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## GOOD FAITH PERFORMANCE OF SECURITY AGREEMENTS: THE LIABILITY OF CORPORATE MANAGERS

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The proposition that a corporate manager<sup>1</sup> is not liable for the debts of his corporation is part of the basic learning of all lawyers and is understood and appreciated by all but the least sophisticated businessmen. It is equally well established, though, perhaps, less well known, that a corporate manager is liable for his torts, although committed in the name of and for the benefit of his corporation.<sup>2</sup> In the modern non-possessory security transaction, which creates a varied assortment of rights and obligations, the applicability of the foregoing principles is frequently obscured. To illustrate, in one recent case, a corporate manager who had not guaranteed his corporation's indebtedness was held liable to the corporation's secured creditor for the amount of the corporation's debt.<sup>3</sup>

Admiral Corporation, an appliance manufacturer, sold merchandise on credit to Winchester Corporation, a retail appliance dealer. To

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<sup>1</sup> The term "manager" is used in the title and text of this Article to identify the individual whose responsibilities may be generally described as running the business of a corporation. In most instances he will be an officer. In some he will be a director. He may, not infrequently, be a stockholder. Occasionally, he will be none of the above. Whatever his official position, the duties discussed herein depend on his function—not on his title.

<sup>2</sup> 3 W. FLETCHER, *CYCLOPEDIA CORPORATIONS* § 1135 (perm. ed. rev. vol. 1965).

<sup>3</sup> *Admiral Corp. v. Winchester Corp.*, 7 UCC REP. SERV. 743 (N.Y. Civ. Ct. 1970). The facts have been simplified to illustrate better the precise problems discussed herein.

secure payment of the purchase price, Admiral requested and was granted a security interest in the merchandise and the proceeds of its sale. Winchester, of course, was authorized to sell the merchandise to its retail customers and agreed to segregate the proceeds of sale from its other property. Periodically, Winchester was to account to Admiral for merchandise that had been sold, paying to Admiral the cost of such merchandise and, presumably, retaining the balance for its own use.

Things did not go well for Winchester. In a desperate effort to save its failing business, the proceeds of sale of Admiral products were used to pay other legitimate corporate obligations. Not surprisingly, the effort was unsuccessful, and the corporation subsequently went out of business leaving Admiral unpaid. Admiral's security interest had evaporated.

Brown was an officer, director, and substantial shareholder of Winchester. It was Brown who, on behalf of Winchester, contracted for the purchase of the appliances and executed the security agreement. It was also Brown who, again on behalf of Winchester, failed to segregate the proceeds, paid the other corporate creditors and, in a very practical sense, was responsible for Winchester's failure to pay Admiral. There is no indication that Admiral had sought Brown's personal guarantee. Almost certainly, it had not obtained it.

Knowing full well that Winchester was unable to respond to a judgment, Admiral sued the corporation on two causes of action. On the first count—breach of contract to repay the indebtedness—the corporation was undeniably liable. The corporation's liability on the second count—conversion of the collateral—was of only theoretical interest because the damages sustained by Admiral were coincidental with and limited by the amount of the unpaid debt. On the second count, however, Brown was joined as an additional defendant.

Admitting the facts, Brown denied liability on the ground that Winchester's arrangement with Admiral "was merely an agreement to purchase merchandise . . . for the purpose of resale and . . . [to turn over] the proceeds of the resale . . . to Admiral"<sup>4</sup>—an agreement to which he, Brown, was not a party. The court granted summary judgment against Brown. Emphasizing that the parties had themselves characterized the transaction as a "trust arrangement," it held that the corporation "was trustee of the goods . . . [and] the proceeds,"<sup>5</sup> that violation of the terms of the agreement was a breach of trust, and that both the corporation and the participating manager were guilty of conversion.

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<sup>4</sup> *Id.* at 744.

<sup>5</sup> *Id.* at 745.

Quite clearly, Brown's contention that he was a stranger to the transaction flies in the face of reality. He was, by his own admission, an active participant at all stages of negotiation and performance and had full knowledge of both the contract and the probable consequence of its breach. On the other hand, it seems equally unrealistic to categorize Brown as a fiduciary, with all the responsibilities such a relationship implies. The actual relationship between corporate manager and secured creditor lies somewhere between these extremes. This Article will explore the nature and extent of the noncontractual duty owed by a manager of a corporate debtor to his corporation's secured creditors in the light of contemporary security law and the reasonable commercial expectations of businessmen.

## I. THE COMMERCIAL SETTING

### A. *Contemporary Security Law*

#### 1. The Limits of the UCC

One might suppose that all of the common business relationships arising out of a secured transaction would be regulated by article 9 of the Uniform Commercial Code (UCC).<sup>6</sup> Such is not the case. Notwithstanding the draftsmen's stated aim to set "out a comprehensive scheme for the regulation of security interests in personal property,"<sup>7</sup> the same draftsmen, in the same Comment, concede that "[t]he rules set out in . . . article [9] are principally concerned with the limits of the secured party's protection against purchasers from and creditors of the debtor."<sup>8</sup> Indeed, the most significant cases concerning the security aspects of commercial financing do involve disputes between the secured creditor and the other creditors of the debtor, frequently represented by the debtor's trustee in bankruptcy. Part 3 of article 9, entitled *Rights of Third Parties*, contains a detailed set of priority rules under which most, if not all, such disputes ought to be resolved. But part 3 does not deal with the rights and obligations of all third parties, that is, persons who are not parties to the security agreement. Notably, the manager of a corporate debtor is not a "third party" within the scope of part 3 or any other part of article 9.

In a less comprehensive manner, other parts of article 9 deal with the relationship between the secured party and the debtor. Part 2 prescribes the requisites for the formation of a valid security agreement

<sup>6</sup> References are to the 1962 Official Text. Uncited articles, parts, sections (designated with §), and comments in the text of this Article will refer to this source.

<sup>7</sup> UNIFORM COMMERCIAL CODE §9-101, Comment (first paragraph).

<sup>8</sup> *Id.* (final paragraph).

and, together with part 5, sets forth some general rules concerning the respective rights and duties of the secured party and the debtor, particularly after default. As the draftsmen comment, however, “[e]xcept for procedure on default, freedom of contract prevails between the immediate parties to the security transaction.”<sup>9</sup> Thus, the secured-party/debtor relationship is not governed primarily by the UCC, but rather by the agreement of the parties, which is presumably binding on them alone. Except, then, to the extent that the managers of a corporate debtor may choose to become parties to the security agreement, the UCC imposes no express duties on them.

One jurisdiction appears to have recognized this problem and has attempted to deal with it in its version of the UCC. As a unique addition to the official text, Illinois has enacted § 9-306.01, which provides:

(1) It is unlawful for a debtor under the terms of a security agreement (a) who has no right of sale or other disposition of the collateral or (b) who has a right of sale or other disposition of the collateral and is to account to the secured party for the proceeds of any sale or other disposition of the collateral, to sell or otherwise dispose of the collateral and willfully and wrongfully to fail to pay the secured party the amount of said proceeds due under the security agreement.

. . . .

(4) In the event the debtor under the terms of a security agreement is a corporation or a partnership, any officer, director, manager, or managerial agent of the debtor who violates this Section or causes the debtor to violate this Section shall, upon conviction thereof, be punished by imprisonment in the penitentiary for not less than one year nor more than ten years.<sup>10</sup>

The Permanent Editorial Board for the UCC has not recommended this provision for uniform adoption. Its tersely stated reason for rejection is that “[t]his kind of criminal provision has no proper place in a commercial statute; it belongs in the criminal code.”<sup>11</sup> Irrespective of the merits of having any criminal provision, the Board’s reason for exclusion from the UCC seems sound.

Curiously, neither the Illinois legislature, in its adoption of this section, nor the Permanent Editorial Board, in its rejection, appears to have considered the imposition of civil liability on the offending corporate manager. Whether or not criminal penalties are justified, the

<sup>9</sup> *Id.*

<sup>10</sup> ILL. ANN. STAT. ch. 26, § 9-306.01 (Smith-Hurd 1963).

<sup>11</sup> PERMANENT EDITORIAL BOARD FOR THE UNIFORM COMMERCIAL CODE, REPORT No. 2, § 9-306.01, at 213 (West ed. 1965) (comment).

imposition of personal liability to the injured party seems an entirely appropriate sanction for a commercial statute to apply to a businessman who acts wrongfully in the performance of a commercial transaction.

The failure of Illinois to consider civil liability may be attributable to inadvertence,<sup>12</sup> but other possible explanations exist. First, the criminal sanction might be viewed as a sufficient deterrent to wrongful conduct. Secondly, the statutory imposition of criminal liability is, a fortiori, a sufficient basis for the imposition of civil liability, without express statutory support. Neither reason is persuasive.

The injured secured party has scant interest in putting his corporate debtor's managers in jail. His primary, if not his only, interest is in recouping his loss. He would therefore have little incentive to institute a criminal prosecution, and deterrence is likely to suffer. Further, the determination whether civil liability should be imposed involves considerations quite different from those involved when the penalty is incarceration. The standard of proof, the requisite mental element, the end the law was intended to achieve, and the class of individuals entitled to press the action, all may, and should, vary according to whether the penalty is criminal or civil.<sup>13</sup> A criminal provision provides little guidance for courts that are confronted with the claim that civil recovery is implied by the existence of the criminal provision. Recovery of damages from another businessman, one who has dealt improperly with the plaintiff, should present fewer procedural and substantive obstacles than successful criminal prosecution. Extrapolation from a criminal provision is less than an ideal way to reach this result.<sup>14</sup>

The failure of the UCC's draftsmen to deal expressly with the secured-party/manager relationship in terms of civil liability may be explained on other grounds. Section 1-103 provides that "[u]nless displaced by the particular provisions of [the UCC] . . . the principles of law and equity . . . shall supplement its provisions." Thus, it is contemplated that, under the UCC, as was the case under pre-UCC security law, the claims that secured parties may assert against the managers of their corporate debtors will be adjudicated by the appli-

<sup>12</sup> The troubled history of the criminal provision, which dates back to 1874, is discussed in the comment following the statute. ILL. ANN. STAT. ch. 26, § 9-306.01 (Smith-Hurd 1963) (comment).

<sup>13</sup> See, e.g., Note, *The Use of Criminal Statutes in the Creation of New Torts*, 48 COLUM. L. REV. 456 (1948).

<sup>14</sup> Provisions similar to Illinois' criminal provision appear in a number of criminal codes. See, e.g., CAL. PENAL CODE § 504b (West 1970); N.Y. PENAL LAW § 185.05 (McKinney 1967). In connection with its criminal provisions, Vermont has an interesting penalty section, which provides for a fine not to exceed twice the value of the collateral, with one-half of the fine payable to the injured party. VT. STAT. ANN. tit. 13, § 2075 (Supp. 1971). There is generally no express reference to the liability of the managers of a debtor corporation such as that contained in Illinois' provision. See ILL. ANN. STAT. ch. 26, § 9-306.01(4) (Smith-Hurd 1963).

cation of such principles of property, tort, corporate, fiduciary, and agency law as may seem appropriate for doing justice in a particular case.

## 2. The Impact of the UCC

The inapplicability of any express UCC provision does not mean that the UCC will or should have no influence on the resolution of secured-party/manager disputes. The contemporary secured transaction is a creature of the UCC, and its impact on both the parties' structuring of their security transactions and the courts' attitudes toward those transactions will surely be felt. To the extent that the UCC has changed prior security law it will have an effect on all problems growing out of it.

