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Peripheral Security Interests -- The Expanded Net of Article 9

John H. Stroh

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PERIPHERAL SECURITY INTERESTS—THE EXPANDED NET OF ARTICLE 9

JOHN H. STROH*

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I. INTRODUCTION

Section 9-102 of the Uniform Commercial Code¹ specifies, in part, that:

- (1) [T]his Article (on Secured Transactions) applies
 - (a) to any transaction (regardless of its form) which is intended to create a security interest in personal property
- (2) This Article applies to security interests created by contract

A “security interest” is defined, in part, as:

an interest in personal property or fixtures which secures payment or performance of an obligation.²

A common failing, one not unique to members of the legal profession, is the general tendency to accept documents or instruments by their labels. If a paper entitled “Equipment Lease” is displayed, and it contains terms smacking of leases, then it is a lease, without more. If, instead, it is labeled “Sales Contract” and has those familiar terms such as “earnest money,” “f.o.b.,” and “seller,” then it is, in our minds, a sales contract and nothing else. Once so characterized, the transaction pulls certain basic understandings into a referential framework regarding the rights and duties of the parties to the transaction and of third parties. The presence of “legal” formalities and their adjuncts may be particularly misleading in evaluating the effects of a transaction in which the parties have, intentionally or unwittingly, created a security interest while using a device not traditionally recognized for such a purpose.

Generally, the professional commercial lender knows exactly what he

* Attorney at Law, Partner, Foster, Vogel & Stroh, St. Louis, Missouri, LL. B. 1958, Harvard Law School.

1. All citations to the Uniform Commercial Code unless otherwise indicated, will be made to the UNIFORM COMMERCIAL CODE, 1962 OFFICIAL TEXT WITH COMMENTS published by The American Law Institute and the National Conference of Commissioners on Uniform State Laws.

2. § 1-201(37).

is doing when he proposes the form of transaction to be used in a financing arrangement, and when he casts it in the mold of something other than one of the traditional forms, he is doing it with some definite purpose in mind. In states in which the Uniform Commercial Code is in force, the professional commercial lender has freedom to use his own judgment with regard to what he will require from his borrower in the way of a security interest.³ He can make his choice of security devices after analysis of the lending risks foreseeable in the individual situation, rather than on the basis of that which is available, as was required under the hypertechnical and structured framework of pre-Code law.⁴ His wits sharpened by a series of running battles with borrowers, courts and tax collectors, he learned to expect the unexpected in the way of disappearance of collateral, decision and ruling, and operated with both eyes open wide and neck swiveling constantly. If a security interest is disguised by the professional, it is disguised with, at least, some apprehension of the potential risks and benefits involved. It is possible, however, that the Code has broadened some of the familiar pre-Code risks and added several new ones.

In contrast, the contracts of the average business are either drawn or negotiated by a divisional sales manager, the accounting department, or that bright young fellow in Corporate Planning. The "contract," if so drafted, is typically based on some other document gleaned from the files and which was used in what apparently was a similar situation. Those who negotiate the contract are generally pushing hard to have the transaction go through in the shortest possible time and cannot see the need for pause or delay in consummation, which may blow the entire deal out of the water, for the sake of the lawyer and his red tape. The parties at the time the bargain is struck do not shape the agreement with anything but performance (and, perhaps, the latest tax gimmick) in mind. Briefly stipulating those matters which seem to them to be important at the time, they do not even consider the rest. In so doing, they may use a form of transaction in an attempt to reach an end for which it was not intended or may attempt to accomplish two irreconcilable objectives in a single document, and thus create a contractual relationship subjecting the entire transaction, or a significant part of it, to article 9 where they would not want it if they gave the matter any thought and for which they are not prepared. Either the creation of such relationship or the application of the rules of the article on secured transactions⁵ may be unwitting, but if the parties objectively intended a result which constitutes a security interest, they are in article 9 country.

3. There is a vast amount of literature on this. See, e.g., *Symposium—A Practical Approach to the Uniform Commercial Code for the Practicing Lawyer*, 19 BUS. LAW 5 (1963).

4. The liveliest discussion of pre-CODE laws may be found in two parts in Gilmore and Axelrod, CHATTEL SECURITY: I, 57 YALE L.J. 517 (1948) and Gilmore, CHATTEL SECURITY: II, 57 YALE L.J. 761 (1948).

5. Art. 9, §§ 9-101 et seq., [hereinafter cited as article 9].

Enactment of article 9 broadened the definition of "security interest" to something beyond the sum total of the areas formerly covered by conditional sales, factors liens, chattel mortgages, trust receipts, pledges and so on. The Code has also broadened the application of the law applying to secured transactions, not only to reach transactions now redefined as security transactions, but to reach those parties to transactions, although defined as security transactions under the common law or pre-Code statute, to whom the courts refused to apply that law in full to aid rather than punish. Except in the case of claimed and tentatively proven violation of some strong public policy, such as that against usury, or fraud, the judicial impulse was to accept a document at face value and leave the parties in the bed that they made, whether it be of rose petals or of thorns.⁶ It was a rare court which would allow itself to be propelled behind the facade of a transaction and then give relief from onerous conditions at the behest of one of the parties, absent actual fraud or the strong public policy mentioned. The Code in its broad definition of security interests and its definite subjection of transactions intended to create a security interest to article 9 in full,⁷ compels judicial investigation of every transaction in which it is claimed a security interest lies, and subsequent application of article 9 rules rather than those of article 2, the common law, or the contract provisions.

There are two common business arrangements in which a security interest may be unconsciously created or may be found by the courts. One may be a new type of security interest: the chattel acquisition lease; the other may be an ancient and honorable part of the law of sales: contracts for sale. Both, since they may represent interests taken by sellers of the property to secure all or part of its price, may create "purchase money security interests" as defined by section 9-107.

II. CHATTEL ACQUISITION LEASES

Equipment leases, like any other mechanism for transferring title, possession, or the use of property, may serve legitimate and non-legitimate purposes in business operations as the parties desire.⁸ An enterprise, by acquiring the use of equipment which it does not own and of which it is not obliged to become the owner acquires its benefits without its burdens. A manufacturer faced with a contract job calling for special machinery, which cannot be used by him following performance, may be able to acquire it for the term of the contract without the need and waste of capital investment for a piece of eventually non-productive but long-lived prop-

6. *Starr's Estate v. Commissioner*, 274 F.2d 294 (9th Cir. 1959); *Tishman Equip. Leasing, Inc. v. Levin*, 152 Conn. 23, 202 A.2d 504 (1964); *Burton v. Tatelbaum*, 240 Md. 280, 213 A.2d 875 (1965).

7. §§ 9-102(1)-(2).

8. Comment, *Acquisition of Industrial and Commercial Equipment Through Leasing Arrangements*, 66 YALE L.J. 751 (1957).

erty or the bother attendant to its disposition after it has outlived its usefulness to him. It may be good business for a meat packer to lease refrigerator trucks which the lessor is to service and maintain rather than to buy trucks and establish a trained (and costly) service department and garage facility. And a business in a field in which there is rapid technological change may, by leasing its more costly equipment for short terms, place the burden of obsolescence on the lessor.⁹

Financing limitations imposed by a debt-heavy balance sheet may compel an expanding enterprise to acquire the use of new assets by lease rather than by debt obligation;¹⁰ restrictive terms of long term financing arrangements, the "negative covenants" of trust indentures, and the overly broad coverage of "all equipment" in financing statements and an after acquired property clause available in article 9 security interests¹¹ may also force the use of the lease. Further, financial obligations of the lessee under a lease are not carried on the balance sheet although they may be just as binding as, and of equal duration as debt obligations; neither are the leased assets carried, but a leasing program allows corporate management to practice a not-so-innocent deception on the shareholders as well as on itself. And a lease arrangement is more suitable for establishment of otherwise per se illegal restraints of trade and tie-ins than a sale, since a lease presupposes a continuing interest of the lessor in the leased property, and the lessor may make periodic inspections, and so on.¹²

If such a distinction is possible, tax reasons, as opposed to business reasons, added the fertilizer to the flower (or weed, if you will) of equipment leasing, causing its increased popularity. Simply, rentals paid for business equipment are business expenses, and, being deductible from income, are paid with pre-tax dollars, whereas reduction of principal indebtedness is made with whatever is left to the taxpayer after taxes are paid. Interest and depreciation deductions (even at the accelerated rate) which are available when the equipment is acquired by purchase and debt, rarely if ever equal the rental deduction in any year, since the term of a lease in which the lessee also intends to acquire ownership of the

9. See *Kearney v. Trecker Corp. v. United States*, 195 F. Supp. 158 (E.D. Wis. 1961).

10. See *Western Contracting Corp. v. Commissioner*, 271 F.2d 694 (8th Cir. 1959).

11. Section 9-402, stating the formal requisites of a financing statement, allows a description of collateral by indicating types *or* item; in other words each item of equipment need not be listed. The wisdom of the use of such a financing statement is questionable, particularly on the part of the debtor, even though the security agreement may describe specific collateral in detail, broad filings may give the lender tremendous leverage in the priority race. See § 9-312(5)(a). Section 9-203(1)(b) provides that the security agreement is enforceable if it contains a "description" of the collateral, and § 9-204(3) provides for the addition of after-acquired property to the security interest. An actual lease is not a security interest, so the "first to file" rule would be inapplicable to downgrade the lessor's interest.

12. See the opinion of Wyzanski, J., in *United States v. United Shoe Machinery Corp.*, 110 F. Supp. 295 (D. Mass. 1953).

property is generally much shorter than the life of the property for purposes of depreciation, and the rents are correspondingly higher. The lease of equipment also has a cash-flow advantage, particularly on contract jobs: the earnings generated by the equipment are used to pay for it or its use.¹³

A true equipment lease, although it may embody a definite obligation of the lessee to pay for a specified term, does not constitute a security interest in the leased article since the interest of the lessor is not retained to secure the lessee's performance, and the lessee has no other rights in the leased article than those of use and possession for the limited and specified term. True, bona-fide, or "straight" leases are those ". . . calling for . . . the 'right to use' described personal property, . . . where the rentals over the term of the lease can be found to bear a reasonable relation to the average loss in value of the leased property due to aging, wear and tear, and obsolescence."¹⁴

It may well be asked then: when is a lease not a lease? The answer supplied by the Code is: when it is a security interest. Section 1-201(37) supplies some help:

Unless a lease . . . is intended as security, reservation of title thereunder is not a "security interest". . . . Whether a lease is intended as security is to be determined by the facts of each case; however, (a) the inclusion of an option to purchase does not of itself make the lease one intended for security, and (b) an agreement that upon compliance with the terms of the lease the lessee shall become or has the option to become the owner of the property for no additional consideration or for a nominal consideration does make the lease one intended for security.

A lease is a security interest, at least, when the so-called lessee has or is acquiring an ownership interest in the property or through performance of the lease obligation will eventually acquire some form of ownership interest. Prior to the Code, a lease intended to create a security interest was classified as a conditional sale, which it most nearly resembled to courts examining the problem.

There is, therefore, a fund of judicial experience available to flesh out the skeleton supplied by section 1-201(37). Deriving from two main sources, creditor's suits, including bankruptcy proceedings, and actions involving the collection of income taxes, the cases demonstrate that the

13. Note, *A Lease by Any Other Name: or When Is a Lease a Conditional Sale*, 44 B.U.L. REV. 103 (1964); *Symposium—Getting Down to Earth on Equipment Leasing Transactions*, 12 PRAC. LAW 9 (Jan. 1966).

