unless there is reliable information about transactions of the former. Thus, under the UCC, purchasers of accounts must file a financing statement to be protected against third parties and insolvency officials.

Should any secured creditor be allowed to tie up the assets of a debtor this completely? The answer of the UCC drafters was twofold. First, certain assets can be freed from the secured creditor's 'floating lien', and the secured creditor is required to look only to the proceeds of those assets. Also, sellers of goods can sell to the debtor on credit and obtain a super-priority which

breaks the dominance of the 'floating lien' creditor. Second, a debtor could be equally tied up under the old title manipulation devices; it was just more costly, and the debtor therefore received little benefit from being so tied up.

Stock in trade sold to a buyer in the ordinary course of business is one asset which could be freed from the creditor's security interest. Also, the debtor's 'chattel paper'[40] can be sold free and clear of the floating lien if the floating lien creditor does not take physical possession of it to a purchaser who is in the business of purchasing chattel paper and acts without knowledge.[41] In both these circumstances, the secured creditor must seek satisfaction from the proceeds. The super-priority of purchase money security interests on stock and equipment are other examples of how the complete coverage of the floating lien security interest can be opened up.[42] However, the secured creditor is given written notice of any such purchase money security interests in stock in trade, and the security interest continues in any old equipment traded in on new equipment,[43] which usually leads to negotiations between new and old secured creditors to create explicit subordination agreements.

The primary reply of the UCC drafters to the charge that the debtor's assets could be tied up excessively was that the secured creditor had the power to accomplish the same result under the old law. It just required much more time and expense under the old law. That expense all came out of *the debtor's* pocket, making the grant of the security equally restricting, but less useful, to the debtor.[44] Under the prior law, there were devices which would permit a creditor to take security in stock in trade, and assignments of accounts were effective. Some of the stock financing devices were cumbersome and costly, such as the chattel mortgage, others were less so, such as the trust receipt; but all were effective.

With those devices available, the equivalent of a general continuing lien could be maintained by a daily 'pay out and pay over' system. In such a system, the merchant debtor would bring all of his receipts from the day's sales to the lender at the end of the day and transfer them to the lender. The merchant would bring the receipts (cash, accounts, checks, chattel paper) all in specie, and accounted for each piece of inventory which had left the store. The merchant, after transferring all the receipts, could then apply for a new loan to replace the stock sold. This loan would be granted on a secured basis, the merchant could then purchase replacement inventory, and the cycle could begin again. Often the cycle was monthly, rather than daily, but the

40 UCC ss 9 - 105 (1) (b) defines 'chattel paper' as writings which include both a promise to pay and a security interest. Thus, chattel paper is the proceeds of a sale of stock by the debtor in which the debtor has taken a security interest from the purchaser. As such, it has great market value. See Peden, note 3 above.

41 Ibid s 308 (a).

42 Ibid s 312 (3) and (4). See prior discussion in text at note 30 above.

43 Ibid s 306 (2) (first half).

44 See Official Comments to UCC ss 9 - 204.

duration was determined by the creditor.

Such a system was in fact effective, even under the most restrictive of laws. It was, however, extremely costly, and most of the costs served no *commercial purpose*. The UCC drafters, in their goal of providing the most effective secured financing decided not to attempt to limit the power of the secured creditor to tie up assets. In their words, 'the cushion of free assets was not preserved [under prior law]. In almost every state it was possible before the Code for the borrower to give a lien on everything he held or would have.'[45] Thus, this policy argument, while meritorious, had been decided a century earlier, when chattel mortgages and assignments of accounts had first been permitted.

Conclusion

What is the position of a lender which wishes to make credit available to a small or medium sized business using a 'security interest'? This brief survey of North American law indicates that use of a security interest will give that creditor valuable rights with respect to the goods with little significant cost. First, a 'floating lien' on all stock in trade, accounts and equipment can be created by a simple contract using a simple description of the types of collateral 'now owned or hereafter acquired'.

Second, as to enforcement, that security interest gives the secured creditor a direct and immediate right to seize or disable the collateral or to collect the accounts if the debtor defaults on its obligations. No court or other official stands between the secured creditor and its collateral. Third, the creditor controls the sale of the repossessed collateral, the buyer at such a sale extinguishes both the debtor's and the creditor's rights to the goods, and the proceeds of the sale are disbursed first to the creditor until the secured debt is satisfied. These enforcement provisions also apply to after-acquired collateral.

The potential secured creditor can establish its priority to the collateral over other third parties before making the loan at little cost. In most cases, it is necessary only to check the appropriate register of financing statements and the debtor's possession of the collateral. 'Perfection' of the interest by filing a financing statement then costs about $5. Such perfection protects the secured creditor against claims by buyers, secured and unsecured creditors and liquidators. Exceptions are made for 'buyers in the ordinary course' of the debtor's business, but the security interest continues on collateral sold to a buyer in bulk, and therefore such collateral can be retaken. Another exception is made for subsequent 'purchase money security interests', but they must be perfected by filing and, in the case of stock in trade, trade creditors attempting such a purchase money security interest must notify any prior secured creditors in writing.

45 Ibid.

In insolvency proceedings, the secured creditor's interest will be recognized and the secured creditor is entitled to return of the collateral or its value. The secured creditor will, however, usually need to obtain court approval to seize or sell any collateral not repossessed and sold before the commencement of the insolvency proceedings. The secured creditor's interest in after-acquired property obtains the same protection as its interest in other collateral, unless there has been a last-minute swelling of assets during the 90 days immediately before the insolvency proceedings. In that case, the net additions during the 90 days are considered a preferential transfer, but the secured creditor still obtains the net value of the collateral as of 90 days before the commencement of the insolvency proceedings.

The result is a financing device which is cost-effective in practice, not just in legal theory. The test of practical effectiveness is whether the use of security affects the price or quantity terms of the loan contract: whether there is a difference in the interest rate or amount of credit available to the debtor under a secured loan and under an unsecured loan. I do not have the expertise to answer that question for Australian banking practice, but I have been told that in practice there is no significant difference here in rate or credit availability between secured and unsecured loans. If that is accurate, adoption of the security interest approach should be considered, to provide a cost-effective alternative for debtors and creditors.