Perhaps the most pervasive of the changes is the abandonment of distinctions based on form.<sup>15</sup> While the old forms of secured transactions are still permitted and may, for many years, in fact be used, the choice of a particular form will be immaterial to the determination of the very important rights and obligations that are expressly covered by the provisions of article 9 and that constitute the subject matter of most security transaction litigation. As a consequence, parties will, in a search for certainty of result flowing from uniformity of interpretation, increasingly couch their agreements in UCC terminology.<sup>16</sup>

Even when the parties cling to the old forms,<sup>17</sup> the courts, conditioned by a system of security law that ignores form in favor of substance for the resolution of the most common disputes, will be less inclined to give formalities the weight they were accorded under pre-UCC law. A court that, in the majority of cases before it, can draw no distinctions between a conditional sale and a chattel mortgage or between a factor's lien and a consignment, is far less likely to hold, as did the court in *Admiral Corp. v. Winchester Corp.*,<sup>18</sup> that a party is a "trustee" simply because he had characterized his security arrangement as a "trust receipt." As long ago as 1934, when formalism may have

<sup>15</sup> "The scheme of the Article is to make distinctions, where distinctions are necessary, along functional rather than formal lines." UNIFORM COMMERCIAL CODE § 9-101, Comment (eleventh paragraph).

<sup>16</sup> [T]he selection of the set of terms applicable to any one of the existing forms . . . might carry . . . the implication that the existing law . . . was to be used for the construction and interpretation of this Article. . . . [A] set of terms has been chosen which have no common law or statutory roots . . . .

*Id.* § 9-105, Comment 1.

<sup>17</sup> A list of the old forms to which article 9 applies is contained in *id.* § 9-102(2). "This does not mean that the old forms may not be used, and Section 9-102(2) makes it clear that they may be." *Id.* § 9-101, Comment (eighth paragraph).

<sup>18</sup> See note 3 *supra* & accompanying text.

been essential to the validity of a security interest, Mr. Justice Cardozo, in holding a debt dischargeable under the Bankruptcy Act,<sup>19</sup> stated that an "obligation is not turned into one arising from a trust because the parties to one of the documents have chosen to speak of it as a trust."<sup>20</sup> If the defendant in the *Admiral* case should have been held liable, as I suspect he should, it is because of what he did and not what he called himself. The scheme of article 9 clearly calls for a functional analysis.

Under the UCC there is no longer any requirement that the secured party retain a measure of dominion and control over the collateral in order to have a valid security interest. By its express repeal of the doctrine of *Benedict v. Ratner*,<sup>21</sup> § 9-205 permits the secured party to repose complete faith in the debtor without fear of losing his position vis-à-vis other creditors or the debtor himself. However imprudent such a course may be, the secured party may now, to an extent not heretofore possible in many jurisdictions, choose to rely upon the debtor's integrity to protect his interest.<sup>22</sup> When the debtor is a corporation, that reliance is necessarily placed on its managers, and questions of manager liability may arise with increasing frequency in the future.

Furthermore, the UCC permits the creation of security interests in personal property, many types of which could not heretofore be used as collateral and some that were not even conceived of when concepts of property and tort law were being developed. To confuse matters still more, § 9-306 provides for the automatic transfer of a security interest to whatever other property is received whenever collateral is sold, exchanged, collected, or otherwise disposed of. Legal rules that have been satisfactorily applied to machinery and groceries may prove inadequate to deal with television rights, goodwill, or even cash.

Finally, § 1-203 expresses "an obligation of good faith" that pervades the entire UCC. While "good faith" is an ancient concept in the

<sup>19</sup> *Davis v. Aetna Acceptance Co.*, 293 U.S. 328 (1934). The issue was whether an automobile dealer had been discharged from liability to a financier to whom he had given, among other documents, a trust receipt. Section 17(4) of the Bankruptcy Act, ch. 541, § 14, 30 Stat. 550 (1898), as amended, Act of Jan. 7, 1922, ch. 22, 42 Stat. 354, provided then, substantially as § 17(a)(4) of the Bankruptcy Act, 11 U.S.C. § 35(a)(4) (1970), does now, that a bankrupt was not released from liabilities that "were created by his fraud, embezzlement, misappropriation, or defalcation while acting as an officer or in any fiduciary capacity."

<sup>20</sup> *Davis v. Aetna Acceptance Co.*, 293 U.S. 328, 334 (1934).

<sup>21</sup> 268 U.S. 353 (1925). The case held that a security assignment of receivables without imposing on the assignor any duty to account for the collections was void, under New York law, against the trustee in bankruptcy. In the oft-quoted words of Mr. Justice Brandeis, the transaction was conclusively fraudulent "because of the reservation of dominion inconsistent with the effective disposition of title and creation of a lien." *Id.* at 363; see UNIFORM COMMERCIAL CODE § 9-205, Comment 1.

<sup>22</sup> UNIFORM COMMERCIAL CODE § 9-205, Comment 5. "[B]usiness and not legal reasons will determine the extent to which strict accountability, segregation of collections, daily reports and the like will be employed." *Id.*

law,<sup>23</sup> its application has frequently lacked statutory support. Of course, the appropriate limits for the application of § 1-203 will require judicial determination, but the mere presence of the section in the basic statute governing security transactions may facilitate the regulation of morally questionable conduct that might otherwise be regarded as within the law.

Thus, while the UCC does not directly address itself to the secured-party/manager relationship, its enormous impact on the totality of security law may require courts to re-examine their heretofore formalistic approach. At the very least, it will give them the opportunity to do so—an opportunity that ought not to be ignored.

### B. *Commercial Expectations*

The creditor who extends unsecured credit to a corporation is satisfied to look for repayment to the general pool of corporate assets. He assumes the risk that the corporation may become insolvent, leaving him unpaid, with full knowledge that insolvency may result not only from factors beyond the management's control but also, wholly or in part, from the manner in which the managers conduct the enterprise. Such a creditor must appreciate the possibility that the corporation may breach its obligation to repay him and may, in the event of such breach, reasonably expect to recover nothing from the managers as individuals unless they have fraudulently transferred corporate assets to themselves or for their benefit.

The insulation of corporate managers from liability to the corporation's creditors can, of course, be eliminated by obtaining the managers' personal guarantees. Financing agreements of commercial lenders frequently have such guarantees printed directly under the place for the corporate borrower's execution or on a supplementary sheet conveniently attached. A lender will often request such guarantees or even demand them as a condition of extending credit. If successful in obtaining them from financially responsible individuals, he may regard them as a welcome addition, or even a preferred alternative, to a security interest in the corporate debtor's assets.

The value of such guarantees extends well beyond the protection they afford in the event of the borrower's subsequent insolvency. Since the guarantors control the operations of the borrower, they can, in their own interest, be counted upon to make every effort to ensure that the guaranteed creditor is paid in preference to those creditors who

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<sup>23</sup> The concept in commercial transactions dates back to the Roman law and the English law merchant. See Farnsworth, *Good Faith Performance and Commercial Reasonableness Under the Uniform Commercial Code*, 30 U. CHI. L. REV. 666 (1963); Summers, "Good Faith" in *General Contract Law and the Sales Provisions of the Uniform Commercial Code*, 54 VA. L. REV. 195 (1968).

were not sufficiently strong, smart, or lucky to obtain guarantees of their own. As evidence of this motivation, one need only witness the desperate efforts of the managers of a failing corporation to make sure that withheld taxes, for which they are made personally liable by statute,<sup>24</sup> are paid before the doors finally close.

On the other hand, such guarantees are not lightly given. The very essence of the corporate form is the insulation of individuals from liability. While, under certain circumstances, the corporate managers might be persuaded to pledge their individual credit as security for what might be their corporation's most significant obligation, they will, in the typical case, make every effort to avoid doing so. If a lender, notwithstanding his failure to obtain requested guarantees, proceeds to extend credit to the corporation, the managers may quite reasonably anticipate that they will not be liable if the corporation fails, for whatever reason, to pay its debt.

Unlike the unsecured creditor, and like the guaranteed creditor, the creditor who demands security is unwilling to rely solely on the corporation's promise to pay. In addition, he acquires a second promise that certain corporate assets will be applied to the satisfaction of his claim if the corporation fails to keep promise number one. Through the mechanism provided in article 9, promise number two, *if it is kept*, can be made effective against the competing claims of other creditors. But promise number two is still the promise of only the corporation and, unlike the guarantee, creates no contractual rights against the corporate managers.

The secured creditor's hope is that he has insulated himself against the risk of the debtor's insolvency. Whether he has succeeded depends on the satisfaction of two conditions at the time of default: the value of the collateral must equal or exceed the then unpaid balance of the debt, and the creditor's interest in the collateral must have been preserved. To an extent that varies with the nature of the particular transaction, the satisfaction of each of these conditions is within the control of the corporate management.

The value of almost every type of commercial collateral is, to some degree, subject to impairment by management conduct. The value of inventory can be adversely affected by unwise decisions on what to buy or manufacture. Accounts can shrink in value because of the injudicious extension of credit. Contract rights can evaporate if the debtor fails to perform its end of the bargain. Even fixed assets can be rendered less valuable by management's failure to provide satisfactory maintenance or to have anticipated technological change. So long as a manager acts

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<sup>24</sup> INT. REV. CODE OF 1954, § 6672; *id.* § 6671(b) (definitions).

without corrupt motive and in good faith in conducting the corporation's affairs, he incurs no liability to the corporation for honest mistakes in judgment.<sup>25</sup> Similarly, a secured creditor cannot reasonably expect errorless management. This is true even when management's errors might result in the diminution of the value of his collateral. Though the value of the collateral, at the critical juncture of default, may be less than he had anticipated, he gets no less than that for which he bargained.<sup>26</sup>

With respect to the preservation of his interest in the collateral, however, the secured creditor's expectations are quite different. Though he cannot reasonably entertain the notion that the corporate managers have a duty to him to preserve the value of particular corporate assets just because they happen also to serve as collateral, the creditor does expect, quite reasonably, to have a prior claim to such value as remains. When the corporation has possession of or control over the collateral, as is the case in most commercial security transactions, the corporation's managers have the power to defeat or diminish the interest of the secured creditor.<sup>27</sup> When they do so, in derogation of the corporation's obligation, the non-guaranteeing manager's expectation to be free from liability to corporate creditors and the secured creditor's expectation to realize on the bargained-for collateral cannot both be satisfied. In the particular circumstances of a given case, the determination as to which of these two conflicting expectations is more justified may be the proper basis for decision.

## II. THE TROUBLE WITH CONVERSION

The traditional route to recovery by a secured party from a corporate manager who has caused his corporation to deal improperly with

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<sup>25</sup> 3 W. FLETCHER, *supra* note 2, § 1039.

<sup>26</sup> The secured party will normally seek protection against a decline in the value of collateral in 2 ways. He will demand an initial cushion of value above the amount of the secured indebtedness, and he will require a clause enabling him to accelerate the maturity of the debt in the event of a decline. UCC § 1-208 expressly permits such clauses, but requires them to be exercised only in good faith. The protection they afford, however, may be illusory. When the collateral consists of working capital or operating assets, the attempt to realize on it in a distress situation may further depress its value. In many cases, the creditor may elect to ride out the storm rather than precipitate a forced sale and the immediate termination of the business. This is a risk he knowingly undertakes.