14. Hiller, *Security Aspects of Chattel Leases in Bankruptcy*, 34 FORDHAM L. REV. 439, 439 (1966). A lessor validated high rentals which decreased over the term of the lease by such a showing in a tax case. See *Kearney & Trecker Corp. v. United States*, 195 F. Supp. 158 (E.D. Wis. 1961).

problem of identification of a security interest is not a particular new one, and that the courts have been able, for the most part, to deal with it. Because of the terms of the Internal Revenue Code, the approach of the Revenue Service has been one of analysis on an economics basis,¹⁵ while that of the courts in the creditor cases tended to be phrased in a legalistic analysis.¹⁶ In actual practice these two apparently divergent approaches were not so far apart in result as the wording of the cases may have appeared, and the courts in creditors cases have recently moved into the area of economic analysis openly, rather than covertly.

In a lease, the lessee makes periodic payments perhaps based on the duration of possession, perhaps based on the amount of use, for the use of the equipment for either a definite or unspecified term, and acquires no other interest in it than the right to use and the right to possession; the lessor remains the owner and regains possession at the end of the term. In a conditional sale, the vendee, in possession and enjoying the right to use the item, pays the purchase price in periodic installments over a definite term to acquire full title. In the eyes of the law, the vendee is paying to remove a condition to this ownership, for he has beneficial ownership under the contract, and the vendor has only a title retained for his security. In the vernacular, the conditional vendee is building up an equity.

Equipment leases which allowed the lessee to acquire ownership of the leased item were recognized before the advent of the Uniform Commercial Code and the Internal Revenue Code of 1939 as a means of disguising that which was essentially a security interest involving purchase money financing.¹⁷ A type of financing similar to chattel mortgage borrowing could also be done by virtue of the sale and lease-back route, more commonly used with improved real estate. Chattel-goods, with their usually movable nature and their comparatively short life do not make good subjects for sale and lease-back financing if it is not actually used to finance chattel acquisition. These disguised leases, chattel acquisition leases really, more closely resembled conditional sales and were un-

15. While according to state law the instrument will probably be taken (with the consequent legal incidents) by the name the parties give it, the internal revenue service is not always bound and can often recast it according to what the service may consider the practical realities.

Starr's Estate v. Commissioner, 274 F.2d 294, 294-95 (9th Cir. 1959).

Rentals, if they are actually rentals paid for the use of trade or business property are deductible business expenses. INT. REV. CODE of 1954, § 162(a)(3); Rev. Bull. 55-540, 1955-2 CUM. BULL. 39.

16. The conflict is there between parties claiming rights in the "leased" equipment. Compare *Burton v. Tatelbaum*, 240 Md. 280, 213 A.2d 875 (1965) (receivers of lessor and lessee; transaction held: a lease) with *In re Midwest Airmoving Corp.*, 184 F. Supp. 474 (N.D. Ohio 1960), *aff'd sub nom.*, *Noll Equip. Co. v. Spilka*, 277 F.2d 792 (6th Cir. 1960) (bankruptcy, transaction held: conditional sale). But see *In re Atlanta Times, Inc.*, 259 F. Supp. 820 (N.D. Ga. 1966) (reclamation; transaction held: a lease).

17. See *Burroughs Adding Mach. Co. v. Bogdon*, 9 F.2d 54 (8th Cir. 1925).

doubtedly originally intended to serve in lieu of such, but the classification of chattel acquisition leases as conditional sales in earlier cases may have placed an unwarranted limitation on judicial analysis of subsequent transactions.

The use of the chattel acquisition lease rather than a clear purchase money security interest for the acquisition of depreciable property, before the days of accelerated depreciation,¹⁸ gave the "lessee" grounds to expense-out his capital items over a much shorter period of time than that allowable under straight line depreciation, for the term of the lease was generally much shorter than the duration of the useful life of the property.¹⁹ This is not so much tax evasion as would be the case if non-depreciable property were involved; it is an attempt to time the incidence of tax. The tax collectors, as might be expected, have not been too sympathetic to taxpayer efforts in this area.

Chattel acquisition leases, in addition to providing an aid to tax timing, provided the mechanism by which restrictions on the use of the traditional financing devices were circumvented. Leases generally are not subject to filing or recording requirements in order to make the retained interest of the lessor effective against the claims of purchasers, levying creditors, and the trustee in bankruptcy.²⁰ By not recording, the "lessor" could save several dollars in recording fees plus the time it takes to walk to the courthouse, and the "lessee" could avoid the notoriety or stigma of publicly acknowledging that he was acquiring his equipment on a time basis. And by not having to record, the lessor avoided several of the acts, on any of which a fatal misstep could occur, necessary to perfect a pre-Code security interest.²¹ In the opinion of the writer, however, this reason, elimination of the need for recordation, for the use of a chattel acquisition lease instead of a chattel mortgage or conditional sale has been badly overworked and overblown by the trade.

Under the Uniform Conditional Sales Act²² and many other pre-Code state statutes,²³ the right of repossession of a conditional seller was materially limited by the vendor's duty to refund a portion of the vendee's payments either automatically or on his failure, after repossession, to resell and account for the proceeds. A lessor, however, could provide his own terms of repossession, liquidated damages, and rental prepay-

18. INT. REV. CODE of 1954, §§ 167(b)(2)-(4).

19. See *Starr's Estate v. Commissioner*, 274 F.2d 294 (9th Cir. 1959) (leased equipment: fire sprinkler system; five year lease 30 years normal useful life); *In re Herrold Radio & Electronics Corp.*, 218 F. Supp. 284 (S.D.N.Y. 1963), *aff'd*, 327 F.2d 564 (2d Cir. 1964) (leased equipment, electric wiring and fixtures and wall partitions; five year lease).

20. Hiller, *Security Aspects of Chattel Leases in Bankruptcy*, 34 FORDHAM L. REV. 439 (1966).

21. See *United States Hoffman Mach. Corp. v. Lauchli*, 150 F.2d 301 (8th Cir. 1945); *Lee v. State Bank & Trust Co.*, 54 F.2d 518 (2d Cir. 1931) and cases cited.

22. UNIFORM CONDITIONAL SALES ACT § 23.

23. *E.g.*, § 428.110 MO. REV. STAT. (1959) (repealed 1963).

ments to be applied upon default, aided by the old property rule that the lessor's retaking the property on the lessee's default does not terminate the latter's obligation to pay rents, with no automatic statutory or judicial compulsion to sell or re-lease and account for proceeds to the defaulting lessee.

A chattel acquisition lease may have also been more valuable to the lessor if he was, himself, financing on his paper, than a conditional sale, inasmuch as it may have been more saleable in some jurisdictions. A sale of a purchase money chattel mortgage involved negotiation of the note secured thereby, and the holder in due course of the note took the mortgage free of all of the buying mortgagor's defenses based on the sales transaction.²⁴ Prior to section 9-206(1), it was doubtful in many jurisdictions whether or not a conditional vendee's agreement to waive claims of warranty or failure of consideration against an assignee of the contract was effective.²⁵ Such waivers were sometimes considered to be contrary to public policy or else invalid as attempts to impart negotiability by contract, and an assignee suing a defaulting conditional vendee could receive a nasty surprise.²⁶ There seems to have been no reason for such a rule except the generalized dislike manifested by the courts toward people in the money business and, indeed, the Code has abolished it.²⁷ Apparently, the rule does not obtain in general contract law and such a waiver by the lessee in a lease was probably effective under general contract law to protect the claim of the assignee of the right to receive rental payments.²⁸ In any event the burden of convincing the court that the lease was really a conditional sale and, more important, should be dealt with under conditional sale rules was on the lessee both in repossession cases and in suits for "rents," and such pleas were not apt to be particularly effective.

Aside from the general statement that the parties to a purported lease have created a security interest when the lessee acquires an "equity" or beneficial ownership by virtue of all or some portion of his periodic payments, no single test or particular combination of factors is determinative in every case.²⁹ The earliest chattel acquisition leases were relatively unsophisticated, being conditional sales contracts which had been re-written to substitute the words "lessor" for "seller" and "rentals" for "time price," and so on.³⁰ The "lessee" acquired title automatically upon

24. The mortgage was ancillary to the note, *e.g.*, *Kingsland & Ferguson Mfg. Co. v. Chrisman*, 28 Mo. App. 308 (1887).

25. *E.g.*, *Industrial Loan Co. v. Grisham*, 115 S.W.2d 214 (Mo. App. 1938).

26. § 9-206, Comment 1.

27. § 9-207.

28. An estoppel could be created. *Securities Inv. Co. v. International Shoe Co.*, 5 S.W.2d 682 (Mo. App. 1928). Or the parties may be found to have intended an assignment free and clear of outstanding claims. *Ex parte Asiatic Banking Corp.*, L.R. 2 Ch. 391 (1866).

29. Rev. Rul. 55-540, § 4, 1955-2 CUM. BULL. 39.

30. *See Burroughs Adding Mach. Co. v. Bogdon*, 9 F.2d 54 (8th Cir. 1925); *In re*

full compliance with the contract.³¹ Such arrangements were resolved by the courts "on the intention of the parties as gathered from the four corners of the contract."³² Although use of lease terms had "undoubted weight in determining the character of the instrument, it (is) not controlling."³³ The courts had little difficulty in finding a conditional sale in such circumstances. If the lessee was to take title at the end of the term upon full compliance with the contract, then the lease was really a conditional sale. If, on the other hand, under the terms of the contract the lessee was required to return the leased item at the end of the term, or if the lessee could terminate his further obligation to pay rentals by returning the item to the lessor during the term, then generally a true lease could be found.³⁴ Initially, this was a good objective test.

By the magic of negative implication, if a conditional sale was a contract in which the holder of property received the title to it upon full compliance with the contract, then an arrangement by which the holder of the property did not automatically acquire title upon full compliance was *not* a conditional sale. That this would not be so was demonstrated by the judicial counterattack which displayed a degree of flexibility surprising in minds which refused to recognize common law trust receipts and persisted in classifying them as chattel mortgages or bailments for sale. From the intention of the parties as gathered from the four corners of the instrument, the judicial horizon expanded to the intention of the parties as gathered from the circumstances existing or contemplated at the time of the execution of the agreement.³⁵ From the legal effect of the

Midwest Airmoving Corp., 184 F. Supp. 474 (N.D. Ohio 1960), *aff'd sub nom.* Noll Equip. Co. v. Spilka, 277 F.2d 792 (6th Cir. 1960) (Monthly rental payments were embodied into notes).

31. First Nat'l Bank v. Phillips, 261 F.2d 588 (5th Cir. 1958).

32. Kolb v. Golden Rule Baking Co., 222 Mo. App. 1068, 1071, 9 S.W.2d 840, 842 (1928).

33. Burroughs Adding Mach. Co. v. Bogdon, 9 F.2d 54, 56 (8th Cir. 1925).

34. 2 WILLISTON, SALES § 336 (rev. ed. 1948). Kolb v. Golden Rule Baking Co., 222 Mo. App. 1068, 1071, 9 S.W.2d 840, 842 (1928).

A test usually applied, in determining whether or not an instrument is a lease or a conditional sales contract, is whether or not such instrument requires or permits the transferee to return the property in lieu of paying the purchase price. If the return of the property is either required or permitted, such instrument will be held to be a lease.

Contra, First Nat'l Bank v. Phillips, 261 F.2d 588 (5th Cir. 1958).

35. The situation of the parties, their purposes, the thing they sought to accomplish, and the method employed, are all important. Once the intention of the parties becomes clear it is immaterial what the instrument is called, nor how skillfully the real intention of the parties is disguised. . . .

First Nat'l Bank v. Phillips, 261 F.2d 588, 591 (5th Cir. 1958). *Contra*, "The intention of the parties must be determined from the language of the lease itself. . . ." *In re Atlanta Times, Inc.*, 259 F. Supp. 820, 826 (N.D. Ga. 1966) (reclamation proceeding). The court held that the parol evidence rule and "an entire agreement provision" (merger clause) created a conclusive presumption against the trustee that the lease document embodied the entire agreement and excluded evidence of an informal option arrangement whereby lessee was to have acquired the property for a nominal price. Perhaps, such presumptions apply between the parties to an agreement, but they cannot be allowed to foreclose the rights of third parties when those

document as written, the courts turned instead to a determination of what the parties must have actually intended. This then, is still the standard against which leases must be measured. In the test, every act of the parties must be weighed in the balance, the practical effect of the transaction being closely scrutinized. The courts' analyses were, however, in terms of conditional sale or lease, since recording acts applied only to conditional sales and chattel mortgages. Because of the need to find a conditional sale, the emphasis still rested upon eventual passage of title.

These "second generation" chattel acquisition leases generally provided that the lessee, at the end of the lease term, should return the leased property to the lessor, unless he exercised an option to purchase it.³⁶ The mere existence of an option to purchase or to take title cannot create a conditional sale; for one reason, such options are otherwise useful and serve quite legitimate business purposes.³⁷ But if an option to purchase, to acquire beneficial ownership, during (or at the end of) the lease term is added to the lease, the arrangement moves somewhat closer in appearance to a conditional sale, or purchase money security interest, for if the option is exercised, the lessee may also acquire beneficial ownership and title under the terms of the contract and no longer must return the property. However, if the option price, only, represents the value of "equity" or the cost of acquisition of *ownership*, the lease still remains a lease coupled with an option. It is the acquisition of "equity" through payments made over the term of the contract, *i.e.*, rentals, rather than through exercise of the option and payment of the option price, which converts the lease into a security interest.³⁸ An option price of one dollar, although sufficient consideration to support a contract at law, if bargained for, fooled no one. If the option price was nominal, then the lease was a conditional sale; the lessee had acquired "equity" over the course of the lease. In other words, his lease payments had given him an ownership interest in the property, as the parties had intended. Therefore, they had

rights arise independently of the agreement. Creditors have generally had the right to go behind unequivocal documents on a claim of a highly attenuated fraud. See 3 WILLISTON, CONTRACTS (3d ed. 1967). The trustee in bankruptcy is armed with a creditor's powers and rights as well as standing in the shoes of the bankrupt, 4 COLLIER, BANKRUPTCY ¶ 70.10, at 1033 (14th ed. 1964), so the application of the exclusionary rules in *In re Atlanta Times, Inc.*, *supra*, is questionable.

36. *In re Herrold Radio & Electronics Corp.*, 218 F. Supp. 284 (S.D.N.Y. 1963) (Built in compressed air lines, wiring and partitions); *In re Crown Cartridge Corp.*, 220 F. Supp. 914 (S.D.N.Y. 1962).

37. In a situation of technological change, for example, a manufacturer may desire to try a new type machine without making the capital outlay needed to purchase what may be an unsuitable item, but if it is satisfactory, he may want to buy it. See *Kearney & Trecker Corp. v. United States*, 195 F. Supp. 158 (E.D. Wis. 1961).

38. *United Rental Equip. Co. v. Potts & Callahan Constr. Co.*, 231 Md. 552, 191 A.2d 570 (1963) (85% of rentals were applicable to the purchase price in the event the option was exercised; the court found a security interest). *Contra*, *Western Contracting Corp. v. Commissioner*, 271 F.2d 694 (8th Cir. 1959); *In re Wheatland Elec. Products Co.*, 237 F. Supp. 820 (W.D. Pa. 1964) (option price was a minimum of 25% of list price).

intended at the execution of the document that the option would be exercised and the lessee would take title, creating a conditional sale. The leases were redrawn to make the option price no longer "nominal"; it was hoped this would indicate that the lessee had a choice to make: exercise the option and pay a substantial amount to acquire ownership or return the property. The cost of exercise of the option, no longer "nominal," could run in excess of five percent of the list price of the property, perhaps in the neighborhood of several thousands of dollars.³⁹ "Nominal," however, is not only a word of description; it also implies relationship or degree. The question which should have been asked was: "Nominal" in relation to what?

The theory by virtue of which the courts ignored the one dollar option served to test all options. If the lessee had paid over the term of the lease all, or nearly all, of the lessor's entire cost of the leased item as rentals, and if the property still had material value to the lessee, then the rental payments previously made had given the lessee an interest in the property, compelling him to exercise his option to purchase if the cost of exercise was less than the value of the property, whether or not he was under an enforceable duty to do so. He must, as a businessman, save his investment or "equity" in the property. Therefore, when the option price was nominal in relation to the then remaining value of the leased property to the lessee, the lessee had acquired an interest in it by paying rent. The parties intended at the time of the execution of the contract that the option would be exercised and that the lessee would take title. They had, by economic elimination of the element of future choice essential to the validity of any option, eliminated the option as a limiting factor to a finding of conditional sale. The situation, therefore, was the same as in those cases in which the lessee automatically took title at the end of the term upon full compliance with the contract. The lessee could not afford not to exercise the option.⁴⁰ Where the option price, however, had some reasonable relationship to the value of the leased item at the option time, the option could then be considered to be real and the option price the cost of acquiring beneficial ownership of the property. The rentals, although perhaps high, may be shown to be intended by the parties solely to compensate the lessor for the lessee's use of the property, and if so, would be neither in whole nor in part intended as installment payments for the acquisition of an "equity" in the property.⁴¹

39. In *In re Herrold Radio & Electronics Corp.*, 218 F. Supp. 284 (S.D.N.Y. 1963) (it was \$11,341.00); in *In re Crown Cartridge Corp.*, 220 F. Supp. 914 (S.D.N.Y. 1962) (the option price was 10% of the list cost or \$4,505.47).

40. [T]hat is to say, whether the terms of the contract are such that the lessee's only sensible course, at the end of the contract term, is to become the owner of the goods.

In re Herrold Radio & Electronics Corp., 218 F. Supp. 284, 285 (S.D.N.Y. 1963).

41. If the purchase bears a resemblance to the fair market price of the property, then the rental payments were in fact designated to be in compensation for the use of the property and the option is recognized as a real one.

It is stated in the cases that the existence of the option will be ignored when the option price is nominal in relation to the fair market value of the property. One assumes, in addition, that the "nominal" price of section 1-201(37) is equally so modified. Thus, an option price of \$4,505.47 was considered to be nominal in view of the fact that the optioned property would have a fair market value of \$24,000 at the time of exercise; total rentals had been \$58,616.76 over a period of five years and the property had cost the lessor \$45,054.79.⁴² The actual measure of value must be the value of the property to the lessee. Since this can be a subjective matter, objective economic value may be used as evidence of value to the lessee, but in some instances fair market value cannot suffice. Cost of replacement may also be helpful in arriving at a figure. The choice of the lessee to exercise an option was ignored, and the lessee had acquired "equity" through rental payments where an option price was \$11,341, but market or salvage value was only \$7,935. Wall partitions, electric wiring and fixtures, and compressed air pipelines, all plastered over, constituted the leased items. The total rentals were \$113,229; the cost of items was \$90,728.29, of which \$44,853.70 constituted installation charges. Assuming that the lessee could tolerate the disruption of its business while the leased property was torn out and removed at the end of the lease term, the court found that the value of the property to the lessee was approximately \$53,000.00, since the lessee would have been required to pay \$7,935 to acquire used property in a similar state and to spend \$44,853.70 to install it.⁴³ Such an option price was nominal.

Where there is an option, and the total rentals are equal to, or are near the list price of the property at the time of the execution of the lease it is certainly an indication that the parties may have intended a purchase money security interest,⁴⁴ particularly when the lease is a net lease and

In re Crown Cartridge Corp., 220 F. Supp. 914, 916 (S.D.N.Y. 1962); *Kearney & Trecker Corp. v. United States*, 195 F. Supp. 158 (E.D. Wis. 1961) (option prices were set after serious evaluations of decline in value of property over the term of use; court held that the contract was not a conditional sale and that lessee, by paying rent, had not acquired an equity); see *United Rental Equip. v. Potts & Callahan Constr. Co.*, 231 Md. 552, 191 A.2d 570 (1963) (Court found a security interest).

42. *In re Crown Cartridge Corp.*, 220 F. Supp. 914 (S.D.N.Y. 1962).

43. *In re Herrold Radio & Electronics Corp.*, 218 F. Supp. 284 (S.D.N.Y. 1963). The Court was not too hard put to sustain the Referee's finding that the lessee was bound to exercise his option. See also *Starr's Estate v. Commissioner*, 274 F.2d 294 (9th Cir. 1959).

44. [A] lease with an option to purchase is not within the Uniform Conditional Sales Act where, as here, the aggregate payments *required* of the lessee are not substantially equivalent to the purchase price (emphasis supplied).

Allen v. Cohen, 310 F.2d 312, 314 (2d Cir. 1962). The court was bound by the former New York statute, N.Y. PERS. PROP. LAWS § 61(2) (1962), converting a lease into a conditional sale where the lessee *contracted* to pay as rent a sum equivalent to the value of the goods and where the lessee is bound to become or has the option to become the owner upon full compliance with the terms of the contract. It disapproved of *American Can Co. v. United States Canning Corp.*, 12 Misc. 2d 750, 170 N.Y.S.2d 727, (N.Y. Mun. Ct. 1958), *rev'd on other grounds*, 15 Misc. 2d 549, 180 N.Y.S.2d 983 (Sup. Ct. 1958), in which that court found a conditional sale in a lease with a purchase option which credited past rentals on the

the lessee is obligated to assume the risk of loss, insure, and pay taxes, all of which are incidents of beneficial ownership. Such a showing may have the effect of throwing the burden of proof on the person attempting to sustain the lease as a lease by showing the relationship of rentals to use, and should serve as a red flag for counsel in reviewing such documents.

Certain of the cases and commentators have stated that, if the lessee is not obligated by the contract to perform for the full term in which rentals equal list price, if he can terminate his obligation for further rentals by returning the leased property to the lessor, then there is no purchase money security interest.⁴⁵ Again, the document may contain words granting this privilege, but to determine whether or not the lessee is obligated to perform the contract fully, the reviewing authority must evaluate the practical economics of the situation. Where a lease called for thirty-six equal monthly rental payments over three years and the lessee was required to pay the initial rental and the last eight months' rentals in advance, the court found a conditional sale contract.⁴⁶ The lessee was not obligated by the contract to pay all of the rentals, but if he did perform fully, the lessor was to transfer the property to him by bill of sale. If he did not perform, he would lose his advance rental payment. Although the fact that the lessee had in essence made a twenty-five per cent down payment which gave him an equity and obligated him to continue his payments and to comply fully with the contract, the court in holding the lease to be a conditional sale, merely stated that the personal obligation of the purchaser to pay the contract price was not essential in order to render a lease a conditional sale. Probably the existence of an enforceable obligation of the lessee to make the full contract payments equal to list price is at best ambiguous in pointing to sale or lease. If the payments the lessee is obligated to make, either by law or economic pressure, do not at least equal the market value of the leased article at the time of the execution of the document, the lease is clearly a straight lease. But if the lessee may continually renew the lease at the end of the lease period until the rentals, all or any part of which are deducted from the lessee's acquisition cost, equal the purchase price and the rentals are so far inflated above normal rentals for the same type of equipment so as to indicate that by paying rentals the lessee is, in fact, acquiring an "equity" which he must protect by renewing, the renewal options should be ignored.