<sup>27</sup> The manner by and extent to which a secured creditor's interest can be defeated depend on the nature of the particular transaction. The dissipation of cash proceeds of sale or collection is the most obvious. Security interests in goods and negotiable instruments and documents, even when properly perfected, can be totally defeated in the circumstances set forth in UCC §§ 9-307, 9-308, and 9-309. Unauthorized dispositions in which the security interest is theoretically preserved may put the collateral beyond the practical reach of the creditor or, at the very least, subject him to the expense of a law suit to get it back. Merely moving the collateral, the records, or the debtor's office may, in some cases, result in a security interest becoming unperfected. See UNIFORM COMMERCIAL CODE §§ 9-103(3), 9-401 (Alternative Subsection (3)).

the collateral securing a corporate obligation has been to allege conversion.<sup>28</sup> According to that theory, the corporation has converted the secured party's property to its own use, and the manager who has participated in the tort is jointly liable for damages.<sup>29</sup> Although Professor Prosser states that conversion "almost defies definition,"<sup>30</sup> the authors of the *Restatement of Torts* have defined it as

an intentional exercise of dominion or control over a chattel which so seriously interferes with the right of another to control it that the actor may justly be required to pay the other the full value of the chattel.<sup>31</sup>

Conversion is an ancient tort, and the course of its development in various jurisdictions has been far from uniform.<sup>32</sup> Its application in a commercial setting presents conceptual difficulties wholly unrelated to the issue of commercial morality. Consequently, conversion, doctrinally applied, as it almost invariably has been, may occasionally impose liability when none should result and may negate liability in circumstances that, by contemporary standards of commercial morality, clearly demand it. The aspects of the "generation gap" between traditional conversion doctrine and the real world of commercial financing illustrated below suggest that, perhaps, a less traditional and more functional analysis should be applied.

### A. Property

The UCC takes the sweeping approach that "any personal property"<sup>33</sup> may be made subject to a security interest, and includes within its scope a category of "general intangibles," which are defined as "any personal property . . . other than goods, accounts, contract rights, chattel paper, documents and instruments."<sup>34</sup> In a comment, the draftsmen suggest that this term embraces "miscellaneous types of contractual rights and other personal property which are used or *may become* customarily used as commercial security . . ." such as "goodwill, literary rights and rights to performance."<sup>35</sup>

The historical antecedent of conversion is the common-law action of trover in which it was alleged that the plaintiff had lost a chattel and

<sup>28</sup> Although all the cases that have come to my attention have used the term "conversion," the term, as used herein, would include all actions based on the premise that the collateral is the property of the secured party, e.g., trespass to chattels.

<sup>29</sup> See 3 W. FLETCHER, *supra* note 2, § 1140.

<sup>30</sup> W. PROSSER, *LAW OF TORTS* § 15, at 79 (4th ed. 1971).

<sup>31</sup> RESTATEMENT (SECOND) OF TORTS § 222A(1) (1966).

<sup>32</sup> See W. PROSSER, *supra* note 30, § 15, at 79-81.

<sup>33</sup> UNIFORM COMMERCIAL CODE § 9-102(1).

<sup>34</sup> *Id.* § 9-106.

<sup>35</sup> *Id.* § 9-106, Comment (emphasis added).

that the defendant had found it.<sup>36</sup> The courts have modified but not obliterated this imprint of history. Although, initially, only tangible chattels could be converted, the action has been expanded to include intangible rights merged in a piece of paper.<sup>37</sup> This expansion, however, has been neither complete nor uniform. Professor Prosser observes that "[t]here is perhaps no very valid and essential reason why there might not be conversion of an ordinary debt, the good will of a business, or even an idea,"<sup>38</sup> but thus far the majority of jurisdictions hold that an ordinary debt cannot be converted, and there is general agreement that there can be no conversion of what the UCC describes as a general intangible.<sup>39</sup>

An example of the difficulties that might beset the courts in applying conversion theory to unconventional collateral is provided by *Pickford Corp. v. De-Luxe Laboratories, Inc.*<sup>40</sup> Plaintiff had delivered the original negatives of a motion picture to defendant, which was in the business of making prints. Without authorization from plaintiff, defendant delivered several prints to a third party, who thereafter exhibited the film on television. In a suit for conversion, the court held that the relevant property was not the actual reels of film, conversion of which was subject to a three-year statute of limitations, but the "intangible incorporeal right" incorporated therein. An action for interference with that right, which the court was willing to call conversion, was, according to the court's reading of a California case, subject to a two-year statute of limitations that had since run. In a supplemental opinion in the same case,<sup>41</sup> the same judge held that while the processor's unauthorized delivery *might not* constitute conversion, the unauthorized exhibition *did not* constitute conversion. The exhibition did, he conceded, amount to some tort subject to the then-expired, two-year statute, and, hence, there was no need to define it further. He did not do so.

Even property conventionally used as collateral can prove troublesome in an action for conversion. In *Petroleum Marketing Corp. v. Metropolitan Petroleum Corp.*,<sup>42</sup> decided by the Pennsylvania Supreme Court in 1959, Petroleum had sold its operating assets to Metropolitan. Expressly included in the sale were "'all franchises, licenses, trademarks, trade names, customers and other records and ledgers . . .'"<sup>43</sup>

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<sup>36</sup> See W. PROSSER, *supra* note 30, § 15, at 79.

<sup>37</sup> See *id.* 81, 82.

<sup>38</sup> *Id.* 82.

<sup>39</sup> *Id.* 82-83.

<sup>40</sup> 161 F. Supp. 367 (S.D. Cal. 1958).

<sup>41</sup> *Pickford Corp. v. De-Luxe Laboratories, Inc.*, 169 F. Supp. 118 (S.D. Cal. 1958).

<sup>42</sup> 396 Pa. 48, 151 A.2d 616 (1959).

<sup>43</sup> *Id.* at 50, 151 A.2d at 618 (quoting the agreement of sale) (emphasis added by court).

The accounts receivable were retained by Petroleum, which authorized Metropolitan to collect them as its agent. Things went along smoothly for six months, but Petroleum then became dissatisfied with Metropolitan's collection efforts and demanded that all records of uncollected accounts be turned over to Petroleum. Because of what the court described as "honest differences between the parties to protect their respective interests,"<sup>44</sup> Metropolitan delayed turning over the records for a period of about two months. When Metropolitan finally tendered the records, Petroleum rejected them and brought an action for the amount of the uncollected accounts, alleging that Metropolitan had converted them.

In affirming judgment for Metropolitan, the court first held that the records had been sold to Metropolitan, were Metropolitan's property, and, hence, could not be converted by Metropolitan. The court then went on to say, "[a]s for the debts apart from the paper record of them, these were choses in action and not subject to conversion."<sup>45</sup> For its only authority on this point, the court cited an 1899 New York case.<sup>46</sup> One should particularly note that Pennsylvania is a leading commercial jurisdiction; that accounts-receivable financing was commonplace in 1959; and that the UCC had been in effect for over four years.<sup>47</sup>

With such a precedent on the books, might it be anticipated that a corporate manager who made a second assignment of accounts receivable previously assigned by the corporation would be free of liability to the first assignee, while a corporate manager who sold a machine, previously mortgaged by the corporation, would be liable to the mortgagee? Certainly such a distinction, unrelated to the quality of the manager's conduct, would be untenable, and one would hope that it would not be made. To avoid it, however, will require either a change in the law of conversion as stated as recently as 1959 or the adoption of another basis of liability.

Goodwill may be a substantial, if not the major, asset of a business and is frequently expressly included in the collateral subjected to a security interest in comprehensive financing agreements. Its components, apart from general reputation, may include such intangible property as customer lists, secret processes, confidential formulas and unique operational ideas. The secured creditor's interest in such components

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<sup>44</sup> *Id.* at 53, 151 A.2d at 620.

<sup>45</sup> *Id.* at 52, 151 A.2d at 619.

<sup>46</sup> "It was agreed that the transaction is governed by the law of New York, where the contract was made." *Id.* at 51, 151 A.2d at 619.

<sup>47</sup> Pennsylvania was the first state to adopt the UCC. P.L. 3, April 6, 1953. It became effective on July 1, 1954. PA. STAT. ANN. tit. 12A, §10-101 (1970).

lies in the preservation of their confidentiality. A manager of a failing corporation might be inclined to disclose them to third parties in return for an injection of cash into the corporate treasury. None appear ever to have been held proper subjects for an action of conversion.<sup>48</sup> Yet their unauthorized disclosure might destroy the secured party's interest in the collateral as effectively as if a negotiable instrument, subject to his security interest, had been transferred to a holder in due course and the proceeds applied to the payment of other corporate obligations.<sup>49</sup> If such conduct is to result in the manager's personal liability, conversion as presently limited seems an inappropriate tool for the job.

### B. *Security Interest*

Since the right to bring an action in trover was based on the right to immediate possession,<sup>50</sup> there was, at one time, a nice question whether the holder of a security interest could maintain an action for conversion before default. It is now well established that a secured party with a property interest *in futuro* may bring such an action, but his recovery is limited to the unpaid balance of his debt.<sup>51</sup> The question that has perplexed the courts is whether the claimant has a property interest or a mere contractual right. If only the latter, conversion will not lie.

An excellent example of a court's typical line of inquiry is provided by a fifty-year-old New York case, *Hinkle Iron Co. v. Kohn*.<sup>52</sup> To secure payment for materials supplied by Hinkle, a contractor corporation, acting through Kohn, its president and principal stockholder, made a written assignment to Hinkle of \$4500 of a designated payment to become due the corporation under a contract with the city. At Kohn's request, and for the benefit of the corporation's credit standing, Hinkle agreed not to file the assignment with the city, and was content to rely on Kohn's oral promise that he would see that the amount so assigned would be paid to Hinkle as soon as the corporation received the payment. When the payment was received by the corporation, \$2500 was paid to Hinkle, but the balance was used to satisfy other corporate creditors. The corporation subsequently became bankrupt. Hinkle did not seek to enforce Kohn's promise but, instead, sued in tort, alleging that Kohn had converted its property.

The essence of Kohn's defense was that an unearned future payment was not *in esse*, could not be legally assigned and, hence, could

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<sup>48</sup> See W. PROSSER, *supra* note 30, § 15, at 82 & nn. 4, 5.

<sup>49</sup> UNIFORM COMMERCIAL CODE § 9-309; *id.* § 9-306, Comment 2(c).

<sup>50</sup> AMES, *The History of Trover*, 11 HARV. L. REV. 277 (1897).

<sup>51</sup> See W. PROSSER, *supra* note 30, § 15, at 95-96.