Because the courts in creditor's cases classified leases intended for

purchase price, but in which rentals would not have equalled the purchase price unless the lease were twice renewed. The approach to such leases suggested in *Allen v. Cohen*, *supra*, seems overly narrow, although the decision there was undoubtedly correct.

45. Note 44 *supra*; *Kolb v. Golden Rule Baking Co.*, 222 Mo. App. 1068, 9 S.W.2d 840 (1928); 2 WILLISTON, SALES 336 (rev. ed.).

46. *First Nat'l Bank v. Phillips*, 261 F.2d 588 (5th Cir. 1958).

security as conditional sales, the intended eventual acquisition of title by the lessee either automatically or by so-called option became the prime test of the document; if the lessee took title, or *would* take title, there was a sale.⁴⁷ More sophisticated lessors, naturally, soon found methods to avoid this test. The option was dropped from the lease; no option was granted the lessee, and provisions for passage of title were stricken. Where the lessee had a corporate structure, the opinion could be given in a supplemental document to a trusted officer, director, or shareholder who could either exercise the option himself at the end of the lease term and lease his newly acquired property to the enterprise, perhaps at a nominal or greatly reduced rate, or else assign the option to the corporate lessee itself.⁴⁸ It was simpler, however, since less people were involved, to drop options completely and provide that the lease could be renewed perpetually at nominal rents, once the economic value to the lessor plus financing costs had been repaid by rental payments made over a fractional portion of the actual economic and useful life of the property.⁴⁹

The Internal Revenue Service had no problems in ruling that rentals paid on the perpetual option-to-renew leases, whether paid in the initial term or in the renewal, were not deductible from income as business expenses. The wording of the pertinent portions of section 23 of the Internal Revenue Code of 1939 and section 162 of the Internal Revenue Code of 1954, dealing with business expenses, places the emphasis on the acquisition of either title or an equity in the property,⁵⁰ and the Service, in Revenue Ruling 55-540⁵¹ provided:

The fact that the agreement makes no provision for the transfer of title or specifically precludes the transfer of title does not, of itself, prevent the contract from being held to be a sale of the equitable interest in the property.⁵²

Although the ruling was *ex parte*, it is correct in excluding such transactions from the classification of leases. However, these perpetual renewal leases are not traditional conditional sales; no legal title ever passes under such leases. They are, instead, a new type of security interest grounded on economic facts of life rather than rules of law.⁵³ They truly

47. *In re Herrold Radio & Electronics Corp.*, 218 F. Supp. 284, 286 (S.D.N.Y. 1963) "Manifestly, his only sensible course would be to pay the \$11,341. Thus, as a practical matter, he was bound to exercise his option to purchase the equipment."

48. *Tishman Equip. Leasing, Inc. v. Levin*, 152 Conn. 23, 202 A.2d 504 (1964) (Court refused to read the option given the promoter of a corporation into the lease of lessee corporation. In the absence of fraud, the corporate veil would remain intact).

49. *Starr's Estate v. Commissioner*, 274 F.2d 294 (9th Cir. 1959); *Mt. Mansfield Television, Inc. v. United States*, 239 F. Supp. 539 (D. Vt. 1964), *aff'd per curiam*, 342 F.2d 994 (2d Cir. 1965).

50. "[R]entals . . . of property to which the taxpayer has not taken or is not taking title or in which he has no equity." INT. REV. CODE of 1954, § 162(a)(3).

51. 1955-2 CUM. BULL. 39.

52. Rev. Rul. 55-540, § 4.02, 1955-2 CUM. BULL. 39, 42.

53. It is difficult for this Court to believe that an astute businessman would incur

represent permanent chattel acquisition by lease, and may be found to be security interests, for the Code deals, not in title, but in ownership.

Assume, for example, the following situation:

Corporation desires to acquire an addressing machine and related equipment, and selects these items from Standard's catalogue. The list price is \$900.02. Standard sells the equipment to Leasing which executes a five year lease with Corporation calling for 60 equal monthly net payments of \$19.80 (total \$1,188.00), with automatic annual renewals thereafter for \$27.00 per year (3% of the list price). The lease provides for termination at the end of any renewal period on 30 days prior notice and that the lessee shall never acquire title to the leased property. The lease also provides that upon default in rental payments, if not cured within seven days following written notice of default from the lessor, the lease will terminate.

Consider the effect of a failure to pay twenty-seven dollars per year after the first five years have elapsed. The lease is still in existence, and the lessee holds under the lease, rightfully, until the lessor notifies the lessee of its default. Until that time the defaulting lessee is only a debtor. In other words, the possession of the lessee remains rightful, and the lessee is the owner as opposed to all other claimants, including the lessor, until the lessor sends a notice of a default which is uncured in seven days. The lessor has recovered its entire investment and its pound of flesh on the initial term of the lease.⁵⁴ Being in the money business rather than in the law suit business, is it probable, or even conceivable, that the lessor will attempt to collect its rental or to replevy the leased items in which it has, in fact, exhausted its economic interest?⁵⁵ More probable than not, the

such a large expense in the initial five years of acquisition, only to have the equipment removed (and at the plaintiff's expense) upon the failure to pay the nominal annual rental of \$747.29.

Mt. Mansfield Television, Inc. v. United States, 239 F. Supp. 539, 544 (D. Vt. 1964), *aff'd per curiam*, 342 F.2d 994 (2d Cir. 1965) (Total rentals for the first five years equalled \$44,904.60; list price of the goods was \$38,240. The Court found that the parties intended a conditional sale).

54. In *Western Contracting Corp. v. Commissioner*, 271 F.2d 694 (8th Cir. 1959), the court in sustaining the transaction as a lease, reversed the Tax Court. The case could be sustained on a failure of the government's proof to show an enforceable option to compel the lessor to transfer title. The rentals paid were to be added to the "option" price, which when totaled equaled the list price, plus. But the equipment was typically offered to the lessee for purchase long before the rents came remotely close to the list price. The facts in the case otherwise indicated that the parties were using the arrangement as a substitute for conditional sales. *Contra*, *United Rental Equip. Co. v. Potts & Callahan Constr. Co.*, 231 Md. 552, 191 A.2d 570 (1963). (Lessee had an option to purchase and 85% of monthly rentals of \$800.00 were applied to purchase price of \$14,500. Apparently, the lease was a month-to-month lease.)

55. "Also, it stretches credulity to believe that the 'lessor' ever intended to, or would, 'come after' the system." *Starr's Estate v. Commissioner*, 274 F.2d 294, 295 (9th Cir. 1959) (Five year "lease" of an installed sprinkler system at an annual rental of \$1,240; renewals were available annually thereafter for \$32.00 per year. Sprinkler systems, for the purpose of depreciation, are considered to have a useful life of about 30 years). *But see In re Atlanta*

lessor will close its books on the lease at the end of the fifth year to reduce its bookkeeping overhead, and would be extremely upset and subjected to additional unbudgeted expense in excess of the amounts of the rental payment, by the receipt of the lessee's check for twenty-seven dollars. On such basis, is there any question that the lessor will not assert its reversionary interest or that it was not intended that the lessee should acquire ownership in the property, let absolute legal title lie where it may?

The test of a document to determine whether or not it constituted a security interest or lease as applied by the courts has been unduly restricted by the necessity to fit the security interest into one of the traditional forms such as a conditional sale.⁵⁶ The test under the Code is the intent of the parties.

Thus the tests which turn on the passage of title automatically or by "option" on compliance with the contract, or which turn on the existence of the legal enforceability of the lessee's obligation to perform to the full course of the contract are, under the Uniform Commercial Code, too narrow.⁵⁷ Of course, such tests are still valid, but they are merely overt indicia of the parties' intent. The analyst of such documents must more openly consider the economics of lending and the economic facts of life in business to a greater extent than before. Business thinking has moved away from the traditional forms of title and legally enforceable obligations to those forms of dealing which give the right to have, rather than to own and which are enforceable under their own economic weight.⁵⁸

Times, Inc., 259 F. Supp. 820 (N.D. Ga. 1966). In this case lessor was allowed to reclaim proceeds of equipment leased for 10 years with substantial life remaining at the end of the term. The list price [\$570,116.10] was substantially exceeded by the rentals payable over the term [\$712,873.00]. The lease contained neither a renewal option nor a purchase option. Lessee was required to make a \$145,000 security deposit, but the decision does not indicate whether the deposit was to be applied to rentals in the waning days of the lease or was to be refunded upon return of the leased items undamaged. If the former were the case, it would have indicated that the lessor's actual interest in the leased items would have been exhausted over the term of the lease. The situation is certainly marginal, but the writer believes a security interest was intended. *See also* cases cited note 35 *supra*.

56. *Starr's Estate v. Commissioner*, 274 F.2d 294, 295-96 (9th Cir. 1959) "[W]e do have the troublesome circumstance that the contract does not by its terms ever pass title to the system to the 'lessee' . . . [but] He could have believed only that he was getting the system for the rental money."

"[A] 'lease intended as security' is one which has the ultimate intent of a sale [sic]." *In re Atlanta Times, Inc.*, 259 F. Supp. 820, 826 (N.D. Ga. 1966).

57. Where it was a custom of the industry, universally followed, to offer leased items to the lessee, the court refused to read an option into the leasing contract; there had been no proof that the lessee was aware of the custom. *Western Contracting Corp. v. Commissioner*, 271 F.2d 694 (8th Cir. 1959). The lessor had financed his leases with a bank with an assignment of rentals and a chattel mortgage on the reversionary interest, indicating *he* did not expect to take the equipment back.

Although "Agreement," § 1-201(3) seems to include "usage of trade" in the bargain between the parties, it is uncertain whether the CODE would allow the interpolation of an option to purchase into the "contract," § 1-201(11), or whether "usage of trade" merely applies to contractual interpretation, § 1-205.

58. *Starr's Estate v. Commissioner*, 274 F.2d 294 (9th Cir. 1959); *Burroughs Adding Mach. Co. v. Bogdon*, 9 F.2d 54 (8th Cir. 1925); *Mt. Mansfield Television, Inc. v. United*

That is to say, the economic pressure generated by the contract itself and the necessity of the sellers to sell and the buyers to buy have been substituted for the potential resort to court action inherent in "legally enforceable" obligations. Indeed, the Uniform Commercial Code does not limit the application of article 9 to the traditional forms of chattel security agreements. It applies article 9 to any contract intended to create a security interest.⁵⁹

There can be one approach to analysis of equipment leases or, for that matter, any agreement which may fall under the net of article 9, and that is a determination of the intent of the parties at the time of the contract with close attention directed to the ends which they are trying to reach, and the action taken by each upon execution. Did they treat it like a security agreement or like a lease; a transfer of the ownership or a grant of the right to use?⁶⁰ With regard to equipment leases, particular scrutiny should be given the time at which rental payments potentially payable under the lease, whether or not the lessee is under compulsion to perform the lease in its entirety, approach the total investment of the lessor or the market price of the leased article. If at that time the further estimated useful economic life of the leased property is still substantial and there is provision for a materially different or reduced performance under the lease with the lessee to retain the property, either by agreement or because it is improbable that the lessor will, in fact, repossess it, and if the lessee is required, during the initial term or terms of the lease prior to the change of performance, to bear the burdens of its ownership, then the so-called lease is a chattel acquisition lease, a security interest falling within article 9.

The difficulty encountered by the analyst in the case of the long term net lease with no acquisition rights granted the lessee, and where it cannot be determined whether or not the parties intended that the lessee would ultimately acquire the property under any terms, is occasioned by the anomalous use of the equipment lease in a financing situation. Under our own conception of a security interest, conditioned by a tradition which interpolates the requirement that the interest in property which

States, 239 F. Supp. 539 (D. Vt. 1964), *aff'd per curiam*, 342 F.2d 994 (2d Cir. 1965). *But see In re Atlanta Times, Inc.*, 259 F. Supp. 820 (N.D. Ga. 1966), where there was testimony to the effect that the lessee would have an option to purchase the leased items at a nominal price. The court stated that even if such evidence were admissible (see footnote 35 *supra*), the court could find no legally enforceable right of the lessee to gain title and no way to acquire anything but the right to use the property.

59. § 9-102(1)(a).

60. Lessor financed full value of leased equipment. *Western Contracting Corp. v. Commissioner*, 271 F.2d 694 (8th Cir. 1959) (court found no conditional sale). Lessee had the risk of loss and was required to submit a financial statement and apply for financing. Rentals were on a net lease basis. *Mount Mansfield Television, Inc. v. United States*, 239 F. Supp. (D. Vt. 1964), *aff'd per curiam*, 342 F.2d 994 (2d Cir. 1965); Rentals were embodied in notes given by the lessee. *In re Mid-western Airmoving Corp.*, 184 F. Supp. 474 (N.D. Ohio 1960).

secures payment be an interest in the property of another, such leases do not constitute security interests. Yet take a second look. Although patently supplying equipment to users, the lessor is in fact in the money business, as much as any commercial lender, supplying medium term capital by purchasing equipment to the lessee's order and turning it over to him under an arrangement which, for tax reasons, is more advantageous to the lessee than a debt ownership-acquisition transaction. By use of a net lease for a sufficient term, the lessor assures return of its capital on that one transaction and avoids the unpredictable risks and burdens of ownership, equating its posture to that of a financing agency whose only interest in the transaction lies in the return of its investment at a profit. Such lessors may eventually be recognized as lenders subject to article 9 rules when their rights come into conflict with those of the lessee's other creditors. Whether or not the lessee eventually is to acquire the leased property would become irrelevant. There is adequate precedent for such expansion of the concept of security interest; witness the inclusion of factored receivables as secured transactions by section 9-102(1)(b). Although such sales of accounts are on a non-recourse basis and absolute, they are analogized to financing transactions. This result, however, could only come from bold judicial pioneering or legislative revision. There seem to be no indications that such a reversal of tradition is in the near future in an expanding economy, but the prudent lessor may well be warned and take precautionary steps. For the present, however, counsel can draw the lease-security interest line at that point where the right to use becomes the rights of ownership.

III. CONTRACTS FOR SALE OF PERSONALTY

In the fall of 1963, the Allied Crude Vegetable Oil Refining Corporation became notoriously and hopelessly insolvent.⁶¹ The collapse was spectacular and out of the debris arose certain litigation pointing to the relationship between articles 2 and 9 of the Code.⁶²

The facts out of which the litigation arose, stripped of elements non-essential to this paper were these:

Procter entered into a contract to sell vegetable oils to Allied, f.o.b. Procter's plant, shipped on order bill to Procter's order,

61. N. MILLER, *THE GREAT SALAD OIL SWINDLE* (1965).

62. *National Dairy Prod. Corp. v. Lawrence Am. Field Warehousing Corp.*, 22 App. Div. 2d 420, 255 N.Y.S.2d 788 (1965), *rev'd in part sub nom.*, *Procter & Gamble Distrib. Co. v. Lawrence Am. Field Warehousing Corp.*, 16 N.Y.2d 344, 213 N.E.2d 873, 266 N.Y.S.2d 785 (1965). The writer is grateful to William W. Owens, Esq., Peter H. Kaminer, Esq., and Patrick J. Hughes, Esq., all of the New York Bar for furnishing him with the briefs in the Appellate Division and the Court of Appeals.

This sort of transaction is by no means unique to the commodity trade. See *Metropolitan Vacuum Cleaner Co. v. Douglas-Guardian Warehouse Corp.*, 208 F. Supp. 195 (S.D.N.Y. 1962). The court reached the same result as in the *Allied* case. See text *infra* at 85.

and stored for Procter's account in a field warehouse maintained by Field on Allied's leased premises. Allied made a down payment of twenty-five per cent of the purchase price (called a "margin requirement") at the time of delivery to the warehouse. Field issued its non-negotiable warehouse receipts directly to Procter. Allied was to have power to sell the oil, and on payment to Procter, or on Procter's delivery order, the oil was to be released from Field's custody. There was no stipulation in the contract as to the time of the passage of title in so many words.

When notified of Allied's collapse, Procter presented the warehouse receipts and demanded the oil. Field was unable to deliver, inasmuch as the oil was not in its warehouse, and Procter sued Field, asking the contract price of the oil as its damages.

On appeal,⁶³ it was held that Procter could recover the full market value of the oil called for in the receipts from Field, which value equalled the sale price, and Field could not set-off the down payment made by Allied against the recovery. Procter was therefore given a total recovery on the transaction equal to 125 per cent of its contract price which is pretty good business in any man's league. In suits by various lenders who had loaned money to Allied with Field's warehouse receipts as collateral, recovery was limited to the lesser of the amount of the indebtedness or the value of the oil called for by the warehouse receipts held by them.⁶⁴

The New York Court of Appeals, in passing on Procter's claim, applied New York law which, it said, was the same as that in force in New Jersey. The Uniform Commercial Code was in force in New Jersey, but not in New York at the time of the events giving rise to the action. Procter's claim to the full sales price (which was assumed to be equal to the applicable market price as the measure of damages in conversion) without set-off was sustained on the theory that Procter was still the owner of the oil, which the court stated without discussion.⁶⁵ Since title had not passed, and Allied did not have possession, Allied had no interest in the oil. Procter, the injured seller, had the right to apply the down payment as liquidated damages on its claim of breach of contract against Allied. Allied as the party breaching the contract could not have recovered the earnest money paid under an executory contract of sale under then existing New York law.⁶⁶ Field could not claim the benefit of the payment in a transaction unrelated to the field warehousing by Allied, a collateral

63. *Procter & Gamble Distrib. Co. v. Lawrence Am. Field Warehousing Corp.*, 16 N.Y.2d 344, 213 N.E.2d 873, 266 N.Y.S.2d 785 (1965).

64. *National Dairy Prod. Corp. v. Lawrence Am. Field Warehousing Corp.*, 22 App. Div. 2d 420, 255 N.Y.S.2d 788 (1965). The Appellate Division could see no difference between lenders and sellers such as procter.

65. 16 N.Y.2d 344, 353, 213 N.E.2d 873, 877, 266 N.Y.S.2d 785, 791 (1965).

66. *Kaufmann v. Baldrige*, 162 F.2d 793 (10th Cir. 1947); *Thach v. Durham*, 120 Colo. 253, 208 P.2d 1159 (1949); *Pirman v. Kurtz*, 267 App. Div. 258, 45 N.Y.S.2d 508 (1943).

source, even if Allied could have recovered the purchase money paid.⁶⁷ Field may or may not have had a right to cross-claim for it had Allied been a party, but Allied was not a party to the suit.

In other words, this was a contract to sell; it was not a sale or a lending transaction. Any difference between the recovery of the seller, Procter, and that of those who advanced money to Allied based on Field's warehouse receipts must be explained by the dimensions of the differing interests of absolute owners and special interest owners, or lenders. Under the Code, Procter's interest would have been precisely the same as that of any of the other lenders. The decision of the New York Court of Appeals was undoubtedly correct under pre-Code law; the same court should not today render the same opinion.

Williston defined a contract to sell as a "contract whereby the seller agrees to transfer the property in the goods for a consideration called the price," whereas a "sale" was a present passage of title in return for the price.⁶⁸ Under the common law and pre-Code statutes, the buying party to a contract to sell did not at the time of making the contract receive any rights in the goods. Procter had not sold the oil to Allied, although it had been identified with the contract and had been shipped. Procter, as absolute owner, had stored its own goods in a warehouse. It could recover damages both from Allied, as a seller, for breach of the sales contract, and from Field in a suit by an owner against a warehouseman, for failure to deliver the oil. Allied, by breaching the contract, forfeited its down payment; Field as a defaulting warehouseman, was liable for the full value of the merchandise, conversion damages. Although those persons who had loaned money to Allied also were holders of warehouse receipts issued by Field to them, their recovery against Field was limited to the amount of the loan.

The transaction between Allied and Procter remained a contract to sell rather than a sale because Procter had shipped the oil under a bill of lading to its own order, and placed them in a warehouse for its own account, thus retaining title to the goods.⁶⁹ Without that bill of lading, and

67. *Wells v. Thomas W. Garland, Inc.*, 39 S.W.2d 409 (Mo. App. 1931) (suits by bailor on bailment contract, collateral payment by insurer); *Healey v. Rennert*, 9 N.Y.2d 202, 173 N.E.2d 777, 213 N.Y.S.2d 44 (1961) (noncommercial case). The "collateral sources" doctrine is now generally used to prevent insurance payments from being used to reduce damages in tort actions; it guards the insurer's subrogation rights. The doctrine is broader, however, than this, applying to most payments received by plaintiff from third parties who are unrelated to the cause of action; its application to commercial cases and in instances where no subrogation rights are involved is questionable. *See* § 1-106(1). Damages are to be compensatory. *Cereal Byprods. Co. v. Hall*, 16 Ill. App. 2d 79, 147 N.E.2d 383 (1958), *aff'd*, 15 Ill. 2d 313, 155 N.E.2d 14 (1958) (tax refund to plaintiff on loss from embezzlement cannot mitigate damages in suit against auditor for negligence). *R.E. Dumas Milner Chevrolet Co. v. Morphis*, 337 S.W.2d 185 (Tex. Civ. App. 1960) (partnership distribution to plaintiff did not reduce his claim against tortfeasor).

68. 1 WILLISTON, SALES § 1 (rev. ed. 1948).

69. *Amtorg Trading Corp. v. Higgins*, 150 F.2d 536 (2d Civ. 1945) (creates security

absent any agreement to the contrary, absolute ownership would have passed to Allied at Procter's plant, since the goods were identified or appropriated to the contract and the contract terms were f.o.b. Procter's plant. F.o.b. was generally considered to be a delivery term with delivery taking place at the f.o.b. point.⁷⁰ But shipment to seller's order and storage for seller's account in the field warehouse amounted to an intentional postponement of delivery and delayed the passage of title to the buyer. Under prior law, passage of title in a sales transaction determined the rights of both of the parties. Prior to passage the seller had everything, the buyer nothing. Subsequent to passage of title the buyer acquired a completely new set of rights and duties with relation to the goods. Except to the extent that he or someone acting for him retained possession or control of the goods, the seller lost all of his interest in them. Ownership was unitary, all of it passed at once or nothing passed.

Section 2-102 provides in part:

This Article (Article 2, Sales) . . . does not apply to any transaction which although in the form of an unconditional contract to sell or present sale is intended to operate only as a security transaction. . . .

Section 9-113 provides:

A security interest arising solely under the Article on Sales (Article 2) is subject to the provisions of this Article except that to the extent that and so long as the debtor does not have or does not lawfully obtain possession of the goods

(a) No security agreement is necessary to make the security interest enforceable; and

(b) No filing is required to perfect the security interest; and

(c) The rights of the secured party on default by the debtor are governed by the Article on Sales (Article 2).