<sup>52</sup> 229 N.Y. 179, 128 N.E. 113 (1920).

not be converted, and that legal ownership was an essential prerequisite to an action in conversion.<sup>53</sup> The Appellate Division agreed and directed judgment dismissing the complaint. In dictum, the court suggested that filing the assignment with the proper city officials would have operated as an equitable assignment, putting the fund beyond the control of the corporation.<sup>54</sup> Even then, however, if the city had mistakenly paid the corporation, an action of mandamus, not conversion, would lie. In summary, the court held:

It is elementary that, to maintain an action for conversion, the plaintiff must show a legal ownership to the particular thing alleged to have been converted. The action cannot be predicated upon an equitable interest or a mere breach of contract obligation. The complaint does not state a cause of action in conversion.<sup>55</sup>

The Court of Appeals reversed.<sup>56</sup> "The instrument of assignment," it observed, "was not an agreement . . . . It consisted of words of transfer rather than of contract."<sup>57</sup> In the court's view an equitable assignment<sup>58</sup> had been established and a property interest created. From that point it was an easy step to say that

[t]he corporation received . . . the assigned sum in a trust capacity, because the sum was equitably the property of the plaintiff, which the corporation, as the owner of the legal title, was authorized to receive and hold only for the purpose of delivery to the plaintiff.<sup>59</sup>

Of course, once it is determined that a defendant is a "trustee" there's not much hope for him. In the court's view, the language of grant in the instrument was the critical factor in its decision. Without that language, presumably, the plaintiff's right would have been merely contractual, and the defendant not liable.

Under the UCC, even that formal distinction disappears. In *Warren Tool Co. v. Stephenson*,<sup>60</sup> a case strikingly similar to *Hinkle*, there was no instrument of assignment. A corporation had accepted

<sup>53</sup> 184 App. Div. 181, 182-83, 171 N.Y.S. 537 (1918).

<sup>54</sup> *Id.* at 183, 171 N.Y.S. at 538-39.

<sup>55</sup> *Id.* at 184, 171 N.Y.S. at 539.

<sup>56</sup> *Hinkle Iron Co. v. Kohn*, 229 N.Y. 179, 128 N.E. 113 (1920).

<sup>57</sup> *Id.* at 182-83, 128 N.E. at 114.

<sup>58</sup> According to the court, the relevant test for an equitable assignment

is the inquiry whether or not an assignment makes an appropriation of the fund so that the debtor would be justified in paying the debt or the assigned part to the person claiming to be the assignee.

*Id.* at 183, 128 N.E. at 114.

<sup>59</sup> *Id.*, 128 N.E. at 114.

<sup>60</sup> 11 Mich. App. 274, 161 N.W.2d 133 (1968).

the plaintiff's bid to provide the tooling required by the corporation to perform a contract with Highway Products, Inc. Unwilling to extend unsecured credit, the plaintiff suggested that the Highway account be assigned to it and that Highway be so notified. Fearing the adverse effect that such notification would have on its relationship with Highway, the corporation offered a counterproposal whereby it would send a letter to its regular bank of deposit, instructing the bank to pay the corporation's debt directly to plaintiff out of the proceeds of two specified Highway orders, copies of which were attached. A copy of that letter was sent to plaintiff, which thereupon proceeded to fill the corporation's order.

When the check in payment for the first of the specified Highway orders was received by the corporation, Stephenson, the corporation's president, took it to another bank and exchanged it for cashier's checks, which he then used for the payment of other corporate obligations. Nine days later, the corporation filed a voluntary petition in bankruptcy. The plaintiff sued Stephenson and a fellow manager individually.

Here, as in *Hinkle*, the corporation had agreed to apply a fund to be received to the payment of a particular creditor. But unlike *Hinkle*, there were no "words of transfer rather than of contract." The court reasoned, quite properly, that an article 9 security interest could be created without special words of transfer, provided only that the parties intended the transaction to have effect as security.<sup>61</sup> It also held that the corporation's letter to the bank satisfied the requirement of a writing set forth in § 9-203(1)(b). The court felt compelled, however, to discuss at great length the conceptual distinctions between equitable assignments and equitable liens and concluded that the plaintiff had an equitable lien on the Highway check. It then followed, as a matter of course, that the defendants might be liable in conversion.

The troublesome aspect of the *Hinkle* and *Warren* cases, and the many others like them,<sup>62</sup> is that they focus on the metaphysical quality of the plaintiff's interest and, only as an afterthought, if at all, on the moral quality of the defendant's conduct. If a corporate manager deals wrongfully (by whatever standards the commercial world deems appropriate) with collateral in the possession of or under the control of his

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<sup>61</sup> "[T]he principal test whether a transaction comes under this Article is: is the transaction intended to have effect as security?" UNIFORM COMMERCIAL CODE § 9-102, Comment 1. "The only requirements for the enforceability of non-possessory security interests . . . are (a) a writing; (b) the debtor's signature; and (c) a description of the collateral . . ." *Id.* § 9-203, Comment 1. In some courts the concept of formalism dies hard. *See, e.g., American Card Co. v. H.M.H. Co.*, 97 R.I. 59, 196 A.2d 150 (1963).

<sup>62</sup> *See, e.g., Hirsch v. Phily*, 4 N.J. 408, 73 A.2d 173 (1950).

corporation, liability should result whether the creditor's interest in that collateral is described as legal, equitable, or merely contractual. When the creditor sues in conversion, the proper inquiry may never be reached.

### C. *Intentional Act*

The comprehensive security agreement will normally contain a prodigious number of debtor's covenants. Some will be negative, capable of breach only by malfeasance. Others will be affirmative and may be breached by mere inaction. In general, nonfeasance is not sufficient to establish conversion. Only intentional conduct is.<sup>63</sup>

The distinction between malfeasance and nonfeasance is not always crystal-clear. Thus, although § 9-503 presumably gives a secured party the "right to take possession" upon default, it expressly permits the parties to agree on the extent of the debtor's obligations to deliver or make the collateral available. Since the essence of trover was the defendant's refusal to surrender a chattel to the plaintiff upon the latter's demand, a corporate manager who, without justification, refused a secured party access to the collateral upon default would probably be deemed a converter, notwithstanding the usual requirement of an intentional act.<sup>64</sup> If, however, the security agreement imposed affirmative duties on the corporation as, for example, "to assemble the collateral" or to "make it available . . . at a place to be designated by the secured party,"<sup>65</sup> the failure to cause the corporation to perform these duties would probably not amount to a conversion, even if it resulted in a substantial, unanticipated loss to the secured party.<sup>66</sup>

Pre-default covenants may produce similar difficulties. Consider, for example, the typical covenant providing that the debtor will not move the collateral without the secured party's prior consent. If the

<sup>63</sup> See W. PROSSER, *supra* note 30, § 15, at 83.

<sup>64</sup> *Id.* 89-90.

<sup>65</sup> UNIFORM COMMERCIAL CODE § 9-503 (expressly permitting the secured party to require such duties by agreement).

<sup>66</sup> Prosser notes one exception to the notion that nonfeasance does not constitute conversion. W. PROSSER, *supra* note 30, § 15, at 83. In that case, defendant-railroad-agent refused plaintiff access to plaintiff's goods stored in the railroad's warehouse despite the fact that the goods were threatened with imminent destruction by fire. The railroad was found liable under a conversion theory. *Donnell v. Canadian Pac. Ry.*, 109 Me. 500, 84 A. 1002 (1912). The court emphasized that the unusual immediacy of the danger to the goods justified invoking the theory of conversion. It stated, however:

Under ordinary conditions we should gravely doubt if the acts of the defendant's agent could be regarded as tantamount to a conversion.

*Id.* at 503, 84 A. at 1004.

collateral is moved to another jurisdiction without the secured party's being informed, the security interest may become unperfected and thereby subject to the superior claims of other creditors or a bankruptcy trustee.<sup>67</sup> Have the responsible corporate officers improperly interfered with the collateral by moving it—an act that could fit easily into the definition of conversion—or have they merely failed to cause the corporation to comply with its contractual obligation to give notice and obtain consent? The answer to that question, which could be determinative of liability in conversion, has absolutely nothing to do with the blameworthiness of the officers.<sup>68</sup>

In the case described in Comment 2(c) to § 9-306, cash proceeds are deposited in the debtor's general checking account and thereafter paid out in satisfaction of other legitimate obligations. The recipients of the funds, of course, take free of the secured party's interest. These transactions would presumably constitute breaches of the typical security agreement. Allowing such deposit of the proceeds would be a breach of the affirmative covenant to segregate the proceeds and might be construed as mere nonfeasance, not amounting to a conversion. Furthermore, at the moment after deposit, the secured party's interest in the proceeds is both valid<sup>69</sup> and perfected.<sup>70</sup> Not only might there have been no malfeasance but, at least in theory, no injury. Paying out the proceeds, however, is an affirmative act that constitutes a breach of the covenant prohibiting transfer of the collateral and results in complete divestment of the secured party's interest. Assuming that manager *A*, with full knowledge of the requirements of the security agreement, allowed the deposits to be made, and that manager *B*, without such knowledge, sent out the checks to other creditors, presumably only *B* would be liable in conversion while only *A* would be at fault.

#### D. *Good Faith*

Although conversion must be based on intentional conduct, there is, at least in the classical formulation of the tort, no requirement that the defendant have knowledge of the wrongfulness of his act.<sup>71</sup> As one

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<sup>67</sup> The effect of moving collateral within a state on the perfection of a security interest therein is governed by UCC § 9-401. The 1962 Official Text suggests several alternative approaches. The effect of interstate moves is governed by UCC § 9-103.

<sup>68</sup> A proper distinction may be drawn between the manager who inadvertently failed to notify the secured party about collateral moved in the normal course of business and the manager who knowingly fails to give the requisite notice with the intention of later disposing of the collateral free of the secured party's interest. The potential injury to the creditor is the same in either case, but the arguments for and against imposing his loss on the manager are quite different.

<sup>69</sup> UNIFORM COMMERCIAL CODE § 9-306(2).

<sup>70</sup> *Id.* § 9-306(3).

<sup>71</sup> See W. PROSSER, *supra* note 30, § 15, at 83.

court put it, "neither good nor bad faith, neither care nor negligence, neither knowledge nor ignorance, are the gist of the action."<sup>72</sup>

In *Morin v. Hood*,<sup>73</sup> the plaintiff held a duly recorded mortgage on certain store fixtures. The defendant, as agent of the owner-mortgagor, conducted an auction sale of these fixtures, presumably on the mortgagor's premises, and remitted the proceeds to the mortgagor. The court held the auctioneer liable to the mortgagee for the full sales price of the fixtures, saying:

The plaintiff as mortgagee under this recorded mortgage had sufficient legal interest in the fixtures covered thereby to maintain an action for conversion against anyone who sold them without his consent . . . . His action can be maintained against an auctioneer who sells such property on order of the mortgagor even if he does so in good faith and without knowledge of the rights of the mortgagee.<sup>74</sup>

Apparently the sole significance of the recordation, in the court's view, was to qualify the mortgagee as a proper plaintiff. There is no indication that the auctioneer's ability to have discovered the mortgagee's interest by searching the record was essential to imposing liability on him, nor is there any intimation that he was chargeable with the knowledge of his principal.

The concept of liability without fault is borne out by *United States v. Matthews*.<sup>75</sup> In that case, one Wheaton had mortgaged his livestock to the Farmers' Home Administration, and the mortgage had been promptly recorded in the county in which Wheaton resided and in which the mortgaged property was located. Wheaton subsequently removed the livestock to an adjoining county, where Matthews, an auctioneer, as Wheaton's agent, sold them in the regular course of business. Wheaton had warranted to Matthews that the animals were free of liens and, although there was no evidence that Matthews had searched the record, such a search in the county of delivery would not have revealed the existence of the mortgage. Nonetheless, Matthews was held liable for the full sale price of the livestock.