Article 2 substitutes for the title concept, when evaluating the rights of buyer and seller, the concept of the bundle of rights, the expanding buyer's interest in the goods and the contracting interest of the seller as the terms of the contract provide and the various steps of performance by the parties under it are accomplished.⁷¹ Where certain third

interest); *Christoffersen v. Murray Packing Co.*, 24 App. Div. 2d 587, 262 N.Y.S.2d 636 (1965), *aff'd*, 17 N.Y.2d 855, 218 N.E.2d 326, 271 N.Y.S.2d 286 (1966) (seller may retain property in the goods). *Pottash v. Cleveland-Akron Bag Co.*, 179 App. Div. 763, 189 N.Y.S. 375 (1921), *aff'd*, 235 N.Y. 520, 139 N.E. 717 (1923) (draft attached); *Quigley v. Wiley*, 107 Vt. 253, 179 A. 206 (1935) (draft attached).

70. *Amtorg Trading Corp. v. Higgins*, 150 F.2d 536 (2d Cir. 1945); *McLeod v. J.E. Dilworth Co.*, 205 Ark. 780, 171 S.W.2d 62 (1943), *aff'd*, 322 U.S. 327 (1944) (when f.o.b. point was in seller's state, sale took place there). *But see Sadler Mach. Co. v. Ohio Nat., Inc.*, 202 F.2d 887 (6th Cir. 1953) ("f.o.b. cars" was a price term; title passed for ascertainable, deliverable goods upon contracting).

71. See generally art. 2, part 5.

party rights and government regulation are concerned, however, title still has some importance under article 2 and simplified rules for determination of its location are established,⁷² for non-Code statutes and much case law dealing with third party rights are typically phrased in terms of title.

As performance of the contract takes place, and the buyer acquires a greater and greater interest in the goods, the seller's interest dwindles to one which is retained by him to protect his interest in payment of the purchase price, allowing him to retake the goods and/or liquidate them by resale on the buyer's default or potential default.⁷³ Essentially, then, such retained interests of the seller are non-consensual security interests arising solely under the provisions of article 2 to secure performance of the buyer's obligation.⁷⁴ They exist regardless of contract until the buyer obtains lawful possession,⁷⁵ unless the parties contract to exclude the seller's remedies,⁷⁶ and they clearly fall within the provisions of section 9-113.⁷⁷ Section 9-113 provides the statutory skeleton and flesh to the seller's security interest rising without an agreement that it arise, and yet recognizes that the seller is still a seller who, having obtained a security interest merely by performance of his contract and, without any intent to become a lender, has still the interests of a seller. Since the seller in this circumstance has no intention to extend credit and expects to be paid on physical delivery, at the latest, he cannot be expected to take the steps generally required of lenders by article 9 for protection.

The status, under the Code of the security interest given the seller when he takes a bill of lading to his own order is somewhat more dubious.⁷⁸ Where the seller identifies the goods to the contract and completes his performance with relation to their physical delivery, ownership passes to the buyer unless the parties agree to the contrary.⁷⁹ The security interest of the seller obtained by taking an order bill running to his order does not arise solely under article 2,⁸⁰ although that article does provide for such security interests.⁸¹ It arises by virtue of article 7, governing the rights of holders and holders by due negotiation of negotiable documents of title, and giving the holder the right to demand and receive delivery

72. See generally art. 2, part 4.

73. §§ 2-703, -705 to -706.

74. Hogan, *The Marriage of Sales to Chattel Security in the Uniform Commercial Code: Massachusetts Variety*, 38 B.U.L. REV. 571 (1958).

75. § 9-113.

76. § 2-719.

77. See note 74 *supra*.

78. §§ 2-505(1)(a), 2-401(1).

79. § 2-401 (passage of title). Comment 1 to § 2-401 makes it clear that the passage of title is generally irrelevant to the rights and duties of the parties to the contract and third parties. See part 5 of art. 2 generally.

80. See § 9-113.

81. § 2-505.

from the carrier.⁸² Yet, although article 7 gives the holder by due negotiation title to both the goods and document,⁸³ this right is limited by article 2, which provides that the seller, who is also a holder, and his transferee, take only a security interest in the goods.⁸⁴ Title, or more properly, ownership, unless otherwise agreed by the parties, would have passed at the f.o.b. point, since at that time the seller has completed his duties regarding shipment.⁸⁵ The use of the order bill of lading with draft attached has a history as a short term financing device,⁸⁶ but its principal use is to enable the seller to obtain his price before the buyer gains possession of the goods and examines them.⁸⁷ Yet, again, the seller contemplates instant or nearly instant payment on physical delivery to the buyer. He does not have the posture of a lender. It is probable that the order bill of lading security interest will be ultimately found to arise solely under article 2 for this reason.⁸⁸

Article 9 rules will apply on default if the order bill of lading does not fall within section 9-113. Otherwise, the holder of the bill will have a seller's remedies. With regard to security interests obtained by negotiable bills of lading, section 9-113, except as it applies to remedies, is otherwise irrelevant. So long as the buyer does not have possession of the bill of lading originally running to the seller's order and properly endorsed, he cannot gain lawful possession of the goods from the carrier. If he does gain possession of the goods lawfully, then the seller must have relinquished his security interest, absent fault of the carrier, and section 9-113 would be inapplicable in any event. If the security interest is represented by a negotiable document of title, then it is enforceable without a written security agreement, since it is possessory, and it is enforceable against the buyer, *i.e.*, not grounds for rejection of the goods, even though there was no agreement between buyer and seller authorizing it.⁸⁹ And the seller's security interest obtained by the order bill of lading does not have to be perfected by filing, since the goods are in the possession of the seller or his bailee, the carrier.⁹⁰ Section 9-113, therefore, may well apply to protect security interests of the seller obtained by his taking an order bill of lading, as well as to those non-consensual security interests

82. § 7-403(1); holders are "persons entitled under the document," since they have a good chain of title to the document, § 1-201(20).

83. § 7-502.

84. §§ 2-401(1), 505(1)(a).

85. § 2-401(2); § 2-319(1) clearly establishes "f.o.b." as a delivery term.

86. Cases cited note 69 *supra*.

87. § 2-513(3)(a).

88. If only because the order bill is so commonly used to obtain payment before the buyer can inspect the goods and rightfully reject them. The seller, in such a case, is extending credit to the buyer only to the extent of not demanding payment before shipment. With the order bill of lading, he still expects to be paid before the buyer gets his hands on the goods.

89. § 2-505(2).

90. § 9-304(2).

which obtain to the seller solely through the steps taken by him in performance of the contract and before the goods are received by the buyer.

That interest retained by the seller who ships his goods to a field warehouse on the buyer's premises to be released to the buyer on the seller's instructions represents, however, an article 9 security interest outside of the provisions of section 9-113. Since its inception field warehousing has been recognized as a financing device,⁹¹ although it has other minor uses such as controlling inventory supplies of franchised dealers. Like that represented by the negotiable bill of lading, the security interest represented by the field warehouse owes its existence to article 7. However, since non-negotiable warehouse receipts are issued by field warehousemen, the secured party's interest depends not so much on the control of the document, as with negotiable receipts, but on the warehouseman's promise to hold possession for his benefit and on his instructions.⁹² Field warehousing was intended to separate ownership and possession of the goods until the actual owner could discharge his obligation with regard to them, with the warehouseman serving as bailee for the seller or lender. In the case of a seller, he has, in effect, completed his entire duty in regard to the goods. They have been delivered to the actual physical premises of the buyer. Unlike security interests obtained through use of negotiable bills of lading, field warehousing does not exist as a creature of article 2 nor do they arise out of the normal performance of a sales contract.⁹³ Section 9-113 should be inapplicable, and the field warehouse security interest fully subject to article 9 rules.⁹⁴

Even if the contract for sale should provide that title to the goods should not pass until payment of the full purchase price, and that the goods would be held in a field warehouse to be released on payment, the reservation of title would constitute a security interest only on behalf of the seller.⁹⁵ Since the only purpose of withholding title in a case such as *Allied* is to retain an interest in the goods to secure payment of the purchase price, then by virtue of section 2-102, use of the field warehouse, should not hold the seller subject to article 2 rules, including rules on default. The seller objectively intends to become a secured lender, or, at least, intends to obtain for himself the benefits of being in the position

91. *Security Warehousing Co. v. Hand*, 206 U.S. 415 (1907); *Union Trust Co. v. Wilson*, 198 U.S. 530 (1905).

92. For example, to effect a complete transfer of goods upon which a non-negotiable document is issued, the bailee must merely be notified of the transfer. § 2-503(4)(b); to procure delivery of such goods from the bailee, the document need not be surrendered. § 7-403(3).

93. Field warehouses are installed on the borrowers premises and the borrower pays their cost, for they provide him with a financing device. See Stroh, *Reduction of Lending Risks in Inventory Financing*, 31 Mo. L. Rev. 209 (1966).

94. It is true that art. 2 does provide for transfer of ownership of goods in the possession of a bailee, § 2-503(4); however, the writer submits that such provision applies only to goods in the bailee's possession at the time of the execution of the contract.

95. § 2-401(1).

of a secured lender, whether he thinks of himself as one or not. His interest in the goods as an owner of the goods has terminated, his duties toward the goods have come to an end, his interest now lies only in being paid, and his rights in the goods lie only in securing the payment of the sum outstanding by the buyer. He has become a lender in spirit, if not in his own mind.

The Code, in its economic analysis of sales and security transactions, recognizes and classifies the parties according to their actual interests rather than by their common law titles, and would characterize the one-time seller as a lender and the one-time buyer as a borrower, and subject them to total application of article 9. This characterization would be effective even though in the earlier stages of the series of transactions, the parties would have been subject to article 2 rules and the saving provisions of section 9-113. The transaction now, in the words of section 2-102, is "intended to operate only as a security transaction." And, it is submitted, this categorization by the Code establishes the basis for application of non-Code law to the parties in their character as determined by the Code.

IV. WITHIN THE AMBIT OF ARTICLE 9

When the parties to a commercial transaction find themselves converted into lender and debtor from lessor and lessee or seller and buyer, the conversion affects their rights and duties toward each other, the goods in question and third parties, and the rights of third parties as established both within and without the Code.

Consider, for example, the claim of the bailor, Procter, in the *Allied* case. Generally there is no question that the absolute owner of goods can recover their value in full from a commercial warehouseman who fails to deliver. The goods are his, and unless the bailee can establish some lawful excuse or justification for failure to deliver, the bailee must "buy" them at conversion or contract damages.⁹⁶ A problem arises, however, when ownership of the goods or ownership and lawful possession of the goods are divided.

The person whose possession of goods is rightful, such as a bailee, may recover the full value of the goods from the person who wrongfully took possession from him, subject to the duty to account to the owner for his interest.⁹⁷ Likewise, the owner of the goods such as a pledgor may recover their value, subject to a similar duty toward other special inter-

96. § 7-403(1) obliges the bailee to deliver; § 1-106(2) gives the "person entitled under the document" an action.

97. *Bradley v. St. Louis Terminal Warehouse Co.*, 189 F.2d 818 (8th Cir. 1951) (no need to join bailor); *Rosenfeld v. Continental Bldg. Operating Co.*, 135 F. Supp. 465 (W.D. Mo. 1955) (bailee sues as quasi-trustee); *Southern Bonded Warehouse Co. v. Roadway Express, Inc.*, 104 Ga. App. 458, 122 S.E.2d 147 (1961).

ests.⁹⁸ Thus, a warehouseman,⁹⁹ or a pledgee¹⁰⁰ may recover the full value from a converter subject to the duty to account to the bailor or the pledgor. Deducting his accrued charges, the warehouseman must account for the recovery of the goods to the depositor. Because the pledgee's interest is that of a secured lender, he may deduct the value of his loan before making payment to the debtor-pledgor. Similarly, the pledgor may recover the value of the goods, but must account for the loan to the pledgee.

When ownership of the goods is divided either into equitable and legal title, legal title and mortgagee's lien, or beneficial ownership and title retained for security, the result is still the same, should a third party who has no lawful relation to the goods damage them or take them. Whichever of the less-than-full owners should sue, he may recover the full value of the goods, but must account for the recovery to the other ownership interests.¹⁰¹ The origin of the rule was in common law procedure. Originally, there could be but two interests represented in an action at law. Rather than compel each person having an interest in the property to maintain his own suit for his own special interest, which could result in inconsistent verdicts upon failure of proof by one plaintiff, or a claim of prejudice of jury members if both cases were tried in the same term (in addition such multiplicity of lawsuits raised the specter of that favorite judicial shibboleth, "opening the floodgates of litigation," *i.e.*, the clogged docket)¹⁰² the courts allowed the holder of a special interest in the property to recover its full value. There was little, if any, harm in this and much good. The wrongdoer would be punished and the persons representing other interests in the property could look to the plaintiff, who having acknowledged his special interest in the main suit, could hardly claim absolute ownership when met by a demand to account. In fact, it was most probable that the holders of the various interests in the property would cooperate in the suit through a common attorney, by agreement to share expenses and costs and by pooling of efforts.

Under Civil Code and Federal Rules type procedure there is less reason to allow the special interest holder to make a recovery in full,

98. *Polytinsky v. Sharpe*, 211 Ala. 510, 100 So. 750 (1924); *Fairbanks v. Chunn*, 2 Ala. App. 642, 56 So. 847 (1911); *Kaufmann v. Parmele*, 99 Neb. 622, 157 N.W. 342 (1916); *Treadwell v. Clark*, 190 N.Y. 51, 82 N.E. 505 (1907) (equitable proceeding). *Contra*, RESTATEMENT OF SECURITY § 38 (1941). In general, under Code pleading, a pledgor could not sue in trover, which was a possessor's action; he could sue for proceeds in assumpsit or in an action on the case for value.

99. *Bradley v. St. Louis Terminal Warehouse Co.*, 189 F.2d 818 (8th Cir. 1951); *Southern Bonded Warehouse Co. v. Roadway Express, Inc.*, 104 Ga. App. 458, 122 S.E.2d 147 (1961).

100. *Graham v. Frazier*, 82 Ga. App. 185, 60 S.E.2d 833 (1950); *Hanover Nat'l Bank v. American Dock & Trust Co.*, 14 App. Div. 255, 43 N.Y.S. 544 (1897).

101. *Prime Business Co. v. Drinkwater*, 350 Mass. 642, 216 N.E.2d 105 (1966) (mortgage); *Equitable Credit Corp. v. Treadwell*, 338 Mass. 96, 153 N.E.2d 882 (1958) (mortgage).

102. No Friday afternoons off for golf, or whatever they did in the days of the good old common law.

since, if all of the interests are agreed, they may sue jointly in their own names as plaintiffs or may be joined as third parties if unwilling. There is even less reason to allow a full recovery by a special interest holder where injustice could result in the form of a double or an excessive recovery by the plaintiff or against the defendant, or where plaintiff, defendant and the other interest holders all have some lawful relationship to the goods. So, where a mortgagee sues a mortgagor or a pledgee sues the pledgor for damage to the goods, plaintiff can recover only to the extent of his interest,¹⁰³ and in a suit by the holder of warehouse receipts, who holds as a secured lender, against the warehouseman, plaintiff can recover only to the extent of his loan, *i.e.*, his actual damages.¹⁰⁴

Field warehousing, although operating under the guise of commercial warehousing, is quite a different animal and should be so recognized. It is a financing device, and field warehouse receipts, non-negotiable receipts, are intended by the financial trade and parties who borrow, and are understood by them, to be symbols of the warehouseman's possession of the goods on behalf of the lender. They are symbols of the bailee's promise to hold the goods rather than symbols of the goods themselves. The security of the holder of the field warehouse receipt lies in his control of the goods through the warehouseman's agreement to hold possession for him. He is a pledgee of the goods who is withholding possession from the pledgor by use of a bailee.¹⁰⁵ In actual practice the field warehouseman is more than a bailee for hire or a stake holder. He is the lender's agent to hold possession,¹⁰⁶ but he must also return whatever goods are left after the pledge is satisfied or the arrangement terminated by the borrower, and he is bound by law to do this.¹⁰⁷ The field warehouseman then, is the alter

103. *Mossler Acceptance Co. v. Johnson*, 109 F. Supp. 157 (W.D. Ark. 1952) (mortgagee); *Rolfe v. Huntsville Lumber Co.*, 8 Ala. App. 487, 62 So. 537 (1913) (pledgee); *Murphy v. Wilson*, 153 Cal. App. 2d 132, 314 P.2d 507 (1957) (mortgagee); *First Nat'l Bank v. Broder*, 107 Conn. 574, 141 A. 861 (1928) (pledgee's suit against pledgor's privy). See also *Amery v. Augusta Lumber Co.*, 128 Me. 472, 148 A. 687 (1930) (conditional seller). Similarly, in a suit by the pledgor, the pledgee is liable for the value of the property less the unpaid balance of the loan. *Larson v. Quanrud, Brink & Reibold*, 78 N.D. 70, 47 N.W.2d 743 (1950); *Rose City Foods, Inc. v. Bank of Thomas County*, 207 Ga. 477, 62 S.E.2d 145 (1950) (pledgee's recovery of value of property limited by amount of loan); *Brandtjen & Kluge v. Hunter*, 235 Mo. App. 909, 145 S.W.2d 1009 (1940) (mortgagee).

104. *First Nat'l Bank v. Bates*, 1 F. 702 (S.D. Ohio 1880); *Maryland Casualty Co. v. Washington Loan & Banking Co.*, 167 Ga. 354, 145 S.E. 761 (1928); *Corn Exch. Bank v. American Dock & Trust Co.*, 14 App. Div. 453, 43 N.Y.S. 1028 (1897); *Fifth Nat'l Bank v. Providence Warehouse Co.*, 17 R.I. 112, 20 A. 203 (1890); *Fletcher v. Great Western Elevator Co.*, 12 S.D. 643, 82 N.W. 184 (1900).

105. See generally *Stroh, Reduction of Lending Risks in Inventory Financing*, 31 Mo. L. Rev. 209, 218-226 (1966).

106. Field warehouse receipts are issued directly to the lender, although the goods are typically deposited by the borrower in a straight lending transaction. In the *Allied* case, although the seller shipped the oil to its own order, Allied's (the borrower-buyer) men took charge of the oil and presumably pumped it into Field's tanks; again the receipts were issued directly to Procter, the seller.

107. The depositor-borrower is the true owner of the goods and has absolute ownership once the interest of the pledgee or receipt holder has ended. In such a case, the bailee may deliver to the owner even though receipts on the goods are outstanding. § 7-403(1)(a).

ego of each when faced by suit by the other. After successful suit for conversion by the receipt holder, for the full value of the stored goods, the warehouseman would still be subject to suit at least for value in excess of the loan by the depositor or borrower. The receipt holder's recovery would be no bar to the depositor's suit. The lender (field warehouse receipt holder), whether his posture is that of financing seller or third party lender, should no more be allowed to make a full recovery on the amount of the goods called for in the receipt, except to the extent that the loan equals or exceeds the value of the goods, than a mortgagee or pledgee should be allowed to make full recovery against the mortgagor or pledgor for their conversion of the goods.

Within the confines of the Code, sales aspects of a commercial transaction involving goods are governed by article 2,¹⁰⁸ but when the transaction converts into a secured transaction by the objectively judged intent of the parties, that area is governed by article 9. Rules of article 9 which may apply disastrously to disguised or unsuspected security interests are primarily those dealing with enforceability, perfection, priority, and default.

A security agreement is an agreement which creates or provides for a security interest.¹⁰⁹ Security interests in goods are unenforceable without regard to dollar limitation on the bottom side, except as to article 2 security interests which exist regardless of security agreements and are protected by section 9-113, unless there is a security agreement either memorialized by a signed writing or evidenced by the possession of the secured party, or someone for him.¹¹⁰ This is a Statute of Frauds type provision which prevents enforcement against either the debtor or third parties. In contrast, the general Code "Statute of Frauds" provides a \$5,000.00 bottom¹¹¹ and the Sales provision establishes a \$500.00 lower limit with several saving provisions.¹¹² Thus, a secured party could find himself with an unenforceable security agreement on what he believed was an enforceable contract for sale whether for goods he had sent to the buyer or for goods upon which he had sent a written confirmation of a "sales contract,"¹¹³ and be able, therefore, to avail himself neither of the article 9 default provisions¹¹⁴ nor of the article 2 provisions for breach of contract, the latter being expressly inapplicable to security aspects of a sale.¹¹⁵ He would, in fact, be merely a general creditor.

108. See Comment § 2-102.

109. § 9-105(1)(h).

110. §§ 9-203(1)(a), (b).

111. § 1-206(1).

112. § 2-201(1).

113. § 2-201(2) gives force to contracts between "merchants" which are "confirmed" in writing by one, and not objected to by the other within 10 days of receipt.

114. Since his security agreement is unenforceable.

115. § 2-102.

Assuming that the evidentiary requirements of section 9-203 are met by the chattel acquisition lease or the written contract for sale which constitutes the "agreement," the security interest will attach to the goods as soon as the lender gives "value," which does not necessarily require the actual transfer of the goods, and the borrower acquires "rights" in the collateral.¹¹⁶

Once the buyer-debtor acquires "rights" in the goods, third persons and other security interests may then reach out for the collateral.¹¹⁷ Perfection of a security interest immunizes it against one or more classes of third persons who may attempt to assert rights to it. These are persons who have no prior contract or property rights to such goods, primarily lien creditors, but also various subsequent buyers of sorts.¹¹⁸ In general, perfection is accomplished as soon as the security interest has attached and the lender either has possession or has filed a financing statement.¹¹⁹ Perfection is good protection against any lien creditor attempting to reach the collateral after perfection.¹²⁰ Filing may not be sufficient protection against a subsequent buyer of inventory in the ordinary course of business.¹²¹ Possession is the only safe means of perfection against such a claimant since the debtor-seller cannot gain access to the goods to make delivery. Filing is, however, good protection against the claim of a buyer of that which in the hands of the debtor-seller is "equipment."¹²² Prohibition against alienability of collateral are ineffective against any buyer from the buyer-debtor, insofar as the debtors rights may always be transferred.¹²³ If the security interest is also unperfected, then the debtor-seller can transfer not only his own rights in the collateral to any other buyer who does not have actual knowledge of the lender's interest, but he can cut off those of the lender as well.¹²⁴ Placing stickers on leased equipment giving notice of the lease, in lieu of filing, if a chattel acquisition lease is used, is risky against both lien creditors¹²⁵ and buyers¹²⁶ since the lessor, to protect his interest after levy or sale, must prove that the creditor or buyer had actual knowledge of his security interest, if the lease is found to be a security agreement.

116. § 9-204(1).

117. § 9-204(1). The definition of "rights" does not give much help, § 1-201(36). Presumably a buyer of goods might have "rights" as soon as he acquired an insurable interest in them. § 2-501.

118. § 9-301(1).

119. §§ 9-302, 9-304, 9-305.