Notwithstanding such holdings, which indicate that an agent's actual or constructive knowledge of a third party's interest is immaterial to his liability, a special rule seems to have developed where the defendant's relationship to his principal is corporate manager rather than independent agent. Thus, in *Darling & Co. v. Fry*,<sup>76</sup> the plaintiff

<sup>72</sup> *Poggi v. Scott*, 167 Cal. 372, 375, 139 P. 815, 816 (1914).

<sup>73</sup> 96 N.H. 485, 79 A.2d 4 (1951).

<sup>74</sup> *Id.* at 486, 79 A.2d at 5.

<sup>75</sup> 244 F.2d 626 (9th Cir. 1957).

<sup>76</sup> 24 S.W.2d 722 (Mo. App. 1930).

manufacturer had delivered fertilizer to a corporation pursuant to a written agreement reserving title in the plaintiff, giving the corporation the power to sell, and requiring the corporation to segregate the proceeds of sale and account to the plaintiff semi-annually.<sup>77</sup>

The defendant became the manager and executive officer of the corporation about two years after the consignment agreement had been executed. Upon the sale of merchandise delivered to the corporation by the plaintiff and subsequent to the defendant's employment, the proceeds were deposited in the corporation's general bank account and used to pay other corporate obligations. The corporation thereafter became insolvent, and the consignor brought an action in conversion against the manager.

Although there was conflicting testimony, the manager testified, and the jury apparently believed, that he had no actual knowledge of the consignment arrangement. On appeal, judgment for the defendant was affirmed, the court holding that, absent actual knowledge, the defendant owed no duty of investigation to the plaintiff.

It is impossible to reconcile the result in *Darling* with that in *Morin* under a conversion theory, which both courts purport to apply. In both cases the defendants were acting solely as agents and could have, but had not, discovered the plaintiff's rights. If any distinction were possible, it would cut the other way. Certainly the agent in complete control of the principal's business is chargeable with more knowledge than an unrelated agent employed for a special situation. *Darling* and cases like it<sup>78</sup> seem to recognize that good faith should be a defense for the corporate manager acting in the corporate interest. If that is true, the theory of conversion is inappropriately applied.

### E. Damages

The measure of damages in conversion is the value of the converted property at the time of conversion.<sup>79</sup> For the secured-party plaintiff, damages are limited to the amount of the secured indebtedness, since any excess would presumably be returned to the debtor or junior secured parties after the satisfaction of his claim. This limitation, however, may not restrict his recovery to the loss caused by the conversion.

In the event of a debtor's insolvency, the critical fact that determines the secured party's loss is not what the collateral was worth at

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<sup>77</sup> This arrangement would probably be construed today as a "consignment intended as security" and, hence, subject to article 9. See UNIFORM COMMERCIAL CODE §9-102(2).

<sup>78</sup> See, e.g., *Santa Barbara v. Avallone & Miele, Inc.*, 270 N.Y. 1, 199 N.E. 777 (1936).

<sup>79</sup> RESTATEMENT (SECOND) OF TORTS §§222A, comment c, at 433 (1965).

some antecedent date, but what the secured party would have realized if the debtor had properly performed the security agreement. In a bankruptcy, for example, the value of an unperfected security interest is zero, since it is subordinated to the rights of the trustee.<sup>80</sup>

Thus, in *Warren Tool Co. v. Stephenson*,<sup>81</sup> where the creditor had intentionally refrained from perfecting its interest in the anticipated payment from the bankrupt corporation's customer, it could not reasonably have expected anything in the very event against which it sought to protect itself. If the check had not been received by the date of bankruptcy, it would have been properly claimed by the trustee.<sup>82</sup> If it had been received and, in accordance with the planned procedure, deposited in the corporation's bank, the creditor could not have successfully challenged the trustee's competing claim.<sup>83</sup> And even if it had been received, deposited, and thereafter paid to the creditor during the nine days before the bankruptcy, the trustee probably could have recovered it as a voidable preference.<sup>84</sup> Measuring the creditor's actual position against what it would have been if the managers had meticulously complied with the agreement, the creditor had lost nothing. The true cause of the creditor's loss was its own failure to perfect; the managers' conduct was largely irrelevant. But, by affording the creditor relief against the individual managers, the court put it in a better position than that in which it would have found itself had there been no default.

The policy of article 9 requires notoriety for security arrangements as a protection for anyone who deals with the debtor.<sup>85</sup> If that policy is to be fully implemented, the creditor who, in cooperation with the debtor, seeks to create a secret lien deserves little solicitude from the law. It is inconsistent to furnish him with a windfall, even at the expense of his co-conspirators. The defense of contributory fault is a familiar concept, and it should be particularly applicable when the secured party's fault is calculated to mislead innocent third parties while the manager's fault injures only a party who is *in pari delicto*.

On the other hand, a secured party can sustain damage from managerial conduct that does not amount to conversion and that thus would not warrant recovery under that theory. The manager's failure

<sup>80</sup> UNIFORM COMMERCIAL CODE §§ 9-301(1), (3).

<sup>81</sup> 11 Mich. App. 274, 161 N.W.2d 133 (1968).

<sup>82</sup> Bankruptcy Act § 70(c), 11 U.S.C. § 110(c) (1970).

<sup>83</sup> See *id.*

<sup>84</sup> *Id.* §§ 60(a), (b), 11 U.S.C. §§ 96(a), (b) (1970).

<sup>85</sup> As an illustration of the importance with which perfection is regarded, the Permanent Editorial Board for the UCC has proposed that § 9-301 be amended to subordinate an unperfected security interest even to a lien creditor with actual knowledge thereof. REVIEW COMMITTEE FOR ARTICLE 9 OF THE UNIFORM COMMERCIAL CODE, PERMANENT EDITORIAL BOARD FOR THE UNIFORM COMMERCIAL CODE, FINAL REPORT 77-78 (1971).

to give the proper information about the location of the collateral, records, or offices can prevent the secured party from properly perfecting his interest, with the consequent subordination to the claims of lien creditors, certain purchasers, and—most importantly—a trustee in bankruptcy.<sup>86</sup> An unauthorized sale of collateral, even when the purchaser's rights are subject to the security interest either expressly or pursuant to the provisions of article 9, may put the secured party to the expense of a law suit to establish his rights. Notwithstanding the theoretical preservation of the security interest, such conduct on the part of corporate managers would surely defeat the secured party's legitimate expectations. Whether the managers might be liable under strict conversion theory is at least subject to considerable doubt.

### III. A NON-PROPERTY APPROACH

Almost without exception, the cases that have imposed liability on the manager of a corporate debtor have been premised on the concept of a security interest as *property*. Section 1-201(37) defines a security interest as "an interest in personal property." Section 9-102(2) indicates that article 9, which governs the vast majority of commercial security transactions, "applies to security interests created by contract . . . ." In cases involving only the secured party and the debtor, there is generally no need to distinguish between interests that are property and those that are contractual. It is only when one litigant is not a party to the security agreement that the distinction becomes important, since only a property interest is thought to be binding on a stranger to the contract. When a court holds that a secured party's rights are merely contractual, the non-party defendant is usually home free.

Although the manager of a corporate debtor is not, in the strictly legal sense, a party to the security agreement, he is surely not a stranger in any realistic sense of that word. His duties, to whatever extent he has duties, grow out of the corporation's duties under the security agreement and his relationship to the corporation. In the adjudication of a dispute between a secured party and the manager of a corporate debtor, I suggest that sound analysis will be promoted, and undesirable distinctions avoided, by focusing on the contractual aspects of the secured party's rights.

#### A. *The Statutory Scheme*

The structure of the UCC lends some support to this approach. Nowhere in the entire UCC is a security interest described as a lien.

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<sup>86</sup> *In re Dennis Mitchell Indus., Inc.*, 419 F.2d 349 (3d Cir. 1969).

On the contrary, the use of the word "lien" is strictly limited to non-contractual interests arising out of legal or equitable process or by operation of law. Thus, under § 9-301(3) an attaching or levying creditor acquires a lien. Section 7-209 sharply distinguishes between a warehouseman's lien, which is a creature of the law and of the nature of the parties, and a warehouseman's security interest, which results only from the agreement of the parties. Similarly, § 9-310 deals with liens for materials and services arising from statute or common-law. Every consequence that flows from the use of the word "lien," and the historical property concepts it connotes, does not necessarily apply to the UCC security interest. As Professor Gilmore points out, "No mortgage statute ever attempted the impossible task of defining what is a 'mortgage.' A mortgage is what the courts, in the light of history and contemporary practice, say, is a mortgage."<sup>87</sup> It would not be earth-shaking for a court to hold that an article 9 security interest is neither more nor less than article 9 provides—a bipartite agreement that establishes the rights and obligations of the parties *inter se* and creates priorities against identified classes of third parties.

In disputes between secured parties and the particular third parties embraced by the provisions of part 3 of article 9 the question is invariably one of priority. In that context, a security interest may indeed be indistinguishable from what is generally called a lien. The concept of the equitable lien, so heavily relied on by the court in *Warren Tool Co. v. Stephenson*,<sup>88</sup> was developed to settle priority problems and may not, in the words of Mr. Justice Holmes, "do much more than express the opinion of the court that the facts give priority to the party said to have it . . . ." <sup>89</sup>

Hopefully, the vast majority of priority problems will now be settled under the express provisions of part 3. For those that are not, the equitable lien may continue to have some vitality.<sup>90</sup> But its use should be confined to solving the problems that necessitated its invention and not extended to questions whether liability should or should not be imposed in a situation that has nothing to do with priority. As between secured party and debtor, for example, the concept of the equitable lien has been applied to compel the debtor to execute a promised mortgage document.<sup>91</sup> So long as the rights of others were

<sup>87</sup> 1 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY §11.1, at 335 (1965).

<sup>88</sup> 11 Mich. App. 274, 161 N.W.2d 133 (1968).

<sup>89</sup> *Sexton v. Kessler & Co.*, 225 U.S. 90, 99 (1912).

<sup>90</sup> See 1 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY §11.1, at 336-37 (1965).

<sup>91</sup> *Schrot v. Garnett*, 370 Mich. 161, 121 N.W.2d 722 (1963).

not involved, the identical result could have been reached, without use of the lien label, by merely holding that the plaintiff was entitled to specific performance of the defendant's promise.<sup>92</sup>

Apart from questions of priority, the analogy between a security interest and a lien is far less compelling. The secured party's interest in collateral not in his possession is derived from two sources—part 5 of article 9 and the security agreement. Even the provisions of part 5, which enable the secured party to take possession of and sell or retain the collateral upon default, and thus could be said to create property rights,<sup>93</sup> are largely repetitive of what a secured party will demand in his security agreement as a matter of course. The chief thrust of part 5 is, in fact, to limit rather than to establish the rights of the secured party, and it is interesting to note that the sole reference to conversion in all of article 9 is § 9-505(1), which gives the *debtor* the right to recover in conversion from the *secured party* if the latter has failed to make a timely and proper disposition of the collateral.

In the businessman's view, there is a significant difference between the kind of an interest held by a secured party and what is commonly thought of as property. The managers of a corporation operating a trust business or a public warehouse are entirely aware that their enterprises are custodians of the property of others. When they deal improperly with that property, even for the benefit of their corporation, they should not be surprised when personal liability results.<sup>94</sup> Collateral subject to a security interest, however, is regarded quite differently. The corporation bears the risk of loss or depreciation of the collateral, stands to profit from its enhancement in value, continues to enjoy its use, and carries it on its balance sheet as a corporate asset. The restrictions that a security agreement may impose on the corporation's right to use, dispose of, sell, or encumber the collateral are, in the view of the businessman, contractual undertakings of the corporation. The collateral itself *belongs* to the corporation.

Again the UCC lends some support. Section 9-311 makes the debtor's rights in collateral, including, presumably, the right to possession, freely transferable and reachable by the debtor's creditors "not-

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<sup>92</sup> The equitable remedy of specific performance is particularly applicable to security transactions because the creditor, by hypothesis, has been unwilling to rely on his normal remedy at law—an action for damages. Cf. text accompanying note 110 *infra*.

<sup>93</sup> The property concept of a security interest may have to be employed in order to qualify the secured party as a proper plaintiff in an action to replevy the collateral upon default. The replevin action and similar "property-type" remedies available to the secured party in an action against the debtor are functional equivalents of the specific enforcement of the security agreement.

<sup>94</sup> See *Taylor v. Alston*, 79 N.M. 643, 447 P.2d 523 (1968) (public warehouse); *Duncan v. Williamson*, 18 Tenn. App. 153, 74 S.W.2d 215 (1933) (trust company).

withstanding a provision in the security agreement prohibiting any transfer or making the transfer constitute a default."<sup>95</sup> Section 9-318(2) enables one who in an article 9 transaction, assigns a contract right, to make a good faith and commercially reasonable modification of or substitution for the basic contract, fully effective against the assignee, even if "such modification or substitution is a breach" of the assignor's agreement with the assignee. Neither of these sections, of course, permits the debtor to defeat the legitimate rights of the secured party with impunity, but both support the view that the secured party's rights against the debtor are essentially contractual.

### B. *An Alternative Theory—Interference With Contract*

The abandonment of the concept of a security interest as property need not leave the secured party remediless against the faithless manager of a debtor corporation. The secured party and the corporation are unquestionably parties to the security agreement, and it is well settled that an action will lie against one who tortiously interferes with a contractual relationship.<sup>96</sup> It goes without saying that a corporate manager whose conduct of the enterprise results in the corporation's breach of a security agreement has interfered with a contractual relationship. Whether such interference constitutes an actionable tort is the hard question. One court has decided that it might.

In *Carpenter v. Williams*,<sup>97</sup> a corporate debtor, as security for an indebtedness to Williams, the plaintiff, pledged certain notes then held by the corporation. The plaintiff and the corporation agreed that the notes were to remain in the possession of the corporation for the purpose of collection, with the proceeds to be paid to the creditor to apply against the debt. Less than two months later the corporation was adjudicated a bankrupt and the notes were nowhere to be found.

The plaintiff thereupon instituted suit against Carpenter, a director and the president of the corporation, who had, on behalf of the corporation, negotiated the transaction. Setting forth the above facts, he alleged that the defendant had "wilfully, intentionally and wrongfully

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<sup>95</sup> The Florida Attorney General has recently held that UCC § 9-311 has repealed, by implication, a provision in that state's criminal code making it a misdemeanor for a person to "pledge, mortgage, sell, or otherwise dispose of any personal property to him belonging, . . . which shall be subject to any written lien, . . . without the written consent of the person holding such lien . . ." Florida Attorney General Opinion No. 071-6, 4 CCH SECURED TRANSACTION GUIDE ¶ 51,504 (1971). If one adopts the reasonable construction that a "written lien" is equivalent to a contractual security interest, this opinion confirms the notion that an article 9 security interest, as between the parties to the security agreement, is to be regarded as a contractual interest.

<sup>96</sup> See W. PROSSER, *supra* note 30, § 129.

<sup>97</sup> 41 Ga. App. 685, 154 S.E. 298 (1930).

disposed of said notes . . . [and] by reason of said unlawful conversion”<sup>98</sup> was liable to the plaintiff to the extent of their value. The defendant demurred on the ground that, because under local law there could be no effective pledge of negotiable instruments without actual delivery,<sup>99</sup> the plaintiff did not have an interest in the notes that would support an action for conversion.

The court first noted, in dictum, that while the plaintiff’s non-possessory interest was clearly ineffective against creditors and innocent purchasers, it was enough of an interest to qualify the plaintiff in an action for conversion. Such a holding would have conformed with cases in other jurisdictions, some of which have been discussed,<sup>100</sup> and the court might have affirmed the lower court’s overruling of the demurrer on that basis alone. But, in an effort to be doubly certain, and perhaps because of some gnawing doubts that defeating an interest otherwise so easily subject to defeat could amount to conversion,<sup>101</sup> the court went on to say:

Moreover, even if the petition may not be sustained, either as an action of trover or as a suit for damages for a conversion, we are still of the opinion that it sets forth a cause of action. . . .

. . . .

The petition shows that the plaintiff had valuable rights under a contract which subsisted between him and the [corporation] . . . and that with knowledge of this fact the defendant wilfully committed acts which made it impossible for the company to perform its obligations under the contract; and we think the principle . . . applicable . . . [that it is] actionable for one maliciously or without justifiable cause to induce another to break his contract with a third person, to the damage of the latter. While the defendant may not technically have induced the company . . . to break its contract, he . . . caused it to do so . . . .<sup>102</sup>

The problem with this theory, when applied to a corporate manager, and absent a very restrictive construction of the words “maliciously or without justifiable cause,” is its broad sweep. A corporation’s breach of any obligation can almost invariably be attributed to, and, therefore,

<sup>98</sup> *Id.* at 688, 154 S.E. at 299.

<sup>99</sup> Under the UCC, possession is usually essential to the perfection of a security interest in negotiable instruments. UNIFORM COMMERCIAL CODE §9-304(1). There are, however, two statutory exceptions. *Id.* §§9-304(4), (5).

<sup>100</sup> *E.g.*, *Hinkle Iron Co. v. Kohn*, 229 N.Y. 179, 128 N.E. 113 (1920); *Warren Tool Co. v. Stephenson*, 11 Mich. App. 274, 161 N.W.2d 133 (1968).

<sup>101</sup> This is, perhaps, just another way of expressing the holding of *Benedict v. Ratner*, 268 U.S. 353 (1925).

<sup>102</sup> 41 Ga. App. at 689-90, 154 S.E. at 300.

caused by, the acts of its managers. If a corporation pays creditor *A* and thereby or thereafter becomes insolvent, leaving creditor *B* unpaid, it has, by paying *A*, prevented performance of its contract with *B*. To hold the manager who caused *A* to be paid liable for damages to *B* would be to make that manager an involuntary guarantor of every corporate debt. To avoid reaching such an absurd result, the courts have articulated a defense, usually characterized as a privilege, that a corporate manager is free from liability for causing his corporation to breach a contract when the breach is committed in good faith and for the benefit of the corporation. Such a view prevails in those jurisdictions that have considered the problem.<sup>103</sup>

The situation herein considered concerns the corporate manager who causes his corporation to breach its security agreement for the sole purpose of satisfying other legitimate corporate objectives and without prospect of personal gain, except as it might result indirectly from the improved financial condition, or even the survival, of the corporation.<sup>104</sup> Therefore, the requirement that the breach be for the benefit of the corporation has, by hypothesis, been satisfied.

The significance of good faith in this formulation, however, is a more difficult concept with which to deal. In the recent case of *Wampler v. Palmerton*,<sup>105</sup> the plaintiff had contracted with a corporation to perform certain logging operations extending over a period of years. About a year after performance had begun, the corporation, without apparent justification, failed to make payment to the plaintiff for logs that had been delivered pursuant to the contract. The court acknowledged that the corporation had committed an unexcused breach of its contract. The plaintiff, presumably upon the theory that the contractual right of action belonged to his trustee in bankruptcy,<sup>106</sup> sought damages, not from the corporation for its breach, but from the corporate managers for having caused the breach. After reviewing the development of both the tort of interference with contract and the privilege of corporate managers to interfere in good faith and for the benefit of the corporation, the court concluded by saying:

We do not believe that "good faith" as used here can reasonably mean anything more than an intent to benefit the corporation . . . .

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<sup>103</sup> See 3 W. FLETCHER, *supra* note 2, §1001; Avins, *Liability for Inducing a Corporation to Breach Its Contract*, 43 CORNELL L.Q. 55 (1957).

<sup>104</sup> See Note, *Interference with Contract Rights and the Stockholder's Privilege*, 54 NW. U.L. REV. 483 (1959).

<sup>105</sup> 250 Ore. 65, 439 P.2d 601 (1968).

<sup>106</sup> *Id.* at 73-74, 439 P.2d at 605.

. . . So long as the officer or employe acts within the general range of his authority intending to benefit the corporation, the law identifies his actions with the corporation. In such a situation the officer is not liable for interfering with a contract of the corporation any more than the corporation could be liable in tort for interfering with it. The words "good faith" should not be employed to render a corporate officer or employe liable for engaging in morally questionable activities upon behalf of his principal that nevertheless would not be tortious if he were acting for himself as the party to the contract.<sup>107</sup>

In the view of the *Wampler* court, a finding of conversion, with all its historical prerequisites, would have been essential to imposition of liability on the defendant in *Carpenter v. Williams*.<sup>108</sup> Such a view would permit a corporate manager, without fear of personal liability, knowingly to cause or permit his corporation to violate the terms of a security agreement so long as the violation did not constitute a recognized tort and the manager sought no independent personal gain. By equating good faith with corporate benefit, the *Wampler* court has made corporate benefit the only test that need be satisfied to establish the privilege.

### C. *Whose Obligation of Good Faith?*

The draftsmen of the UCC were evidently aware of the saying that good things (including faith) come in small packages. The text of § 1-203, in its entirety, reads as follows:

Every contract or duty within this Act imposes an obligation of good faith in its performance or enforcement.

There can be little doubt that the typical commercial security agreement is a "contract . . . within this Act." Although "its performance" by a debtor corporation is, in theory, a purely corporate activity, it is unreal to conclude that no "obligation of good faith" is imposed on the individual managers who, in fact, determine what the corporation does. If the obligation of good faith, however limited and defined, is to have any meaning in the regulation of commercial transactions, which are for the most part conducted by corporations, corporate managers must come within its scope. Corporations have assets and liabilities. Only people have good or bad faith.

The courts have wisely recognized that the personal liability of the responsible corporate managers cannot result from their causing the

<sup>107</sup> *Id.* at 76-77, 439 P.2d at 607 (footnotes omitted).

<sup>108</sup> 41 Ga. App. 685, 154 S.E. 298 (1930).

breach of every kind of corporate contract. To hold otherwise would be to destroy the concepts of representative management and limited liability, which may be the most important attributes of the corporate form. But that need not lead to the conclusion that there may not be some kinds of contracts the breach of which, under certain circumstances, is inconsistent with good faith, irrespective of corporate benefit. I submit that the security agreement, or at least certain provisions thereof, is that kind of contract.