120. § 9-301(1)(a).

121. § 9-307.

122. The definition of a buyer in the ordinary course of business § 1-201(9) limits such buyers to persons buying from others in the business of selling goods of that kind. "Equipment" is defined as goods *used* primarily in business. § 9-109(2).

123. § 9-311.

124. Such buyers must give value and receive delivery.

125. If the lien creditor has actual knowledge of the unperfected security interest, his levy is subordinate to the security § 9-301(1)(b).

126. § 9-301(1)(c), similarly with buyers.

It has been suggested in the writer's conversations with other lawyers that, with regard to equipment leases coupled with options to purchase or to extend, the lessor might file a financing statement covering the equipment which contains a proviso that the filing does not constitute an admission that the transaction is anything else but a lease, but that the lessor is filing to be on the safe side. Generally, this sort of two faced posture does not appeal to the average business man, be he lessor or lessee, and the lessee may protest vehemently, if he is attempting a bit of tax timing, that filing may be a tip-off to curious tax people. But if the reviewing court finds that the parties intended a security interest and if the security interest is not perfected, lien creditors, including trustees in bankruptcy,¹²⁷ can destroy the lender's interest in the collateral relegating him to the extremely undesirable status of a general creditor in bankruptcy.

If perfection describes the status of the lender's interest in the property with regard to the claims of third parties, then priority describes the relationship of the lender's interest to the property and those claims, and the claims of other secured lenders. In the terms of the Code, priority rules are stated to apply to claims of other secured creditors and the claims of lien creditors and buyers. The claims of all third parties seeking an interest in the property are dealt with as a matter of priority.¹²⁸ If a security interest is immunized against the claims of a certain class of persons, for example, lien creditors, it is prior to those claims which may, in turn, still attach to the property and be prior to the claims of others. Similarly, the claim of a buyer of inventory collateral in the ordinary course may be prior to the claims of all others.

Generally, priority between claims of secured creditors is governed by the means of perfection and the order in which the interests are perfected.¹²⁹ The chattel acquisition lease particularly may fall afoul of the priority claims of other secured lenders who have made a broad filing covering all of the debtor's equipment whenever acquired and who have placed an after-acquired property clause in *their* security agreements when it could actually have taken a boost in priority status.¹³⁰ Straight

127. Trustees in bankruptcy occupy the same position as lien creditors, except that they do not have knowledge of the unperfected security interest unless all lien creditors had such knowledge § 9-301(3). The trustee's interest is expandable to the full dimensions of the value of the property. *Moore v. Bay*, 284 U.S. 4 (1931), and not limited to the size of the interest of any particular lien creditor.

128. § 9-301(1) deals with the claims of lien creditors and buyers in terms of subordination of unperfected security interests to certain claims. § 9-307(1) dealing with buyers in the ordinary course does not speak in terms of priority but in those of absolute cut off. § 9-312 arranges the priority relationship between competing secured interests.

129. Although purchase money financing is granted a special status by §§ 9-312(3) and (4), § 9-312(5) contains the general priority provisions for goods.

130. The after-acquired property clause in the security agreement provides for instant and automatic accretion of after-acquired property to the security interest, so long as other pre-requisites for attachment are met, see §§ 9-204(1) and (3). The financing state-

equipment leases are not subject to article 9 since they do not create security interests, and the lessor's interest could not be cut off by a secured creditor.¹³¹ The lessor, in a chattel acquisition lease, however, is a purchase money financier with a security interest and as such has the opportunity of obtaining a prior status for his interest in the equipment leased if he perfects within ten days after the debtor acquires possession of the collateral.¹³² However, to perfect, the lessor must realize that he *has* a security interest, and he must file.

Even if there were no pre-existing security interest covering the leased property, a subsequent perfected security interest granted by the lessee which covered that property would take priority over the lessor's interest.¹³³ In the unlikely event that the holder of the later security interest did not perfect, then, and only then, would the chattel acquisition lessor prevail, since his interest attached first.¹³⁴

Although the requirements for obtaining stepped up priority for a purchase money interest in inventory are more stringent,¹³⁵ the question would not have arisen in a situation similar to the *Allied* case even if there had been a pre-existing filing covering after-acquired oil, where a field warehouseman retained actual possession of the goods. In the case of inventory financing, the conflicting, pre-existing security holder must be notified of the claim of the purchase money lender before the debtor-buyer receives possession.¹³⁶ Since legal possession of the goods would be withheld from the debtor by the warehouseman until the debt had been paid, the purchase money interest would be free of the claim of any pre-existing interest, section 9-312(3) not coming into play. However, if the goods were released to the debtor from the field warehouse, the claim of the pre-existing security holder would be stronger and would prevail.¹³⁷

ment may be phrased in terms of "all road-building equipment, whenever acquired" without the need to itemize, *see* § 9-401(1).

131. § 9-102(1). The lessor's interest in the rents payable and his reversion in the property may be subjected to security interests, however, by the lessor who wants to finance on his property. *See* *Western Contracting Corp. v. Commissioner*, 271 F.2d 694 (8th Cir. 1959).

132. § 9-312(4). Perfection would have to be by filing.

133. The priority status of a secured lender is not affected by his knowledge of the existence of other security interests; security interests are rated only by the order of certain objective acts. § 9-312(5).

134. § 9-312(5)(c).

135. The purchase money financier on inventory must make sure his interest is perfected at the time that the borrower receives possession and he must serve notice on pre-existing secured parties. § 9-312(3).

136. There is some question whether or not § 9-312(3) was intended to apply to possessory security interests, since § 9-312(3)(b) speaks of the holder of the purchase money security interest as making a filing. If § 9-312(3) does not apply, then § 9-312(5)(b) would. It may also be questioned whether or not the "possession" of the borrower in § 9-312(3) would be satisfied by delivery to a field warehouseman on his premises.

137. Although a possessory security interest remains perfected for twenty-one days after goods are released to the borrower, § 9-304(5), this perfection appears to relate only to lien creditor attacks and not to claims of other secured lenders.

A literal reading of section 9-312 develops a disturbing conflict in the *Allied* situation if section 9-312(3) is inapplicable. Section 9-312(5) provides that, where other priority rules do not govern, conflicting interests are judged by order of perfection where one or both are not perfected by filing. Perfection can only occur at or after the time of attachment of the security interest. A security interest perfected by filing with an after-acquired property clause in both the financing statement and security agreement could pick up newly acquired property as soon as the debtor acquired rights in it. The *security interest* of the seller-lender obtained by field warehousing could literally attach and be perfected at no sooner time. Common sense, of course, demands that the seller-lender, whether or not he realizes he has a security interest, be given priority so long as he maintains a perfected interest and takes any special steps required for priority in special situations.

Upon the debtor's default, the rights and duties of both lender and debtor are as provided in the security agreement, subject to certain limitations on the secured party as set out in section 9-207, dealing with possessory security interests and the secured party's possession after default, and in part 5 of article 9, which deals with the manner in which the lender must look to the collateral to satisfy the debt. It should be pointed out that most of the debtor's rights and lender's duties under part 5 of article 9 cannot be waived,¹³⁸ or, if they are waivable by the debtor, cannot be waived prior to the debtor's default.¹³⁹ Thus, default provisions common in leases, such as those allowing absolute repossession upon default as satisfaction of the lessor's claim for future rents or permitting a subsequent sale without any accounting for surplus are ineffective if the lease is a chattel acquisition lease. Whether or not a lender-seller has retained title in a contract for sale, and the title retention was objectively intended to serve as security, he is not the absolute owner of the goods, and he, too, is subject to the same provisions governing accounting for surpluses and repossession as the out-and-out lender since his article 2 rights vanished at the time of the creation of the security interest and he became subject then to article 9.

V. REPRISE

It has been the intention of the writer to suggest that it is no longer sufficient for counsel to examine and pass upon a commercial transaction

138. § 9-501(3).

139. After default, the lender has the right to take possession of the collateral, § 9-503, and has the right to dispose of it, § 9-504(1). Prior to disposition of the collateral, the borrower or a subordinated secured party has the right to redeem the collateral, unless he waives this right after default. The secured party, after taking possession, may propose to accept it in satisfaction of the borrower's obligation, and if the borrower fails to object within thirty days, the secured party may retain the collateral, § 9-505(1). If he elects to dispose of the collateral, he must account to the borrower for the proceeds and pay over any surplus to him, § 9-504(2).

purely in terms of formal legal characterization based on the often self-serving words of the parties to the arrangement under scrutiny. Sections 9-102(1) and 1-201(37) of the Uniform Commercial Code raise questions with regard to leases, sales, and other transactions which are determinable only by a finding of the intent of the parties, and this intent must be resolved by an approach in terms of function and practical economics within the framework of the law. Analysis of intent is no longer a question so much of the form into which a transaction is cast, as it is a question of ascertaining the result within the law which the parties desired to accomplish, and then classifying. The question to be asked is: What is the function and result of the transaction in that particular situation?

Article 2 with its departure from the concept of title in determining the rights of the parties to a sales transaction, seems to go further than the other articles of the Code in the economic, practical, functional or transactional approach, as you will, to commercial law, yet it points the direction and sets the tenor for analysis and examination of other Code transactions.¹⁴⁰ And certainly, in the area of secured transactions, section 9-202, rendering the location of title immaterial in the application of article 9 rules, carries the same germ. That the determination that a transaction constitutes a security interest places the parties and the collateral within article 9 is clear, except where specifically excluded by sections 9-104 and 9-113. It is not clear yet that such a characterization places the parties into a debtor-lender position rather than that of lessor-lessee or of vendee-seller for application of law outside of the Code, in the area of, for example, damages or rights against third parties other than those of priority and perfection. The writer believes that it does.

The parties to a transaction, whether it be a pure sale, a commercial loan, or what have you, above all must know what they are doing, what end they are trying to reach, when they couch their arrangement in one form or another. They must also know to what end the form of transaction they are using will lead. If they do not know, the courts will eventually tell them what they intended, and in so doing may supply an unexpected and costly answer. Substantial justice, curbstone equity, and judicial interpretation of the intent of the parties have a distinct place in our system of law.¹⁴¹ They have, however, no place in commercial law as

140. See, e.g., King, *New Conceptualism of the Uniform Commercial Code: Ethics, Title and Good Faith Purchase*, 11 St. Louis L.J. 15 (1966); King, *The New Conceptualism of the Uniform Commercial Code*, 10 St. Louis L.J. 30 (1965).

141. "[T]he whole matter floats nebulously in that fog, 'the intent of the parties' out of which courts are so apt to evoke what they most want." L. Hand, *In re German Publication Soc'y*, 289 F. 509, 510 (S.D.N.Y. 1922).

A judge . . . violates his duty as a minister of justice . . . if he seeks to do what he may personally consider substantial justice in a particular case and disregards the general law as he knows it to be binding on him.

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applied between merchants and other businessmen. For one thing, too much money is involved. In a commercial transaction, the sole criterion of acceptability is predictability and pre-litigation control of outcome. Where the courts are called upon to determine the intent of the parties, and the determination of this intent controls the outcome, this is obviously not always possible. Yet this hazard may be largely overcome by establishing the function the transaction is to perform and not hiding it under an anomalous or ambiguous formalism. That control by counsel of clients may be impossible in some circumstances is true. He may not be consulted, or he may be overruled. But he should be able to inform his principals of the attendant areas of danger and suggest alternatives, even though he cannot or will not forbid. It is only through an avoidance of the mindless use of legal forms and an approach to a transaction in terms of economic substance and function, with a thorough understanding of what the Uniform Commercial Code *means*, that this can be done.