The question of managerial liability for causing the breach of a security agreement is of serious financial import to the secured party only when, and only because, the corporation cannot respond to a judgment for damages resulting from the breach. This, however, is true for all corporate contracts.<sup>109</sup> The characteristic of the security agreement that distinguishes it from other corporate obligations, is that its primary function is to safeguard the secured party's interest in the precise event of the corporate debtor's insolvency. If the managers can cause their corporation to breach a security agreement with the same impunity as any other contract, the secured party may find himself with only an unsecured claim against the corporation for the amount of his debt. This is exactly what he would have had if there had been no security agreement in the first instance. Therefore, if the security agreement is to be accorded any independent significance, and its unexcused breach is not to be an injury without a remedy, the secured party ought to be compensated by some right he would not have otherwise had.<sup>110</sup>

One might conclude that this risk of defeasance is inherent in non-possessory security transactions, and that any creditor who is unwilling to undertake such a risk should stick to real estate mortgages and pawn brokerage. Such a conclusion would be a return to the business and legal philosophy characteristic of an earlier era and inconsistent with the objectives of the UCC's framers.<sup>111</sup> In order to facilitate financing transactions at reasonable cost, for the mutual benefit of borrowers, lenders, and the economy in general, article 9 permits the secured party

<sup>109</sup> The theory that corporate insolvency should be the determinative factor in the imposition of managerial liability is properly rejected in Note, *Liability of Directors and Other Agents for Procuring Breach of Corporate Contract*, 48 HARV. L. REV. 298 (1934).

<sup>110</sup> Upon the breach of an ordinary contract by a corporation, the injured party acquires a right to collect damages. If the corporation is insolvent, that right may well be almost worthless, but it is nevertheless a right that arose from the breach and that the injured party would not have had in the absence of the breached contract.

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The aim of this Article is to provide a simple and unified structure within which the immense variety of present-day secured financing transactions can go forward with less cost and with greater certainty.

UNIFORM COMMERCIAL CODE § 9-101, Comment.

to give the corporate debtor almost absolute power to defeat a security interest in certain types of property widely used as collateral. Without such power, inventory financing, non-notification accounts-receivable financing, and a wide variety of transactions involving negotiable instruments and documents could proceed, if at all, only at an increased and unnecessary cost. The price of such power is responsibility, and one name given to responsibility by the UCC is good faith.

In connection with its factoring operation, one leading commercial financier<sup>112</sup> frequently obtains from the principal managers of its corporate debtors an agreement entitled "Guaranty of Validity," whereby they give their assurance that all assigned receivables will be the consideration for bona fide sales of merchandise and will be free of any third party claims. Such an agreement is, in essence, an undertaking of the managers not to misrepresent. It does not make the manager a guarantor of the loan, of the assigned accounts, or even of the corporation's continued solvency. He guarantees only his own integrity. If a corporate manager should refuse to execute such a document, I suspect the financier might look elsewhere for customers.

Although no instance of this has come to my attention, there is no reason a similar undertaking could not be obtained from the managers of a corporate debtor, to whom possession or control of collateral is necessarily entrusted in connection with the particular financing operation. Such a "Guarantee of Good Faith," as it might be called, would obligate the managers neither for the corporation's debt, nor for the maintenance of the collateral's value, but only for the good faith performance of the corporation's promise to preserve the secured party's interest in the identified collateral. Although such agreements would be particularly applicable to transactions involving cash proceeds, inventory, chattel paper, instruments, and documents, they could be adapted to other non-possessory security arrangements in which important but less obvious risks of defeasance exist.

Were I counsel to the secured party, such good faith guarantees would have great appeal. The obvious advantage is that, in the event of the corporate debtor's insolvency, the secured party would have a clear-cut contractual right of action against one or more solvent defendants who, by their conduct, had defeated his legitimate expectation of recovery. Even more important, however, would be their deterrent effect. No individual manager, having subscribed to such an agreement, could legitimately expect to be insulated from liability for bad

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<sup>112</sup> The cooperation of a number of lenders and their counsel was of great assistance in the preparation of this Article. The author's gratitude can only be acknowledged in such general terms, for one condition of this cooperation was that the specific identity of these sources of information not be revealed.

faith conduct by the corporate veil. Criminal statutes notwithstanding, the threat of civil liability is both a powerful and an entirely proper method of regulating the conduct of businessmen. When they know it exists, they respond accordingly. Finally, from a purely business point of view, the refusal of the corporate managers to execute such an agreement, provided that it was properly limited in scope,<sup>113</sup> would not be an encouraging indicator of the corporation's prospective proper performance.

In my capacity as a law professor, I find this idea (which I believe to be my own) mildly offensive. In a system that embodies a pervasive obligation of good faith, an express undertaking to act honestly should not be essential to impose liability on those who do not. One should not have to negotiate for an agreement to act honestly from those individuals who are, in fact, the only instruments by which corporate dishonesty can be implemented. In the ideal commercial world, all participants will understand and appreciate what they may or may not do. Until we arrive at that happy point, however, the good faith guarantee might serve as a welcome reminder.

#### D. *The Meaning of "Good Faith"*

Good faith is defined in § 1-201(19) as "honesty in fact in the conduct or transaction concerned." Such words have been historically construed as applying only to the actor's subjective state of mind.<sup>114</sup> So limited, the good faith obligation might prove inadequate to deal with the instant problem.

The manager of a failing business not infrequently believes with deep conviction—*honestly*, if you will—that all that is needed to turn the corner is a little more money and a little more time. When he deals improperly with the collateral securing an obligation in order to obtain either or both, his purely subjective motive is to save the business. He does not act maliciously in the sense that he wants to injure the secured creditor. Rather, he hopes to avoid financial disaster for the mutual benefit of the owners and all the creditors of the business. In some instances (those we never hear about) his judgment is correct.

The whole point of the secured transaction, however, is that the debtor's management is not privileged to make that judgment. The security agreement imposes restrictions on the normal prerogative of

<sup>113</sup> Counsel for one lender has predicted that great resistance might be anticipated to the execution of any form that contained the term "guaranty." Even though proper drafting may satisfy the borrower's counsel that the requested undertaking is appropriate, it may be necessary to invent a title that will not preclude the borrower from at least taking the agreement to his counsel for review.

<sup>114</sup> See Farnsworth, *Good Faith Performance and Commercial Reasonableness Under the Uniform Commercial Code*, 30 U. CHI. L. REV. 666 (1963).

management to dispose of the debtor's assets in any way that it alone determines will most benefit the enterprise.<sup>115</sup> A unilateral reversal of that determination can hardly be justified by any quantum of managerial optimism. It is certainly not commercially reasonable conduct.

Professor Farnsworth suggests that "[g]ood faith performance [as opposed to good faith purchase] properly requires some objective standard tied to commercial reasonableness."<sup>116</sup> In fact, § 2-103(1)(b) defines good faith as including, in the case of a merchant, "the observance of reasonable commercial standards of fair dealing in the trade." Unfortunately, this definition is confined, by the terms of the statute, to article 2 sales transactions.<sup>117</sup> The reasoning that led to the imposition of an objective standard of good faith in the performance of sales transactions by businessmen, however, is equally applicable to the performance of security transactions by the same businessmen. This is especially true when, as in *Admiral Corp. v. Winchester Corp.*,<sup>118</sup> there is a unitary transaction that has both sales and security aspects.

The principles of article 2 have already been extended, by analogy, to encompass transactions that do not literally fall within its ambit.<sup>119</sup> Their extension to impose a standard of commercial reasonableness to the performance of security transactions by businessmen would lack neither logic nor precedent. Indeed, though with express statutory support, the concept of commercial reasonableness has probably been applied by the courts in article 9 default cases more frequently than in any other area covered by the UCC.<sup>120</sup> But, whatever route is taken to introduce some standard of commercial reasonableness, it should be introduced because it makes absolutely no sense to excuse a businessman

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<sup>115</sup> Even under the broad formulation of the corporate privilege set forth in *Wampler v. Palmerton*, 250 Ore. 65, 76-77, 439 P.2d 601, 607 (1968), it could be said that the manager who causes his corporation to violate a security agreement is not acting "within the general range of his authority," since the execution of the security agreement by the corporation is a revocation of the manager's authority to deal with the collateral contrary to the provisions thereof.

<sup>116</sup> Farnsworth, *supra* note 114, at 671.

<sup>117</sup> UNIFORM COMMERCIAL CODE § 2-103(1); *see id.* § 1-201, Comment 19; *cf. id.* § 7-404.

<sup>118</sup> 7 UCC REP. SERV. 743 (N.Y. Civ. Ct. 1970).

<sup>119</sup> In *Sherrock v. Commercial Credit Corp.*, — Del. —, 269 A.2d 407 (Del. Super. Ct. 1970), the court held that a merchant buyer, to take free of a security interest under UCC § 9-307(1), must act in "good faith" as defined in UCC § 2-103(1)(b), which includes a standard of commercial reasonableness. The court stated, "If the standard of good faith is to have meaning in Article 9 with regard to merchants, it should not vary with that applied to merchants under Article 2." *See also* Farnsworth, *Implied Warranties of Quality in Non-Sales Cases*, 57 COLUM. L. REV. 653 (1957).

<sup>120</sup> The requirement is imposed on the secured party with respect to procedure on default. UNIFORM COMMERCIAL CODE §§ 9-502(2), 9-504(1), (3), 9-507(2). In virtually every case the secured party is in business while the debtor may or may not be. In the situation discussed in this Article, the debtor is always in business, or, more accurately, recently out of business.

from intentionally causing his corporation to breach its security agreement and defeat the secured party's legitimate expectations on the sole ground that he had vainly hoped the enterprise might thereby be saved.

### E. *The Sacred Covenants*

The comprehensive financing agreement, which includes the security provisions and may sometimes be described as a security agreement, typically contains dozens of covenants. The breach of some of these covenants, even when knowingly and intentionally caused, is not inconsistent with good faith. If an obligation of good faith is to be imposed on the corporate debtor's management, one must identify the particular covenants breach of which might give rise to managerial liability.

The first category of covenants includes those that set forth the corporation's basic obligation to pay the principal of the underlying debt with interest and, perhaps, appropriate penalties for lateness. The possibility that the managers might cause the corporation to breach these covenants, and leave the secured party to his remedies for collection under the law and the agreement, is a risk knowingly undertaken by the secured party, and should not result in managerial liability any more than the failure to cause the corporation to pay an unsecured debt. The *Wampler* court has aptly expressed this conclusion:

The person contracting with the corporation cannot reasonably have any contractual expectancy that does not take into consideration the fact that the corporation may be advised to breach the contract, in accordance with its interest, by a person whose duty it is to do so.<sup>121</sup>

A second category of covenants is principally concerned with the preservation of the value of the collateral. In this category are promises to keep the collateral insured against fire and other casualty, to maintain the collateral in good operating condition, and to refrain from using the collateral in any manner that might impair its value. Both the secured party and the corporation have an interest in the performance of these covenants since a decline in the value of the collateral is also a decline, of equal magnitude, in the value of the corporation's assets. Thus the creditor is afforded some protection by the manager's duty to the corporation not to mismanage its affairs and the reasonable expectation that the managers will not act contrary to their own, the corporation's, and the creditor's interests, all of which are presumably parallel. Furthermore, the creditor can, without undue inconvenience and without

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<sup>121</sup> *Wampler v. Palmerton*, 250 Ore. 65, 75, 439 P.2d 601, 606 (1968).

impeding the normal flow of commerce, take certain precautions for his own protection. He can require, in connection with the covenant to insure, that he be a named insured and demand evidence of proper coverage from the insurer. He can also, by maintaining such contact with the debtor's operations that reasonable business prudence would demand, spot, in its incipiency, any tendency toward sloppy management practices that might ultimately impair the value of the collateral.<sup>122</sup>

The case for imposing liability on managers who even deliberately cause the corporation to breach covenants in this second category is not a compelling one. The identification of the secured party's interest with that of the corporation and the threat of liability to the corporation for unjustified conduct against its interest should deter a manager from intentionally causing such breaches. The normal expectation of a manager to be free from liability to outsiders in connection with his conduct of the corporation's business should not be defeated except when there is no other reasonable control.

A third category of covenants occupies a unique position. These covenants are those concerned with the preservation of the secured party's interest in the collateral, that is, his ability to look to those assets for the satisfaction of his debt upon the corporation's default. They include the covenants to segregate, account for, and deliver the proceeds of inventory and receivables; the prohibitions against sale, assignment, mortgage, or other disposition; and the covenant not to move the collateral without prior notice to and consent of the secured party. Other than the avoidance of a declaration of default, which, in the desperate situation when the survival of the enterprise is at stake, can be considered a mere detail, there is no corporate interest in the performance of these covenants. In fact, the breach of such covenants may be in the corporate interest, at least as that interest appears to the managers, because it enables the corporation to satisfy other obligations or to obtain additional credit. The secured party alone is injured by such breaches, and it is for his sole protection that such covenants are designed.

It is against breaches of these covenants that the secured party needs protection. Their performance depends solely on the corporate managers, and their enforcement against the corporation is meaningless in the event of corporate insolvency, which will almost invariably accompany their breach. Good faith performance is required by the UCC. When it is not rendered, there can be no more appropriate sanction than to impose, on those who knowingly and intentionally prevent it, liability to the injured party.

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<sup>122</sup> This is the principal value of acceleration clauses discussed in note 26 *supra*.

### F. A Comparison of Theories

In the vast majority of cases either of the two theories discussed—conversion and interference with contract—will lead to the same result. The basic difference is one of adaptability. Conversion is many centuries old, and its attributes have been developed in settings far removed from the modern commercial world.<sup>123</sup> On the other hand, interference with contract is a comparative babe-in-arms.<sup>124</sup> Its boundaries can be adapted to commercial realities far more readily and without conflict with factually inapposite precedents. To my knowledge, the theory has not been applied to this kind of commercial dispute except in the single case of *Carpenter v. Williams*,<sup>125</sup> which in the view of one commentator might, and probably should, have been decided solely on the theory of conversion.<sup>126</sup>

With full appreciation of the pitfalls of stating a black-letter rule of law, one is attempted below:

**If a corporation is the debtor under the terms of a security agreement, any manager of said corporation**

**(1) who knows or, by reason of his position, ought to know, of the material provisions of such security agreement, and**

**(2) who, not in good faith, including observance of reasonable commercial standards, willfully causes or knowingly permits the said corporation to breach any provision of such security agreement the effect of which breach is to defeat or diminish the secured party's interest in the collateral**

**shall be liable to the secured party for the amount of the secured party's loss proximately caused by such breach.**

Some of the advantages of looking at the problem from the contractual aspect can best be illustrated by pointing out the advantages of this rule in comparison to the inadequacies of conversion discussed in Section II of this Article.

#### 1. Property

The historic limitations of conversion would not be available as defenses when the collateral was other than tangible personalty or in-

<sup>123</sup> See Warren, *Qualifying as Plaintiff in an Action for a Conversion*, 49 HARV. L. REV. 1084 (1936).

<sup>124</sup> The tort first appeared in definite form in 1853 in England and "is now recognized virtually everywhere." W. PROSSER, *supra* note 30, § 129, at 929-30.

<sup>125</sup> 41 Ga. App. 685, 154 S.E. 298 (1930); see text accompanying note 97 *supra*.

<sup>126</sup> Note, *Liability of Directors and Other Agents for Procuring Breach of Corporate Contract*, 48 HARV. L. REV. 298, 300 n.12 (1934).

tangibles merged in a writing. This is particularly significant in the light of the large volume of financing now collateralized by accounts and contract rights and may develop additional significance in future situations in which that amorphous and limitless category of general intangibles is used for security. The draftsmen of article 9 express the hope that "new forms of secured financing, as they develop [will] fit comfortably under its provisions."<sup>127</sup> One would also hope that any theory for the imposition of liability on the managers of a corporate debtor would have the same capacity to accommodate new developments.

## 2. Security Interest

It would not be necessary to spin webs of conceptualism to force the secured party's interest into some historically labelled category. The secured party's interest, if it constitutes a reasonable commercial expectation, is deserving of protection no matter what one calls it. If it is defeated, the proper inquiry is whether the conduct responsible for the injury is or is not entitled to superior protection. If not, liability should follow.

## 3. Intentional Act

There would be no intentional-act requirement like that generally regarded as a *sine qua non* in a suit for conversion. Rather the significance of intention would be whether the manager intended to interfere with the corporation's performance of its obligation, regardless of the manner of interference.<sup>128</sup> Thus, the manager who, with full knowledge of his corporation's obligation to segregate the proceeds of the sale of inventory collateral, knowingly permits a subordinate employee to deposit such proceeds in the general bank account, with the probable consequence that the funds will be paid to others, would be no less liable for the secured party's loss than if he had himself paid out the money to others. Whether the manager knowingly permitted the proscribed procedure would, of course, be a question of fact in any particular case, but at least it would be the right question.

## 4. Good Faith

A duty premised on good faith<sup>129</sup> cannot be breached by one who is unaware that the duty exists. Consequently, a corporate manager

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<sup>127</sup> UNIFORM COMMERCIAL CODE § 9-101, Comment.

<sup>128</sup> See W. PROSSER, *supra* note 30, § 129, at 936.

<sup>129</sup>

In actions for interference with economic relations, the defendant's motive or purpose frequently is the determining factor as to liability, and sometimes it is said that bad motive is the gist of the action.

*Id.* § 129, at 927-28 (footnotes omitted). Compare quotation in text accompanying note 72 *supra*.

who, by either intentional conduct or omission, caused his corporation to breach a security agreement would not be liable for causing the breach unless he had, or, at the very least, should have had, knowledge of the existence and the material terms of the agreement. This is essentially an affirmation of the good faith defense successfully raised by the defendant in *Darling & Co. v. Fry*,<sup>130</sup> which, although purportedly decided on the theory of conversion, departed from the normal standard of conversion liability in which good faith is irrelevant. The *Darling* court may have gone too far by holding that actual knowledge of the security arrangement was necessary to impose liability on the defendant, who had been the corporation's manager and chief operating officer for a substantial period of time. Whether a manager without actual knowledge should be charged with such knowledge by reason of his position in the corporation would also seem to be a proper question of fact in each case. In any event, the lower-echelon manager, while, perhaps, technically guilty of conversion,<sup>131</sup> would avoid liability for even his most deliberate acts unless he in fact knew them to be violative of the corporation's obligation.

### 5. Damages

In contrast to conversion, where the damages are measured by the absolute value of the collateral, a court would attempt to evaluate the secured party's loss by comparing his actual position with what it would have been in the event that the security agreement had not been breached.<sup>132</sup> Thus, when a corporation had become bankrupt, the holder of an unperfected security interest could recover from a corporate manager only when that manager, without complicity of the secured party, had been instrumental in preventing perfection.<sup>133</sup> The secured party

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<sup>130</sup> 24 S.W.2d 722 (Mo. App. 1930) ; see text accompanying note 76 *supra*.

<sup>131</sup> According to strict conversion theory, any person who intentionally mailed a check drawn on a bank account in which the proceeds of collateral had been deposited would be guilty of conversion, whether that person was merely a clerk or the president and chairman of the board. As a rule, creditors of a corporation do not sue its clerks.

<sup>132</sup> Some speculation might be involved in determining whether what actually occurred would have occurred if the agreement had not been breached. Assume, for example, a creditor holding an unperfected security interest. Breach of the agreement and dissipation of the collateral might actually lead to a quiet insolvency without judicial proceedings. On the other hand, performance of the agreement, if a large amount were involved, might have triggered an involuntary bankruptcy to recover the payment as a preference. In such a case, perhaps bankruptcy should be assumed even if it did not, in fact, ensue.

<sup>133</sup> This view is borne out, in a slightly different context, by the court in *Bruer v. Sanford Atl. Nat'l Bank*, — Fla. Supp. —, 247 So. 2d 764 (Dist. Ct. App. 1971). There, the debtor corporation had mortgaged its equipment to Bruer, who failed to file a financing statement. Subsequently, in violation of the security agreement with Bruer, the corporation mortgaged the same equipment to a bank, which promptly filed. Upon a later sale of the corporation's assets, including the mortgaged equipment, the manager of the corporation assumed the obligation to the bank. Only

who, by intention or negligence, fails to ensure that his interest is perfected has no legitimate expectation to be protected in the event of bankruptcy. Conversely, an unauthorized transfer of collateral made in bad faith would result in the liability of the responsible manager, to the extent that it caused a secured party to lose, even though the security interest had been preserved inviolate. The question of proximate cause, slippery though it may be, is one with which courts have long dealt with reasonable success.

### CONCLUSION

There is, perhaps, no commercial contract under which one party relies on the good faith performance of the other to a greater degree, and with greater risk, than the non-possessory security agreement. Because the party relied upon is typically incorporated, the quality of its performance is determined by persons who are not even parties to the contract. Apart from the criminal law, there is no statutory regulation of their conduct. The necessary application of "principles of law and equity" evokes a uniquely large and confusing assortment of tort, contract, property, and corporate concepts.

In this Article, I have attempted to develop a combination of concepts more relevant to the commercial realities than those the courts have heretofore applied. However, as one of my wiser colleagues has observed,<sup>134</sup> they are still only concepts. Good faith performance has been aptly defined as the fulfillment of reasonable commercial expectations.<sup>135</sup> In the absence of a statutory solution,<sup>136</sup> the courts should focus less on the concepts and more on the question whether or not the quality of a participant's conduct merits the fulfillment of his expectations.

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then did Bruer file. When the purchaser defaulted, the manager paid the bank and proceeded to replevy the equipment as the bank's subrogee under UCC § 9-504(5). Admitting that the bank had priority under the first-to-file rule of UCC § 9-312(5) (a), Bruer claimed that the manager was equitably estopped from being subrogated to that priority. In holding for the manager, the court held that the defense of estoppel was not available to Bruer unless his delay in filing was "*due to a reliance upon some conduct, act or omission to act on the part of [the manager].*" *Id.* at 766. The dissenting judge, who relied almost exclusively on the good faith obligation of UCC § 1-203, colorfully remarked that "[t]he provisions of the Uniform Commercial Code were not intended to wash the stains of broken promises from this [manager] plaintiff's hands." *Id.* at 767.

<sup>134</sup> This is an appropriate point, though belated, to express my deep appreciation to Professor Noyes Leech of the University of Pennsylvania Law School. He is, among others, a fine teacher and scholar. He is, however, an editor without a peer.

<sup>135</sup> Farnsworth, *supra* note 114, at 669.

<sup>136</sup> The adoption of a UCC provision addressed to this problem is not anticipated in the near future. Between now and the time, if ever, that such a provision is implemented, such problems will best be solved by a combination of creative lawyers and intelligent judges operating in the context of a real commercial situation.